



## Episode 1,093: Are We in a Giant Bubble?

Guest: Kevin Duffy

**WOODS:** All right, there's a lot of commentary about what's going on out there in financial markets, in the economy at large. And I think there are a lot of people who are tired of bearish forecasts, because they say you bears are so bearish I miss out on big rallies because all you do is give us bearish advice. So I want to know — and of course, we've also just come off a — we're recording this on — let's see, what is today's date? Is it the 12th today? Yeah, it's the 12th. So it's February 12th, 2018, so you may be listening to this on February 13th. But anyway, we've obviously had tremendous stock volatility and there are people saying this is the beginning of the end. But 1987 had a major stock collapse too, and nothing came of it. So I say this not to prejudice the audience, but I think I'm reflecting the views of a lot of people. I have a lot of bears in my audience, but I think I have a lot of people who think the bears are so darn bearish all the time, how valuable can that be? Of course eventually you're going to be right. How do you answer that? I have a lot of friends who take this kind of position, and to some extent, I myself do. How do you answer the: *Of course you're right. You've been saying the same thing for X number of years.* What's wrong with that critique?

**DUFFY:** Well, I think you have to take a balanced approach, and Jim Grant has a great quote here. "The only permanent truth in finance is that people get bullish at the top and bearish at the bottom." I think sort of investing 101 is when one side of the boat gets crowded, you need to be looking at the other side, or at least listening to the arguments of the other side. So for example, at the top, we could go back to Davos. And Davos, now, you know, you think these are really smart people. Well, back in 2005, '06, '07 at the top of the credit bubble, what did you see in Davos? You saw optimism. What did you see at the bottom in '08, '09, 2010? You saw a tremendous amount of pessimism. Recently in Davos, there was basically euphoria. So I think it does pay attention to at least consider the other side right now, even though, yes, you have permabears and they've been wrong all the way up. But right now when you have universal optimism, I think it pays attention to at least listen to what they have to say.

**WOODS:** All right, indeed. Now, what evidence is there that stocks, let's say before the recent correction or even now, were overvalued?

**DUFFY:** Well, valuation, you can't just lump everything together. I think what happens with — I believe we're in a bubble. I think we're in a bubble for everything. And one of the things that you get at the top of these bubbles is rationalizations. And one of the things that we're hearing over and over again is that stocks are reasonably valued, the forecasts have been raised. Part of this is because of the tax cuts and stocks are trading at 16.5 times forward earnings. Well, they're trading at 20 times previous earnings, but that doesn't really tell the

whole story. You really have to look at almost on a company-by-company basis, and there's a lot that sort of goes into the stew, and I think you have to be very careful about aggregates.

So you look at companies — here's a company that's not even public: Uber. Uber has a valuation of \$48 billion during their eighth year of operation and they lost \$5 billion. You look at a company like Tesla, which is valued at more than Ford and GM and losing money and losing money as far as the eye can see. And then on the other side, you look at stocks like Google and Apple and Facebook, and these companies are generating a tremendous amount of cash flow. Their free cash flow I believe is \$76 billion combined. And you look at those stocks, and they look reasonable, but they all have certain issues. Apple, for example, is only growing at 6% and they've got operating margins of 27%. I mean, how sustainable is that? When you can sell the iPhone X for \$1,000 and you get this huge premium, the question is how long can they keep doing that, and is the market for smart phones saturated? So even though Apple looks, let's quote "cheap," at, say 15 or 16 times earnings, maybe it's not so cheap. So I think you have to ferret out what's going on. You can't just lump everything together.

**WOODS:** All right, let's try and disaggregate some things then. Let's look at different sectors and get your opinion on things. I've been reading some stuff that you've been writing, and you've covered all different areas. For example, I've heard for years that something stinks in the auto loan market, but yet nothing seems to come of it. But yet we see that they keep extending the length of these terms out to like 72 months and stuff like that. What's going on over there?

