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Bubbles, Bitcoin, and the Bigger Picture

As Bitcoin skyrockets, bubble mania is once again part of investors' lexicon. This month, we compare it to bubbles past, such as the tulip mania in the 17th century, railroads in the late 1800s, and the cable, communications, and Internet in more recent years. We find that past is not always prologue, and although most bubbles were disasters at the time, they proved valuable for society in the long term. Viewing Bitcoin through the prism of mania could prevent investors from benefiting from legitimate opportunities.

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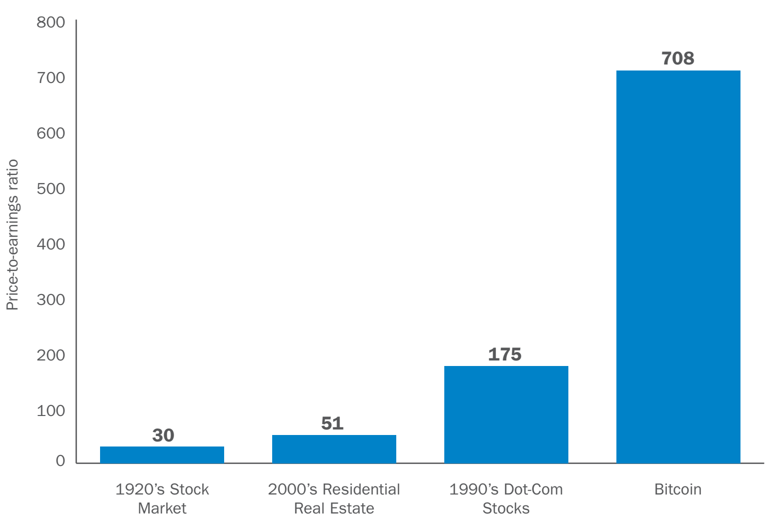
Bubble mania is upon us, this time in the form of Bitcoin. In the past weeks, CNBC has added a Bitcoin price ticker to its list of important indicators, along with the major stock indices, interest rates, and currency rates. Given that Bitcoin's market size is barely $300 billion compared to the tens of trillions of dollars of these other asset classes, that attention seems excessive in relative terms. But the focus currently garnered by Bitcoin is indicative of the age we are in, when soaring prices attract inordinate attention and anxiety about bubbles is embedded in the collective consciousness of the financial world.

Bubbles are fun to watch as they inflate and often painful to witness as they collapse. But as investors gorge on Bitcoin news, it might be wise to keep a few things in mind: Being an investor in a bubble asset can be lucrative if timed right and disastrous if not, but bubbles themselves are not always a societal negative. Often, they mobilize capital to create a new and better economy. Bubbles may be bad for some investors in the short-term, but they are often quite good for society in the long term. And lastly, our bubble mania is its own bubble, wherein we scour the land for inflated assets that we think are terribly overvalued. Bubble-hunting can be diverting, but it

Figure 1:
Bitcoin up more than 1,500% in 2017 YTD
BTC USD 2017 YTD

Source: Yahoo Finance. Chart reflects adjusted close prices for BTC USD as of 12/13/2017.

Figure 2:
Bitcoins are four times as expensive as dot-com stocks were at their height
Price-to-earnings ratios: Bitcoin vs. previous "bubbles"



Source: Bloomberg, "Bitcoin Bubble Makes Dot-Com Look Rational", November 27, 2017.

also can be a distraction that says more about a fragile market's psychology than about bubbles or prices themselves.

Are we? Aren't we?

Almost any chart will show that Bitcoin's rise resembles epic bubbles of the past, from the infamous Tulip mania of the early 17th century to the stunning Internet stock bubble of the late 1990s (Figure 2). Charts are helpful in presenting patterns that may illuminate the messy and uncertain present by referencing the less messy and certain past. The presumption is that if investors can identify a past pattern that looks like a present one, they may be better able to gauge how it will turn out.

The problem, of course, is that the past—as all financial literature in a highly regulated climate reminds us—is no guarantee of the future. Even if Bitcoin's stunning rise looks nearly identical to bubbles past, that does not mean that Bitcoin going forward will have the same outcome of crashing permanently towards zero.

Tulip mania is a useful historical lesson, because it represented significant capital invested in something that had limited social utility. The bubble that formed has been etched into investors' collective memory because it is one of the starkest and simplest illustrations of irrational price inflation. Few other examples are quite so simple.

Among the more famous bursting bubbles of the 19th century were the many railroad companies that collapsed in the 1870s and 1880s, leaving their investors and bondholders with pennies on their investments. In the frenzy to build railroads across and up and down the United States, many companies were undercapitalized and overextended. It was left to financial barons, such as E.H. Harriman and J.P. Morgan, to pick up the bonds and the bankrupt companies, which then enriched them even as the first wave of investors went broke. But the railroad bubble was an immense boon to American economic growth in the early part of the 20th century. Those thousands of miles of rail lines, locomotives, and rolling stock were the needed infrastructure for the mass industrialization and urbanization of the continent.

