



Weekly Market Commentary

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Bubbles

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Highlights

Bubbles, speculative run-ups in asset values, have long been a natural part of financial market behavior.

Financial bubbles have tended to follow a common pattern seen in gold prices in the 1970s, Japan's stock market in the 1980s, and the dot-com boom and bust of the 1990s.

The bursting of the housing bubble is now well underway with home prices returning to the pre-bubble, long-term average of 3.5 times income.

Oil prices, China's stock market, agriculture stocks, and "green" stocks are late in the bursting stage.

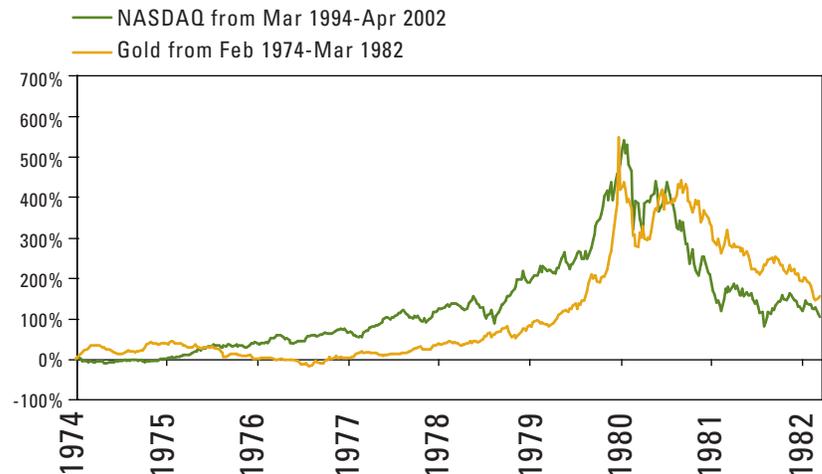
There appear to be two potential bubbles on the horizon. The first, though not a typical bubble, the market in cash equivalents, appears to be fully inflated and ready to burst, while the second, Treasury debt, has yet to inflate.

The formation and bursting of bubbles are regular events in the financial markets. Answering key questions about financial bubbles is important to effective investment decision making. These questions include: What does the financial bubble pattern look like? What bubbles are bursting now? And what bubbles may be forming?

What does the financial bubble pattern look like?

Looking back at financial bubbles, the classic example is the dot-com boom and bust of the 1990s. In fact, we can use the 1990s dot-com bubble as a template for illustrating bubbles both past and present. The dot-com bubble, best represented by the NASDAQ index, exhibited a pattern that was a lot like the many that preceded it, such as gold bubble of the 1970s or the Japanese stock market bubble, measured by the Nikkei, during the 1980s.

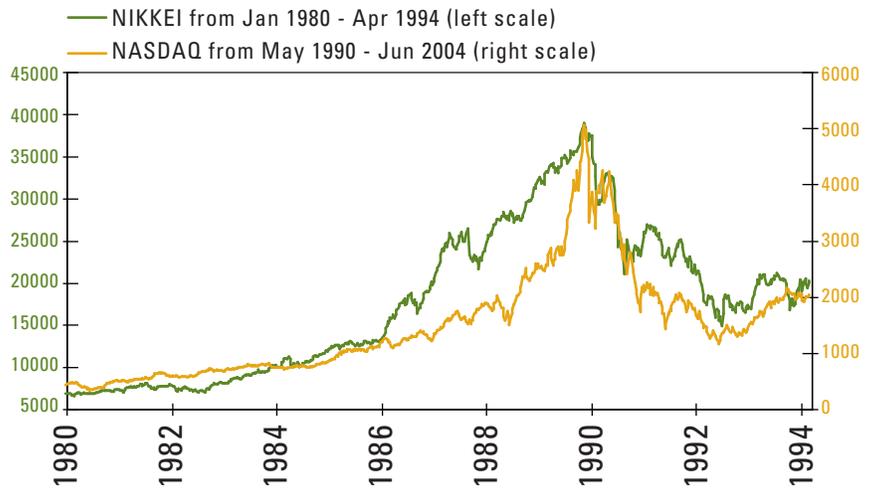
1 1990s Dot-Com and 1970s Gold Price Bubbles



Source: Bloomberg, LPL Financial



2 1990s Dot-Com and 1980s Japanese Stock Market Bubbles

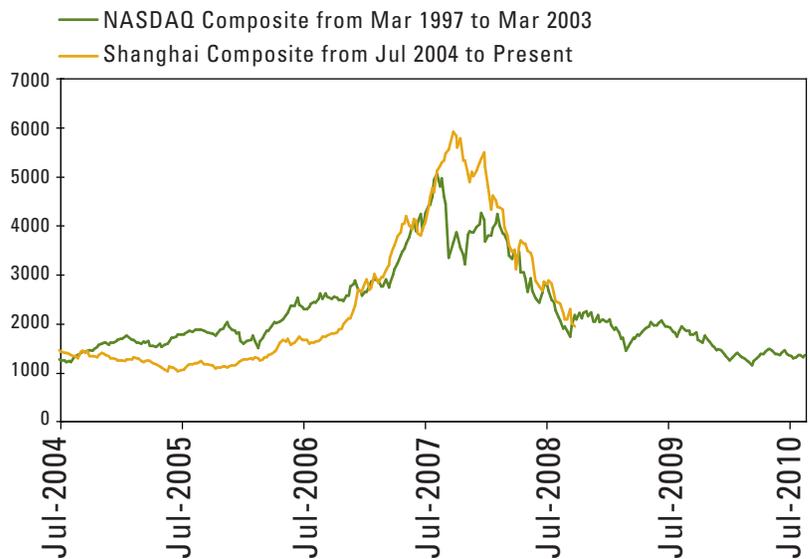


Source: Bloomberg, LPL Financial

What bubbles are bursting now?