**DUFFY:** Yes, that's one area that we're actually short in our funds. And a company like CarMax, when you get into the companies, they really provide a lot of good information. And you see, for example with CarMax, that recovery rates are going down. Of course, their loan book keeps on climbing, but the delinquency rates are starting to go back up. And the auto finance area really should have gotten a boost from the problems in Houston and half a million cars that need to be replaced. So you're starting to see problems crop up in that area.

**WOODS:** How do you distinguish a bubble from just plain old good times?

**DUFFY:** The thing about bubbles is that they have common characteristics, but they also are very different and they don't just come in, announce themselves, "Hey, here I am. I'm a bubble." So some of the common characteristics are, number one, the seeding of the bubble with artificially low interest rates. That's absolutely paramount. You get a parabolic rise in prices and a parabolic rise in just general activity. So an example of this might be the FAANG stocks — Facebook, Apple, Amazon, Netflix, Google. At the start of this bull market, combined they spent \$5 billion on research and development. Today they're spending \$57 billion. So you see this, it's sort of crowd behavior, where you see this parabolic rise in activity.

You see the public coming in at the end. That is sort of a classic sign of a bubble. You have to have rampant bullishness, of course, but also, the retail investor, the little guy sort of coming in at the end. And we're starting to get that. For example, TD Ameritrade, they reported earnings in mid-January, and retail activity was up, trading activity just for the year in two and a half weeks was up 34%, and 6 to 9% of that was speculation in cannabis stocks and block chain stocks. So you're definitely seeing — when you see Charles Schwab report good numbers, and I just read the release last night. They said we're seeing the highest levels of investor

sentiment in nearly two decades. Well, if you go back nearly two decades, that was the top of the tech bubble. They didn't say anything about that in the press release.

But you also get rationalizations, I think rationalizations for why the boom will continue. This is very, very important to recognize. You're hearing a lot of things like the economy is sound, this is just a healthy correction, don't worry about this. So I have this quote here by a financial advisor, and I did a lot of surveying of the sentiments seen over the weekend, and this one sort of caught my eye. "Turn off CNBC. Go to exercise class. Read a book. This market pullback was expected and very much needed to happen for the market to go higher. No need for defensive action."

**WOODS:** What about housing? That's a sector obviously where we've had pretty major trouble ten years ago, and you get people saying that the market there is a bit frothy too. And again, that's not an area where you can just speak in generalities, because it would be concentrated in particular areas. But are you seeing warning signs in housing as well?

**DUFFY:** Yes, there seems to be an echo bubble in housing, and this sort of makes sense. I mean, with any kind of an artificial boom or a bubble, you really look for signs of malinvestment at one end and overconsumption at another end, especially consumption that can be financed. So you mentioned auto finance and the terms being stretched out. In this country, we're not seeing the excesses that we saw certainly at the top of the mortgage bubble, and that also goes back to how these bubbles change their spots. This is a little bit different. You didn't have the bubble in auto finance back in 2007. You have it today. You have more of the problems in student loans. But at the same time, I think housing will be a problem, because any time you drive interest rates down, and now we have a rising rate environment, that's going to spell trouble. But you're also seeing places like Toronto and some real craziness going on there that really looks like a housing bubble.

**WOODS:** Do you have any kind of insight into Jerome Powell and where he might take things at the Fed?

**DUFFY:** I don't have any special insight. I've just heard some of the commentary. He's not an academic. That's a good thing. I mean, the fact that he's been chosen for this position is probably not a good thing –

**WOODS:** [laughing] Right, right.

**DUFFY:** I mean, Donald Trump's said he likes low interest rates, and so I think we can expect basically a continuation of the same. And I mean, I don't think we've seen much difference between the past four Federal Reserve chairmen, and so it's just going to be a continuation of the same policies.

**WOODS:** What's the condition of American households? I think I kind of know the answer to this question, but you hear all these polls revealing shocking things, like if people had an unexpected \$500 expense, they don't know how they'd handle it or they'd have to borrow money from friends or sell things or whatever. But we've heard this for a long time. Is the American household in a precarious situation, and if so, what does that mean precisely for the future?

