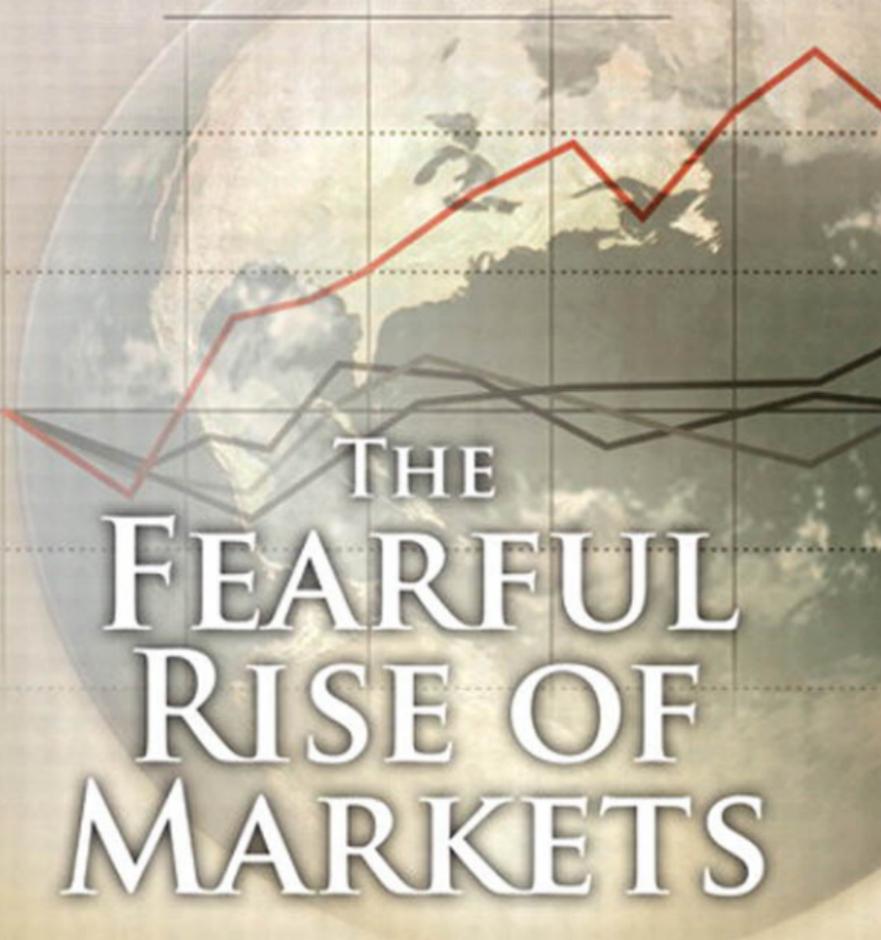


FOREWORD BY MOHAMED A. EL-ERIAN

GLOBAL BUBBLES,
SYNCHRONIZED MELTDOWNS,
AND HOW TO PREVENT
THEM IN THE FUTURE



THE
FEARFUL
RISE OF
MARKETS

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Foreword

I suspect that most of us have a daily routine when it comes to reading the news and looking for insightful commentary and analysis. I know that I do; and my routine includes seeing what John Authers has to say.

John's daily column in the *Financial Times* is a "must read" for many of us who are not just interested in markets, but also involved in their inner workings, daily fluctuations, and volatile emotions. His writings provide us with timely insights into market developments and the outlook; and they fuel interesting, and at times, lively debates in the marketplace.

You will understand, therefore, how delighted and honored I was when John asked me to write a foreword for this wonderful book. I also felt intimidated at the thought of appearing in print together with one of the best writers in the financial media. Thankfully, this foreword is of a length that would limit any meaningful comparison of my approach to writing with John's engaging and insightful style.

This enjoyable and fast-moving book is written in the style of John's daily columns—concise, relevant, and containing perceptive examples. Think of the book as your vehicle for a journey of discovery. Each stop will precisely inform you of the forces that have come together to determine market valuations and correlations—or, in the words of John, the drivers of the rise in markets, their collapse, and their ongoing re-emergence (albeit one still vulnerable to failures and weak regulatory and private infrastructure).

