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"I could calculate the motions of the heavenly bodies, but not the madness of the people"

Sir Isaac Newton, in 1720

In the spring of 1720, Isaac Newton sold his shares in the South Sea Company, which was at the time the hottest stock in England. He doubled his original investment of £7,000, and the quote above attributed to him was based on his observation of the market for the company's stock. Despite his status as one of the smartest persons ever to live, he decided months later that his sale was premature and jumped back into the stock – eventually losing £20,000, the equivalent of $3 million in today's money. It seems that formulating the laws of gravity and motion and inventing calculus did not confer infinite wisdom to such a great man.

While the South Sea Company had assets and was not conceived as a fraud, the asset that led to the stock's bubble status was a monopoly granted to them by the Crown to trade with South America (hence the "South Sea" name). This monopoly proved to be worthless, as Spain controlled all trade with South America and short of success in battle (England was at war with Spain at the time), there was little hope that the company would ever make any money on trade. The potential for great wealth from this monopoly was widely publicized, and these "most extravagant rumours" set up the trading frenzy. Investors, from lords to the lowliest of peasants were caught up in the bubble, and many, including wealthy people such as Newton lost fortunes when the bubble popped in late 1720.

Since most investors behave like real people, not rational economic beings, bubbles have formed (and popped) many times in history. From 1634 to 1637, the Dutch bought and sold tulip bulbs at ever-increasing prices, and rare hybrids commanded prices as high as the value of twelve acres of land for a single bulb. The collapse of tulip mania may have been due to a threat of bubonic plague, which kept buyers away from an auction in Haarlem in February 1637.

The bubble that had the greatest impact on us as stock investors in modern times was the dot-com bubble in the late 1990s. The promise of the internet and online commerce resulted in the creation of lots of companies that were to benefit from this trend. Investors ignored such normally vital data as price/earnings ratios and business results, and instead relied on more fluid data such as the number of eyeballs viewing web pages. Companies were able to raise billions of dollars from investors at their initial public offerings (IPOs) despite having little more than a written business plan. The *Wall Street Journal* published an article at the time referring to the "quaint idea" of profits. When the bubble popped, even tech companies with real assets and earnings saw deep plunges in their stock prices.

A more recent example of a bubble came with the inflated housing prices from the late 1990's through 2006. Housing prices normally rise at about the same rate as consumer price inflation, and since 1987 inflation has averaged 2.7% per year. During the housing bubble years from 1998 to 2006, home prices rose at an average rate of 9% per year, or 6.5% more than the average rate of inflation during that time. While this growth rate pales next to the dot-com bubble's feverish pace of increases of about 20% per year, the housing bubble did far more damage to the global economy when it popped in June 2006.

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The housing bubble was triggered by a confluence of low interest rates, easy access to money, and government policies focused on increasing home ownership. Alan Greenspan, in Mallaby's 2016 biography "The Man Who Knew" acknowledged that as Fed chairman he probably kept short-term interests rate too low for too long, and that may have contributed to the bubble.

Easy money came as mortgage lenders increasingly focused on lending, then selling the mortgages off. Banks and investment firms packaged them up into bonds that could be sold to investors, including Fannie Mae and Freddie Mac. Once a loan was sold, the mortgage lender could take the proceeds and lend them out to new borrowers. While this process of reselling mortgages has its advantages, it made more money available at a time when the demand for money was rising quickly in the housing market.

The third leg supporting the housing bubble was a move by the federal government. In 1992, Congressman Barney Frank succeeded in imposing "affordable housing" requirements on Fannie Mae and Freddie Mac. Frank's thinking was that the then-current high lending (prime) standards kept low income borrowers out of the housing market, and the "affordable housing" requirement resulted in a decline in underwriting standards. Eventually, more than 50% of the loans Fannie and Freddie bought had to be from low income borrowers. The bonds holding these subprime mortgages carried high and attractive ratings (many were AAA), and the popping of the bubble made many of these bonds decline sharply in value as the mortgages failed. Investors lost fortunes on the bonds while many homeowners lost their homes in a deep recession. Banks holding lots of these supposedly safe bonds were forced to rebuild their balance sheets, and regulators increased their oversight of financial institutions thought to have played a role in the crisis.

In July of 2017, Alan Greenspan warned of a developing bubble in bonds, a statement that was discounted by many financial pros. Greenspan's premise for his statement centers on the low level of interest rates and the persistence of low inflation, and his warning is that increasing inflation will drive interest rates higher and thus bond prices will decline. If the economy is growing at a faster rate, a higher inflation rate may be inevitable and even healthy as long as it doesn't rise rapidly or too high.

The argument against a bond bubble is centered on the behavioral aspects of investors. The mania associated with bubbles seems to be absent in the bond market, as bond investors rarely buy bonds in the hopes of selling them at a higher price to a "greater fool". Bonds pay interest that investors need for income, and these payments can be valued with precision. It is easy to calculate a total rate of return for a bond held to maturity, and large capital gains in bonds aren't part of that calculation.

After a hot market in 2017, investors have understandably been worrying about the current valuation of stocks, and the word "bubble" has been mentioned a few times. It is too soon to know if stocks are in a bubble. While the U.S. markets declined more than 7% on Feb. 2nd and 5th on inflation fears and some pundits talked about a pop, relief came today in a late rally that offset some of the losses of the previous two days. Economic growth appears to be even stronger than we suspected just a month ago, and corporate earnings continue to look good. While valuations as noted by the current P/E ratio are still elevated, they have not approached levels that have triggered big selloffs in the past. Investors still remain cautious about stocks and hold lots of cash, and that alone suggests that the complacency and exuberance so often seen as bubbles form is not in place today. As always, the final word will be in the history books, and they are yet to be written.

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