

THE END IS NEAR? 05.29.2007

We surely must be in the final days of the greatest bubble ever known—or should we say blown? None of the great historical bubbles come even close to the worldwide asset bubbles that exist today. We are mindful of one of the sayings of John Maynard Keynes: “The markets can stay irrational longer than you can stay solvent.” As you know, we are not great fans of his economic model, but the above quote, plus his famous, “In the long run, we are all dead,” are words we can relate to.

The world economy is at a crossroads not seen in 80 years. The Keynesian economic model indicates (as it did in the 1920’s) that there is no problem; new innovations—both financially and in the realm of business—are propelling us into a new era. On the other hand, the Austrian economic model indicates (again, as it did in the 1920’s) that we are experiencing a credit cycle of immense proportions, which always end in severe economic consequences.

Our vote goes to the Austrians, but frankly one knows not when it might end. We thought it would have happened a year or two ago. We do see present evidence of the psychology that permeated the markets in 1999 just before the crash of the stock market in 2000-2002. There is now a mini-flight from bonds in order to get in on the action. As you may recall, this was the major feature of the 1999 financial market. If anything can cause a major recession, it’s a spike in long rates, which currently seems to be underway. We pointed out the same thing in 1999, which was followed in 2000 by the best first quarter in bond market history. Expect no less this time.

According to Ludwig von Mises, “The breakdown begins when the banks become frightened by the accelerated pace of the boom and begin to abstain from further credit expansion. The change in the banks’ conduct does not create the crisis. It merely makes visible the havoc spread by the faults which business has committed in the boom period.”