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Why you can't make money even if you know a crash is coming.

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Of all the financial crashes in history, what makes 2008's mortgage-credit-stock collapse unique is that so many people saw it coming. The people who predicted it were by no means marginal. The gallery of doomsayers included everyone from widely followed economist Nouriel Roubini to [Stephen Roach](#) [3], the chairman of Morgan Stanley Asia. By comparison with say, the 1987 crash, which was predicted by few but Paul Tudor Jones (still amazingly boyish then in [this video from the time](#) [4]), the road to this particular purgatory was practically a jazz funeral with cautionary bands playing trumpets and trombones on every corner.

The biggest-selling business author of 2007 was Nassim Nicholas Taleb, author of *The Black Swan*-a man whose claim to fame as an investor is the \$35 to 40 million* he made in the 1987 market fall. In an [interview with the Times of London](#) [5], Taleb bragged that what was then still being called the subprime credit crash wasn't any surprise to him. Indeed, a lot of people suspected that a crash would happen-that's why they bought Taleb's book. When folks buy books by people who make money in dark times, you can bet they have an inkling that there are dark times ahead.

When so many people see a crash coming, much of what we thought we knew about the behavior of markets tells us that everyone-from banks giving out credit to investors in stocks and mortgages-should pull back before it happens. At the very least, a good number of the naysayers should have been positioned to make a lot of money from the downturn they saw on the horizon. In fact, the first obviously didn't happen, and the second doesn't seem to be happening either. Why? It comes down to inexorable illogic of a bubble economy:

1) Bubbles make the market as a whole less rational than the participants in it. In ordinary times, banks that see that credit is overextended or investors who see that the market is overvalued will pull back and the whole thing will fizzle. Bubbles, however, create short-term rewards for those who follow an irrational trend, creating a huge incentive to make investments that are very risky in the long term.

So it is that even people who see that a crash is coming ride the crest of the wave, hoping that it will go down slowly and they will be able to jump off before it breaks. The business best-seller *The Wisdom of Crowds* argued a couple of years ago that crowds come to better decisions than individuals. A lot of folks at the time found that insight interestingly counterintuitive; it turns out that the 19th-century intuitions of Charles Mackay's

[Extraordinary Popular Delusions and the Madness of Crowds](#) [6] were right on the money after all.

2) Bubbles actually punish rational expectations. [Andrew Lo, an economist at MIT](#) [7]-and another one of the folks who loudly predicted a big shakeout-explains it like this: "A bubble is a very strong upward trend in prices that is not necessarily based on reason or rationality, and unless one gets the timing just right, it's easy to be crushed by the onslaught of enthusiastic investors." As Lo points out, a lot of fund managers saw a bubble forming and bet against financial stocks in 2005 and 2006. And basically, they got killed.

The walloping taken by those who followed their rational instincts and analysis warned others against trying the same thing. So, as the credit bubble got bigger, fewer and fewer people bet against it. There were exceptions: Hedge-fund manager John Paulson made more than \$3 billion betting on the collapse of the mortgage market. But in the main, the lesson that investors took from 2005 and 2006 was that the last place they wanted to be was standing there taking arms against the sea of troubles and betting against the wave.

3) It's very hard to protect yourself against a bubble that a lot of folks see bursting. The words *hedge fund* come from the idea of hedging-making investments that not only look toward possible gains but protect against losses. Bubbles, however, make hedging very difficult. In bubble times, risky investments-say, bonds backed by subprime mortgages or the shares of financial companies that issue them-go up in price to irrational heights.

But the price of safe investments goes up, too, as does the price of instruments like credit default swaps that are supposed to insure you against losses. As a bubble builds, the risks of an implosion get bigger even as fewer and fewer companies are willing to sell you protection against a blowup. And even worse, the bursting of the bubble takes with it the very players whose business was offering protection against a crash-that's what we saw with giant insurer AIG. So, not only is it expensive to buy protection, but it turns out it might not be there when you need.

A convention of lists is that they tend to end on odd numbers, and this one won't try to be different. But it's probably worth mentioning one more consequence of what is now showing itself to be a worldwide credit bubble: When it bursts, the panic that replaces it is every bit as powerful as the buildup and in the end might turn out to be more extreme. The logic of the bubble gets replaced by an even faster movement pulling us in the opposite direction: the logic of the run on the bank as investors around the world try to get to safety before everyone else. The bubble economy has finally woken up with a major hangover, gone to look in the mirror, and is now seeing there, unshaved and blurry-eyed, its evil twin.

***Correction (June 15, 2009):** An earlier version of this story said that Taleb earned \$1 billion in the 1987 crash. In fact, according to Taleb's account, in the *Wall Street Journal* and other publications, Taleb earned \$35 to \$40 million.

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