**DUFFY:** Well, there's an awful lot to look at and it's not just the American household, but also the corporations, we have to look at the balance sheet of the federal government, because it all goes together. And then even with the household, I think we have to disaggregate between the middle class, the lower class, the upper class. But right now, if you look at household net worth as a percentage of disposable income, it's very high. It's I think 670%, which is higher than the past two bubbles. But the problem with this is that the household net worth is really dependent on high asset prices, and so if those come down, I think we're really setting ourselves up for some problems. And you could also look at the public pension funds and the potential problems there.

I think one of the differences, the important difference with this bubble, the everything bubble, is that in past bubbles, there were places to hide. Bonds were reasonably priced. Commercial real estate was reasonably priced. This time, you have a bubble in bonds and a bubble in stocks and commercial real estate, and so these pension funds are really going to get themselves – they're already underfunded, but they're going to get themselves into a lot of trouble. And now there's talk about an infrastructure build, and I don't know where that money is coming from. But we're running up higher deficits, and I think this all kind of goes together. So if you can just imagine what it would be like if we had lower asset prices in both stocks and bonds and the pressure that that would put on state budgets and the pressure that that will put on raising taxes, I don't know where the money's going to come from.

**WOODS:** Well, in a situation like this, then, where things are quite precarious, the questions arises, what do people do with their money? Now, it's certainly the case that obviously there are going to be some stocks that are perfectly fine, but a lot of people might be unsure of their ability to navigate those waters, so they may be inclined just to hold a cash position. Is there anything wrong with that? What should they be doing?

**DUFFY:** I think they should be holding cash right now. And I think the first thing that I would do would be to make sure you have at least a year or two, three years of living expenses set aside in cash. Try to build that up. And call your financial advisor and try to sell something. Try to lighten up. And my guess is that you'll get a lot of resistance, and so that should probably be your first sign to fire your financial advisor. The next thing they can do is ask their financial advisor what causes recession. And if they don't get a good answer, then that's probably another reason to fire them. And I think the third bit of advice would be maybe get a copy of *Devil Take the Hindmost: A History of Financial Speculation* by Edward Chancellor and read up on financial bubbles, and maybe get a copy of *America's Great Depression* by Murray Rothbard and see what the potential is. Because I do believe that there is the potential for something very dramatic in terms of even a crash a la a 1929 or a 1987. People are not prepared right now.

**WOODS:** I always have trouble with episodes like this, because although I try to stay informed about what's going on, I myself have a completely different financial strategy from almost everybody else. I'm not in the stock market. I have no interest in getting in it. And I'm not saying that it's not for some people. For some people, it's a great idea, but it's not for me, because I don't want to be in something that I haven't researched a lot. I don't want to just rely on somebody's advice. And I'm just not sure I have the skills or the time to do it.

So my strategy has been rather different. I'm not in real estate, except obviously in the house that I live in, but I like the John Schaub recommendation of finding – the key is finding good places to buy real estate. You rent it out. You use the rent money to pay off the mortgage.

And then at the end of the mortgage term, you have this productive asset that's just going to generate an income stream for you. Well, I don't do that with real estate, but I do that with other forms of income streams. I've got a bunch of income streams coming from all different things that I do, and some of them pretty much run on autopilot. They would keep going for a while even if I dropped dead tomorrow. And my view is that not all of these is going to collapse. One of them might stop, but then I'll just pick up another one. And this way, I don't have to subject myself to the vicissitudes of the stock market. I come up with whether it's — I don't know. I don't want to go through all the different streams that I have, but that's my idea, is that I'm betting on myself and I have enough of these things going, and the work I do is fairly low intensity that I feel like this is far less risky for me.