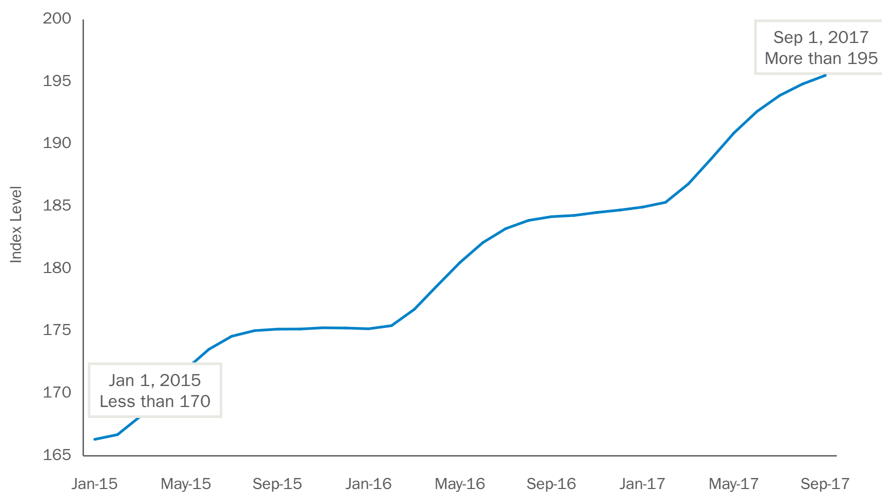
In a similar vein, the Internet bubble of the late 1990s saw absurd valuations on many new IPOs of tech companies with no earnings and no viable plan for profitability. Companies raised hundreds of millions of dollars on impossible models. Kozmo.com, for instance, raised more than $200 million on a business plan to deliver food, videos, and snacks for less money than it paid for them—much less—hoping that it could acquire enough customers to one day make a profit.

The telecom and fiber optic companies were an even greater bubble. Remember WorldCom and Adelphia? The specific accounting scandals aside, companies such as these were part of a

Figure 3:
Equities up 20% in 2017 YTD
S&P 500 2017 YTD

Source: Yahoo Finance. Chart reflects adjusted close prices for GSPC as of 12/13/2017.

Figure 4:
Housing prices: modest growth in recent years
S&P/Case-Shiller US National Home Price Index, Jan 2015–Sept 2017



Source: S&P Dow Jones Indices. Chart reflects monthly data for SPCSUSA from Jan 1, 2015 to Sept 1, 2017.

massive build-out of cable and communications infrastructure that left many investors broke but which formed the critical backbone of the early 21st century information technology revolution. The billions spent on the lines, switches, and technology made it possible for wireless and broadband connectivity that has been the indispensable prerequisite for the new economy behemoths of today and the services they provide.

Bitcoin, of course, fits none of these earlier models. Its proponents believe it will be an alternate store of value and a global digital currency that will enable capital flows across borders, unmediated by banks and governments. Its detractors argue that it is nothing but a speculative set of bits and bytes with no utility and hence no value. Time will tell, of course, though one wonders why it is attracting such attention

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given its relatively small size and its plethora of skeptics. Simply charting its price action against past bubbles does not prove that it is one. It might be, of course, but similar charts don't make the case.

More germane for markets and investing today is a tendency since the late 1990s, and enhanced by the housing bubble beginning in 2007, to bubble-hunt. Having been twice burned in the period between 1999 and 2009, financial investors over the past decade have been sensitive to the possibility of future speculative bubbles that could lead to financial instability and significant losses. This makes psychological sense. Many investors are understandably cautious, having failed to appreciate the depth and breadth of these early bubbles, and seem determined not to repeat the same mistakes.

But bubble-hunting is not without its own costs. Looking at equity valuations today (Figure 3), for instance, some analysts see nascent bubbles, even though we now are near the Nasdaq companies' late 1990s valuations. Although you might be able to make a case for small bubbles in the high-end art market, or real estate in global hubs such as New York, London, San Francisco/Silicon Valley, and some Chinese cities, it's not clear why those should cause undo concern. Small bubbles form and pop with harm to those directly involved but are no threat to financial stability. Yes, small bubbles popping can also trigger other issues, but that is hardly a given.

Bubble-hunting speaks to a fragility of investor psyche that has its own costs. It has kept some investors wary of equities even as those gains have outpaced the gains in most bonds year after year. Safety and security are essential investing concerns, but avoiding otherwise wise investments because of bubble mania does no one nor their portfolios any good.

Watch and learn

Two conclusions flow from the above: By all means, be wary of assets, such as Bitcoin, that materialize out of nowhere and are new and untested. Bitcoin might fulfill the hopes and dreams of its most ardent backers, and it might do so now. Either way, some massive price volatility should be anticipated. But bubbles are not necessarily a bad thing for future growth, and even if Bitcoin has a sad end, the rise of digital currencies could prove a great boon for global commerce and affluence. Second, bubble-hunting itself can be destructive if it reinforces a sense of peril in the financial world at the expense of solid opportunities. For sure, investing can be risky, and no one should be blithe about the potential for loss. The flip side, however, is not to be so focused on loss that it blinds investors to otherwise legitimate opportunities. The Bitcoin frenzy exposes these crosscurrents, however small they are. For most people, it will be wise to stay on the sidelines of that frenzy, but equally wise not to read into it a referendum on investing and the financial system as a whole. And above all to recognize that bubbles might harm some investors in the short term but can benefit society as a whole over the long haul. ■

December Takeaway:

The meteoric rise of Bitcoin is justification for caution, as investors recall similar bubbles. The Tulip mania was a financial disaster for investors. So were the railroad, Internet, and telecommunications bubbles initially, and it took years before investors benefited from the mass industrialization and urbanization of the continent and the revolution in wireless and broadband connectivity they spawned. But the tendency to draw parallels with bubbles past can harm investors, making them avoid investments that could be solid opportunities. Undue caution emanating from the market sell-offs in the late 1990s and the severe housing decline in 2007 prevented some investors from participating in the recent equity boom. Investors who venture into Bitcoin must expect volatility, but its outcome could mobilize capital and be a windfall for global commerce.