During this journey, you will discover why markets can move together for a long time and to an excessive degree (for example, the formation of "bubbles") before correlations collapse in a spectacular and wrenching fashion; why so many investment managers fall victim to herd behavior; why inappropriately specified and monitored principal/agent relationships result in a misalignment of incentives between

the end investors and the managers that work for them; how risk management techniques can morph from being mitigators of risk to amplifiers; and why regulators have so much trouble maintaining their finger on the pulse of the markets.

As you proceed with your journey, you will come across a lot of interesting tidbits, including how emerging markets acquired the name and evolved into an investible asset class. Most importantly in my eyes, you will also see how society is being forced today into important tradeoffs between stability and efficiency—and yet this imperative balance (that will impact both current and future generations) is being inadequately considered by governments around the world.

The timing of this book is also highly appropriate. It is published at a time when, having survived a near-death experience during the 2008-09 global financial crisis, too many market participants have reverted to old and eventually unsustainable mindsets and behaviors; at a time when regulators are slipping in both the design and implementation of measures to strengthen market infrastructure and limit systemic risk; and at a time when political expediency risks overwhelming economic and financial logic.

Yes, this book is about a highly relevant journey and about great timing. It is also about what the destination is *likely* to be, as well as what it *should* be.

On reading the book, I suspect that you will come away with a much clearer understanding of the remaining potential for market accidents and policy mistakes. You will be exposed to a summary of what governments need to do to lower the risk of additional large market disruptions. And you will be armed with an expanded toolset to consider where risks and opportunities lay in today's (and tomorrow's) marketplace.

This book is of even greater relevance if you buy into the work that my PIMCO colleagues and I have done on the manner in which

FOREWORD

markets and economies will likely reset after the 2008-09 global financial crisis. Our work suggests that rather than be subject to a conventional reversion to the most recent mean (the “old normal”), the global system is now engaged on a bumpy, multi-year journey to a “new normal.”

For reasons cited in John’s book—including inadequate framing, herding behavior, and backward-looking internal commitments and principal/agent problems—it will take time for societies to fully recognize and adapt to the regime changes. This is not for lack of evidence. After all, who would deny the multi-year influence of the sudden, simultaneous, and large deterioration in the public finances of advanced economies; the unexpected surge in several of these economies’ unemployment rates, coupled with the realization that the rates will stay high for an unusually long time; the consequential erosion in the institutional standing of both private and public entities; and the growing importance of socio-political factors in driving economies and markets?

My bottom line is a simple one: John’s book should be read by all those interested in the way markets operate, be they investors, analysts, or policy makers. Yes, markets are here to stay; and, yes, they are still the best construct for organizing, valuing, and allocating resources. But this should not blind us to the fact that markets do occasionally fail.

Markets do become overly synchronized at times and overshoot, and they can involve activities that are insufficiently understood and inadequately supported by the necessary infrastructure. By neatly and succinctly speaking to all this, John Authers’ book also gives us hope that markets could also be made to work better in enhancing global welfare.

**Mohamed A. El-Erian, CEO and co-CIO of PIMCO,
and author of *When Markets Collide***

The Fearful Rise of Markets

“A rising market can still bring the reality of riches. This, in turn, can draw more and more people to participate.... The government preventatives and controls are ready. In the hands of a determined government, their efficacy cannot be doubted. There are, however, a hundred reasons why a government will determine not to use them.”¹

J.K. Galbraith, 1954

World markets are synchronized, and far more prone to bubbles and meltdowns than they used to be. Why?

It was in March 2007 that I realized that the world’s markets had each other in a tight and deadly embrace. A week earlier, global stock markets had suffered the “Shanghai Surprise,” when a 9 percent fall on the Shanghai stock exchange led to a day of turmoil across the world. By that afternoon on Wall Street, the Dow Jones Industrial Average suddenly dropped by 2 percent in a matter of seconds. A long era of unnatural calm for markets was over.

Watching from the *Financial Times*’ New York newsroom, I was trying to make sense of it. Stocks were rising again after the shock, but people were jittery. Currency markets were in upheaval.

I anxiously checked the Bloomberg terminal. One screen showed minute-by-minute action that day in the S&P 500, the main index of the U.S. stock market. Then I called up a minute-by-minute chart of

the exchange rate of the Japanese yen against the U.S. dollar. At first I thought I had mistyped. The chart was identical to the S&P.