**DUFFY:** Yeah, I think everybody has their own expertise, their own specialized knowledge. And I think the important thing is to stick to your circle of competence if you have an unfair advantage, if you can see the future a little bit better than others. And there will always be opportunities. This isn't all about, oh, the sky is falling and just stick your head in the sand. There will always be opportunities. And even in the stock market right now. That happens to be my expertise. And I'm not saying that I can't put together a portfolio of some reasonably priced stocks. There happens to be a bubble in passive investing, and if stocks don't fit into the indexes across what they call the index divide, there are some opportunities to go in and ferret through that. So I think you just have to get back to what do you know that others don't know and how can you see the future a little bit better than the rest. And also, as Ludwig von Mises says, try to avoid the errors of the multitude. And I think right now we have this cluster of errors taking place, where the brightest people, the CEOs in Davos, the financial advisors, they're just not prepared for what could happen, that this actually could be a bubble. There is actually a business cycle, and maybe holding interest rates down below a quarter of a percent for seven years wasn't such a good idea.

**WOODS:** Well, I asked you about the condition of U.S. households. Even more relevant would be what is the condition of central bank balance sheets and government budgets and the fiscal picture of governments around the world? How does that affect the equation?

**DUFFY:** Yeah, we talked about this a little bit earlier. I'm very concerned about state and local balance sheets and also the government's balance sheet. If you look at — so the government debt now is \$21 trillion, I believe. During this cycle, the debt that's been held by the public has gone from about 35% of GDP to 75% of GDP. And if you look at it right now, interest expense consumes all of 6.4% of the \$3.8 trillion budget. And the problem is that if you look at from the period from 1977 to 2007, 30 years, the real interest rate, so the interest rate above the inflation rate, averaged about 3%. Now, in the ten years since we've had this low interest rate environment, it's been 0.8%. So that's going higher, and we've seen since Donald Trump, since the election, if you look at the proxy for the government's borrowing cost, would be the five-year Treasury yield, because their average maturity on their debt is about five years. So it was 1.3% during the election. Today it's about 2.5%, 2.55%. So it's gone up 95%. In other words, those interest costs are going up. They're not going to stay this low. So that's going to start to be a problem.

We've also seen the deficit, this is something that's unusual and something that we ought to be paying more attention to, is that normally we're hearing talk about this synchronized boom, global economy, and normally you would see deficits go down like you saw during the tech bubble. We actually ran a surplus under Clinton, and of course this had nothing to do with the Democrats being fiscally conservative or anything. It just had everything to do with a

tech bubble and tax receipts pouring in from capital gains taxes. But we've had this really unusual period where stock prices have gone up and the economy seems to be doing well, and yet deficits are already starting to go up. And I think this is a sign of trouble.

**WOODS:** More on the economy after this quick but awesome message.

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Talk to me about precious metals, where a lot of people have pinned their hopes, and for a while they did pretty well and now they're more or less stabilized. What do you think the future is there?

**DUFFY:** I think we've got multiple twists and turns and acts in this play. And so the next act is going to be I think an unwinding of a lot of leverage trades. We saw a blowup in the short volatility trade early last week, and I think one of the rationalizations that you get is that these problems as they first appear, they're isolated and contained. We saw that with subprime back in 2007. We saw it with the dotcoms in 2000. So I really think there's a lot more leverage below the surface. There's \$640 billion in margin debt, over 3% of GDP, which is about as high as it gets. And so I think we're going to unwind this leverage. And that means that basically there's going to be a demand for dollars, demand for cash, which is why I actually like cash right now. So that is probably a bit of a headwind for gold, but at the same time, if we get into a crash, we get into systemic problems, people get concerned about the economy, they start to lose faith in the Fed, that those are all tailwinds for gold. So I see this next act as being kind of a mixed bag. We own a lot of gold, Tom, but I really see gold performing well in maybe the next act after the one right in front of us.

**WOODS:** Kevin, the question I get probably most often when I say I'm going to have someone — when I get Peter Schiff on the show, let's say, whom I have not had on in quite some time. I should probably talk to him. Anyway, when I get somebody like Peter on, people say, *Here's what I want to know*. And I would say probably 30% of the time, it's the same question out of all of the questions I get. It's: let's say I've got 1,000 bucks or 5,000 bucks. I'm not an investor with six or seven figures to throw around. Should I just keep it in the bank account at this point? What would be the best thing to do with any of it?

**DUFFY:** Yeah —

**WOODS:** Let's say it's not money they need urgently. I don't mean that's all the money to their name. I mean that's the money they can play with.

