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Robert Shiller on Bitcoin and Speculative Bubbles

*"All money is a matter of belief."
- Adam Smith*



"These bitcoins things are backed by
technology and the internet!
What could possibly go wrong?"

CartoonStock.com

Digital Currencies have received a lot of attention this year on the back of explosive valuations. According to the website coinbase.com, the two most popular of the lot - Bitcoin and Ethereum – have appreciated approximately 350% and 3,700% year-to-date. My grasp of the technical features surrounding digital currencies may be limited, but I will opine that the magnitude of realized price variability diminishes their usefulness as a means of exchange.

Quartz recently published the below interview with economist Robert Shiller. Dr. Shiller is best known for his work on asset price forecasting and is well respected among both academia and market professionals. In this interview, Dr. Shiller discusses Bitcoin,

financial markets, and speculative bubbles.

IRRATIONAL EXUBERANCE

By John Detrixhe
September 5, 2017

Robert Shiller wrote the book on bubbles. He says, “the best example right now is bitcoin.”

Yale economics professor Robert Shiller won the Nobel prize for his work on bubbles. He wrote a seminal book on speculative manias, *Irrational Exuberance*, a deep analysis of the dramas over the centuries when otherwise sane people drove prices for tulips, stocks, and houses to inexplicable heights.

Shiller developed some of the tools that are considered vital for taking a sober look at markets. He helped create indexes for measuring real estate prices and his stock market valuation indicator, the cyclically adjusted price-earnings ratio, or CAPE ratio, is seen as one of the best forecasting models for stock returns.

As Shiller sees it, “big things happen if someone invents the right story and promulgates it.” Quartz spoke with him about some of the frothiest assets today, from bitcoin to tech stocks. The conversation was edited and condensed for clarity.

Quartz: What are the best examples now of irrational exuberance or speculative bubbles?

Shiller: The best example right now is bitcoin. And I think that has to do with the motivating quality of the bitcoin story. And I’ve seen it in my students at Yale. You start talking about bitcoin and they’re excited! And I think, what’s so exciting? You have to think like humanities people. What is this bitcoin story?

It starts with Satoshi Nakamoto—remember him? The mysterious figure who may or may not be real. He’s never been found. That has a nice mystery quality to it. And then he has this clever idea about encryption and blockchain and public ledgers, and somehow the idea is so powerful that governments can’t even stop it. You can’t regulate this. It kind of fits in with the angst of this time in history.

If you look at the third edition of *Irrational Exuberance*, I’m arguing that there’s a fundamental deep angst of our digitization and computers, that people wonder what their place is in this new world. What’s it going to be like in 10, 20, or 30 years, and will I have a job? Will I have anything?

Somehow bitcoin fits into that and it gives a sense of empowerment: I understand what's happening! I can speculate and I can be rich from understanding this! That kind of is a solution to the fundamental angst.

So I'm trying to deconstruct the bitcoin story. Big things happen if someone invents the right story and promulgates it.

Quartz: So is bitcoin a bubble, or the biggest bubble?

Shiller: I don't know how to quantify that. But I have a sense that something is exciting to you. Another thing that is exciting to people now is Donald J. Trump. You may have heard of this guy. It's just amazing how he dominates and I think he has a genius at recognizing stories and listening to his audience and understanding what drives them.

He too is related to this fundamental angst that we have about where are we in this digitized society — international and digitized. And it's that angst that he spoke to, and he presented a story that involves you, the voter, as a success in this new world, and that's why the Trump story was so popular.

There really are idea epidemics.

Quartz: Something you've written about is the role of media in speculative bubbles. In the past, you didn't seem convinced that the internet has boosted the media's ability to do that. Has that changed?

Shiller: The big thing that happened wasn't the internet. It was the printing press, Gutenberg in the 1400s. It didn't really get going until the 1600s. It was then that we started seeing bubbles.

The problem with things going viral is that there has to be some transmission that's adequate to the job. You can still go viral without newspapers, but it's harder. There were celebrities and international stars, like Homer, who wrote the Iliad and the Odyssey. He did that by traveling from town to town and reciting his books. And it worked! He's still going, long after he died.

Things have always gone viral, it's the nature of civilization, but it got stronger with the printing press, much stronger. And then around the 1600s they invented the idea of weekly newspapers that told you what happened this week. And that really went like wildfire. People loved newspapers.

The internet takes it to another dimension. But I have a sense it's not as important as the printing press.

Quartz: Hasn't the internet democratized information? Someone can promote their views widely without getting buy-in from editors or other gatekeepers? That's what Trump has done with Twitter.

Shiller: One really important thing that's happened is that reputations don't seem to matter as much at this point in history. Maybe it will come back. You have news media that have developed their reputation for honesty and integrity. And something that's gone viral is a conspiracy theory that the news media, the mainstream media, are in a conspiracy, and it's embellished in crazy ways like the Rothschilds or George Soros, or somebody, are in a conspiracy to destroy America and have bought the media and are controlling them. Those are the extreme, crazy forms of the narrative.