If it were not so sinister, it might have been funny. As the day wore on and turned into the next, we in the newsroom watched the two charts snaking identical courses across the screen. Every time the S&P rose, the dollar rose against the yen and vice versa. What on earth was going on?

Correlations like this were unnatural. In the years leading up to the Shanghai Surprise, the yen and the S&P had moved completely independently. They are two of the most liquid markets on earth, traded historically by completely different people, and there are many unconnected reasons why people would exchange in and out of the yen (for trade or tourism), or buy or sell a U.S. stock (thanks to the latest news from companies in Corporate America). But since the Shanghai Surprise, statisticians show that any move in the S&P is sufficient to explain 40 percent of moves in the yen, and vice versa. As they should have nothing in common, this implies that neither market is being priced efficiently. Instead, these entangled markets are driven by the same investors, using the same flood of speculative money.

The issue is vital because as I write (in early 2010), markets are even more tightly linked than they were in early 2007. It is once again impossible to tell the difference between charts of the dollar and of the U.S. stock market. Links with the prices of commodities and credit remain perversely tight.

The Shanghai Surprise, we now know, marked the start of the worst global financial crisis for at least 80 years, and plunged the global economy into freefall in 2009—the most truly global economic crash on record.

Inefficiently priced markets drove this dreadful process. If currencies are buoyed or depressed by speculation, they skew the terms

of global trade. Governments' control over their own economies is compromised if exchange rates make their goods too cheap or too expensive. An excessive oil price can drive the world into recession. Extreme food prices mean starvation for billions. Money pouring into emerging markets stokes inflation and destabilizes the economies on which the world now relies for its growth. If credit becomes too cheap and then too expensive for borrowers, then an unsustainable boom is followed by a bust. And for investors, risk management becomes impossible when all markets move in unison. With nowhere to hide, everyone's pension plan takes a hit if markets crash together. In one week of October 2008, the value of global retirement assets took a hit of about 20 percent.

Such a cataclysm should have shaken out the speculation from the system for a generation, but evidently it has not—and this implies that the risk of another synchronized collapse is very much alive.

What I hope to do in this short book is to explain how the world's markets became synchronized, how they formed a bubble, how they all managed to crash together and then rebound together, and what can be done to prevent another synchronized bust in the future. In the process, I also hope to provide some guidelines for investors trying to deal with this situation.

Investment bubbles inevitably recur from time to time because they are rooted in human psychology. Markets are driven by the interplay of greed and fear. When greed swamps fear, as it tends to do at least once in every generation, an irrational bubble will result. When the pendulum snaps back to fear, the bubble bursts, causing a crash.

History provides examples at least as far back as the seventeenth century “Tulip Mania,” in which wealthy Dutch merchants paid their life savings for one tulip bulb. Then came the South Sea Bubble in England and the related Mississippi Bubble in France, as investors fell over themselves to finance prospecting in the New World. Later

there were bubbles in canals. The Victorian era saw a bubble in U.S. railroad stocks; the 1920s saw a bubble in U.S. stocks, led by the exciting new technology of the motor car.

But the last few decades have seen an increase in bubble production. Gold formed a bubble that burst in 1980; Mexican and other Latin American debt suffered the same fate in 1982 and again in 1994; Japanese stocks peaked and collapsed in 1990, followed soon after by Scandinavian banking stocks; stocks of the Asian “Tiger” economies came back to earth in 1997; and the Internet bubble burst with the dot-com meltdown of 2000.²

Some said good news for the world economy had understandably created overenthusiasm. From 1950 to 2000, the world saw the renaissance of Germany and Japan, the peaceful end of the Cold War, and the rise of the emerging markets—all events that had seemed almost impossible in 1950—while young and growing populations poured money into stocks. Maybe the bubbles at the end of the century were nothing more than froth after an unrepeatably Golden Age.

But since then, the process has gone into overdrive. Bubbles in U.S. house prices and in U.S. mortgage-backed bonds, which started to burst in 2006, gave way to a bubble in Chinese stocks that burst in 2007. 2008 saw the bursting of bubbles in oil; industrial metals; foodstuffs; Latin American stocks; Russian stocks; Indian stocks; and even in currencies as varied as the Brazilian real, the pound sterling, and the Australian dollar. Then, 2009 brought one of the fastest rallies in history. News from the “real world” cannot possibly explain this.