**DUFFY:** Yeah, I think at this point in the cycle, I would get a good book on financial speculation like *Devil Take the Hindmost*. I would put it in the bank. I would watch what's going on. And you know, I think a lot about this is preparation, getting ready for — try to learn about what you might want to buy. Try to look at your area of expertise. Try to develop a circle of competence. Identify trends, long-term trends that — say you've got the cyclical, you've got the secular long-term trends. I mean, the fact is the aging population, that's not going away. That's demographics, and the over-65 demographic is going to be by far the fastest growing around the world for the next 10, 20 years. So there will be opportunities. Study things like genomic sequencing. There will be a lot of opportunities in health care. But I

think just try to build up a little dry powder, try to gain some knowledge, and try to get ready because there will be some opportunities down the road.

**WOODS:** All right, in this discussion, what am I overlooking in terms of questions to ask you? What's a part of the picture that we haven't hit on?

**DUFFY:** I think the most important thing right now is the level of complacency. This is very unusual. The fact that we had this big run-up. You had the public sort of come in at the very end of it with some crazy speculation, and we just got the first blow up in terms of the short volatility trade, and financial advisors are out there basically telling everybody to be calm. I think Nassim Taleb wrote a book called *Fooled by Randomness*, and there's a chapter in there called "Survival of the Least Fit." And the problem is that when you get a long period, you get this — he calls it a sample path, an environment where the people that come out on top, they're prepared. They are hardwired to do well in that environment. But the problem is what happens when you get a change in the environment. They are the least prepared for that change.

So I think this is really important to understand, if you have a financial advisor, that they are going to tell you we know what we're doing, we've seen this happen before, markets always go up, you just have to be patient, you just have to hang in there. And these are people that, they don't understand Austrian economics. They don't understand the Austrian business cycle theory. They will be the least prepared for what we're going to experience. I think this is the most important point that I can stress to people, is ask your advisor, do they understand what causes the business cycle, do they understand what causes inflation? And if they don't give a coherent answer and they don't have a plan — because as Mike Tyson said, everybody has a plan until they get hit in the place. And I think it's better to start planning right now than to wait. And another thing that I think is very important is that we've seen — I mean, I experienced it the business when I first got into this business in 1987, that things can come unglued in a hurry. And right now with this much complacency, you just can't rule that out.

**WOODS:** Geez, this is scary. But underneath all the frothiness or the bubbles, once all this stuff gets cleared out, do you feel like there are nevertheless strong fundamentals? Like does the U.S. economy have anything to recommend it at its root? When you get rid of all the monetary policy and stuff and you get rid of all the artificial stuff, what's good about it? What's fundamentally there that we can hang our hats on?

**DUFFY:** Yes, I think you make a good point, Tom, and I think we're always guilty — I mean, right now I'm obviously stressing this because it does scare me. The complacency that I saw this weekend really does scare me. But no, you're right. And I think as Austrians we understand that there is a natural decentralized order in that there is the miracle of the marketplace, and so you see what's going on with people around the world getting smart phones. I was just reading that 70% of the smart phones are in places like India and China. And so the damage being done is from the central planners, and the miracle of the marketplace is all bottom-up. It's decentralized.

And there are a lot of positive things going on around the world, emerging markets, the fact that people are questioning what's going on. You've got more sort of market-oriented policies. You're lowering tax rates around the world. Even Italy, I saw that tax rates come down a little bit. So there are positives. There are also the I think the technology trends. And we have lived through this incredible period of time where you have prices going down. You have the

cost of bandwidth has gone down by 99% since 2000. And I think a lot of these things will continue. So no, I'm not just all doom and gloom, that's for sure. I think we have to be watching this. And there will be opportunities in terms of the positive things that are going on, so we have to be very well aware of that.

**WOODS:** All right, well, Kevin Duffy, I appreciate your insights and we'll get a link or two up at [TomWoods.com/1093](http://TomWoods.com/1093) for people interested in exploring this further. Thanks a lot.

**DUFFY:** Thanks again for having me.