But there's also a more general narrative that liberals are somehow soft and can't handle reality. This is another narrative.

You're asking about bubbles. These are the stories that drive the bubble. Trump speaks to these things, and he seems to be saying things that nobody else will say but maybe you're thinking.

He also legitimizes wealth. It wasn't that long ago that we held rich people in contempt. We have a billionaire president, and he's kind of welcoming: You can be rich, too. The Trump story helps inflate all kinds of bubbles, not just bitcoin. I think there are aspects of a housing bubble, and a stock market bubble right now.

Quartz: Are your feelings on the stock market based on the CAPE ratio?

Shiller: The CAPE ratio is just one indicator I'm particularly known for. I have another indicator you can find on my website that not many people pay attention to. Since 1989 I've been doing questionnaire surveys of both individual and institutional investors. I've been doing this a long time without getting much notice for it. But I believe in it, somewhat, though I don't think it answers everything.

I have something I call a valuation confidence index. I don't have it really up to date because it's only a six-month moving average based on small surveys. Maybe I should expand my size.

But valuation confidence is at the lowest it's been since around 2000. In other words, people think the market is highly valued. They don't have to look at CAPE. People think it. I know that. Both individual and institutional investors. We are in a time of mistrust of the market.

The only time mistrust of the market was lower since 1989 was in 2000. So around 2000, the peak of the dot-com bubble. It seems like the mindset is somewhat similar to the dot-com mindset. And that brings us to the FANGs [Facebook, Amazon, Netflix, and

Google], as well. High-tech companies are probably more exciting, as they were in 2000.

The year 2000 was kind of like 1849. That was the gold rush. It really created a viral explosion of men going out west in 1849 looking for gold. Now is the time, you can't wait until 1850! You have to do it now! It was the same thing in 1999 or thereabouts, when stories of some internet companies were coming out and people said, you know, this is the future, these guys are going to take over.

Usually these stories have an element of truth to them, but the question is how fast is it going to happen, and what's a realistic view for investors. And they got ahead of themselves with the dot-com bubble. We're maybe doing that again with the FANGs.

Quartz: Is low volatility a bubble, of sorts?

Shiller: Well volatility is very low, both actual and projected in the VIX. So, why is that?

Quartz: Some people say it's because of central bank accommodation.

Shiller: I tend to think of it as something that reflects the quality of the narrative, which is not encouraging a lot of trading activity now. I'm guessing—I can't tell you why it's low.

One thing I emphasized in my book *Irrational Exuberance* is attention is capricious. There's a social basis for attention. We all focus our attention in the same way. Like we're all watching Donald J. Trump. When Houston floods, well that's got our attention. But part of the story has to be what Donald J. Trump said about it.

Somehow the attention is elsewhere than day-to-day motions of the stock market. It could suddenly change.

I remember in October 1987. That was the biggest one-day stock market drop ever. How did I hear about it? I was teaching my lecture in the morning. I noticed that one or two students were listening to transistor radios. Finally, one of them raised his hand and said, "Do you know what's going on? There's a historic stock market crash." That's how you hear about it. It suddenly grabs people's attention. And it's just not there right now.

Monetary policy has entered a new regime. The only historical precedent for when interest rates were low for anything like this long was in the 1930s, the Great Depression, and how did that end? It ended with World War II.

It doesn't tell you what's going to happen now. Why are long-term interest rates so low? It's a big thing. It's been trending down since 1982. There's been a downtrend around the world in long-term real interest rates.

And it's nothing particularly to do with the financial crisis. News media like to tie things in with already popular narratives. The natural instinct of a newspaper reporter is to tie it back to that, but it's been going on longer than that.

I don't have any unique insight into why interest rates have gone down. But I know they're vulnerable to changing narratives.

Quartz: Have you by any chance looked at initial coin offerings?

Shiller: No, what is an initial coin offering?

Quartz: It's like using a crypto token, not bitcoin itself but the blockchain architecture, and issuing these virtual encrypted tokens almost like shares, even though they say they're not shares.

Shiller: How is it different from bitcoin?

Quartz: It's somewhat like crowdfunding. Say you've started a bar, and you want to fund it by issuing these tokens. A token is worth one beer, but your bar will only ever serve a set number of beers. If people think it will be a really hot bar, the value of the tokens trades for up to \$100 or \$200. People are raising hundreds of millions of dollars this way, with pretty thin business plans.

Shiller: Yeah, that's a classic bubble. I'll have to read about that. There are a lot of cryptocurrencies but they don't have as good a story as bitcoin. Maybe there's a new narrative. Maybe this is a more viral story.

You're making me think about writing something about this. You have my thinking going.

Sincerely,

Justin Kobe, CFA
Founder, Portfolio Manager & Advisor

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