Why have markets grown so much more prone to new bubbles? Overenthusiasm and herding behavior are part of human nature and it is fashionable to blame greed. But this makes little sense; it implies that people across the world have suddenly become greedier than they used to be. It is more accurate to say that in the last half century, fear has been stripped from investors’ decisions. With greed no longer moderated by fear, investors are left with overconfidence.

This, I suggest, is thanks to what might be called the fearful rise of markets. The institutionalization of investment and the spread of markets to cover more of the global economy have inflated and synchronized bubbles. The rise of markets has brought the following trends in its wake.

Principal/Agent Splits

In the 1950s, investment was a game for amateurs, with less than 10 percent of the stocks on the New York Stock Exchange held by institutions; now institutions drive each day's trading. Lending was for professionals, with banks controlling virtually all decisions. Now that role has been taken by the capital markets. As economists put it, in both investing and lending, the "principals" have been split from the "agents." When people make decisions about someone else's money, they lose their fear and tend to take riskier decisions than they would with their own money.

Herding

The pressures on investors from the investment industry, and from their own clients, are new to this generation, and they magnify the already strong human propensity to crowd together in herds. Professional investors have strong incentives to crowd into investments that others have already made. When the weight of institutions' money goes to the same place at the same time, bubbles inflate.

Safety in Numbers

Not long ago, indexes were compiled weekly by teams of actuaries using slide rules. Stocks, without guaranteed dividends, were regarded as riskier than bonds. Now, mathematical models measure risk with precision, and show how to trade risk for return. Computers can perform the necessary calculations in milliseconds. The original theories were nuanced with many caveats, but their psychological impact on investors was cruder. They created the impression that markets could be understood and even controlled, and that led to

overconfidence. They also promoted the idea that there was safety in investing in different assets, or diversification—an idea that encouraged taking risks and led investors into new markets they did not understand. This in turn tightened the links between markets.

Moral Hazard

As memories of the bank failures of the 1930s grew fainter, banks found ways around the limits imposed on them in that era, and governments eventually dismantled them altogether. Banks grew much bigger. Government bank rescues made money cheaper while fostering the impression among bankers that there would always be a rescue if they got into trouble. That created moral hazard—the belief that there would be no penalty for taking undue risks. Similarly, big bonuses for short-term performance, with no penalty or clawback for longer term losses, encouraged hedge fund managers and investment bankers to take big short-term risks and further boosted overconfidence.

The Rise of Markets and the Fall of Banks

Financial breakthroughs turned assets that were once available only to specialists into tradable assets that investors anywhere in the world could buy or sell at a second's notice with the click of a mouse. Emerging market stocks, currencies, credit, and commodities once operated in their separate walled gardens and followed their own rules. Now they are all interchangeable financial assets, and when their markets expanded with the influx of money, many risky assets shot upward simultaneously, forming synchronized bubbles. Meanwhile, banks, which had specialized in many of these areas, saw their roles usurped by markets. Rather than disappear, they sought new things to do—and were increasingly lured into speculative excesses.

THE FEARFUL RISE OF MARKETS

These toxic ingredients combined to create the conditions for the now notorious mess in the U.S. subprime mortgage market, as financiers extended loans to people with no chance of repaying them, and then repackaged and dispersed those loans in such a way that nobody knew who was sitting on losses when the loans started to default. That led to a breakdown of trust in the U.S. financial system and—thanks to interconnected markets—global finance. Bad lending practices in Florida created a synchronized global crash.

This is not the place to dwell in detail on the subprime mess. Nobody now seriously questions that the absurdly complex financial engineering that undergirded it must not be repeated. It is much tougher, however, to deal with the conditions that made such a disaster possible. They are still in place and involve many worthwhile investment products we take for granted. Dealing with the problem at this level will involve very difficult choices.

As a start, I suggest we need rules to contain the most extreme behavior. Simply put, we must put fear back into the hearts of traders and investors, and force them to treat the money they are investing as if it were their own. The structure of the investment industry, which has evolved to reward and encourage herd-like behavior, must be rebuilt.

How markets rose to lead the world into such a synchronized mess is a fascinating but long story. As many of these themes overlap, I will cover them chronologically. But remember that bubbles are rooted in human psychology. It is inevitable that they will recur, but not inevitable that they need recur so swiftly or burst together, as they did in 2007 and 2008.

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