Today, we can compare this classic financial bubble pattern to the current pattern of performance among assets to help in projecting future performance. One area where we can see this pattern unfolding is in the emerging markets. China's stock market is completing the bubble pattern with the potential for some additional downside.

3 1990s Dot-Com and 2000s China Stock Bubbles

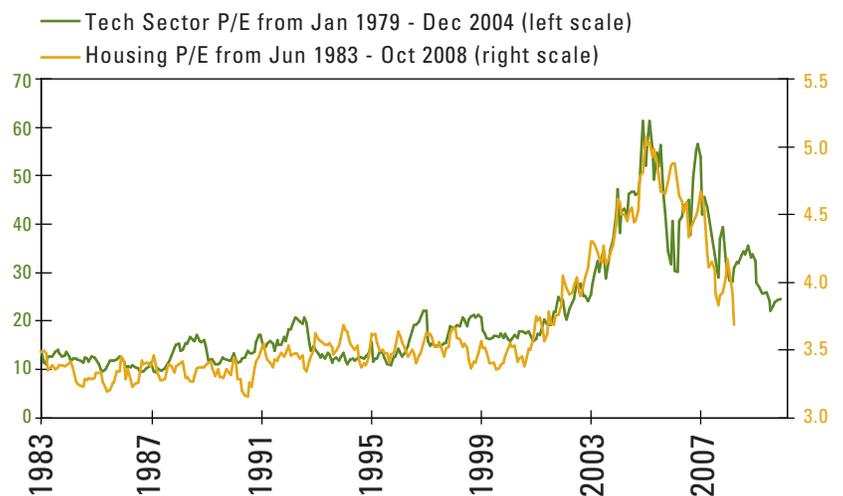


Source: Bloomberg, LPL Financial



Another asset class following this pattern is the housing market. The recent financial bubble in housing appears to have nearly completed the bubble pattern. Home prices did not soar 1,000% as the NASDAQ did over the 10 years leading up to the peak, but clearly they disconnected from the fundamentals before they peaked. Over the long-term, existing home prices have been about 3.5 times median household income. Prices rarely varied more than 0.25 from that proportion, staying in a tight range of 3.25 to 3.75 for nearly 20 years. However, home prices began to rise relative to income in the early 2000s and by 2006 exceeded 5 times family income. By then interest rates had fallen to near 40 year lows, and lending standards had been loosened. The correction in the housing bubble is now well underway, with home prices falling to below 4 times income. If over the next year home prices come back down to 3.5 times income, home prices would still have to decline about 5% from the current level to complete the bubble pattern.

4 1990s Dot-Com and 2000s Housing Bubbles

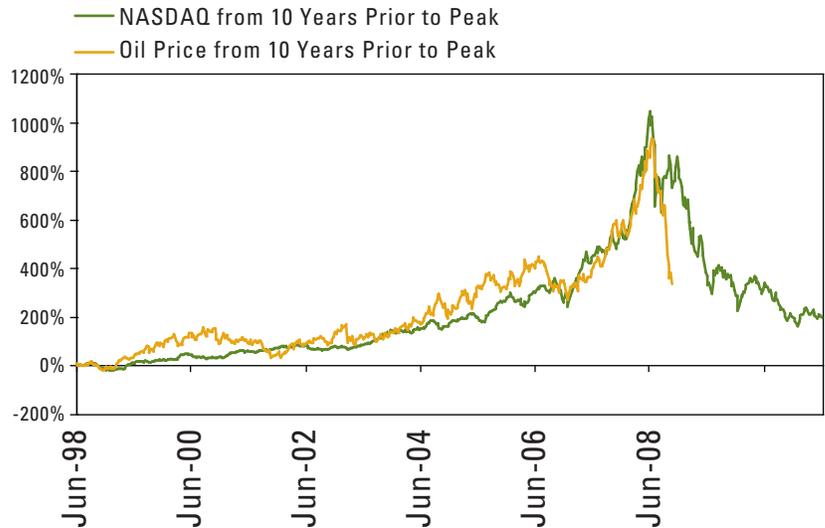


Source: LPL Financial Research, Factset Research Systems, Bureau of the Census, National Association of Realtors

Oil prices have closely tracked the classic bubble pattern. During the 10 years leading up to this summer's peak oil price of \$147 per barrel, the price of oil mirrored the run up in the NASDAQ over the 10 years leading up to its early 2000 peak. In fact, the pattern and percentage gain was nearly identical to that of the tech bubble. The sharp decline of oil to about \$60 has also tracked the bursting of the tech bubble.



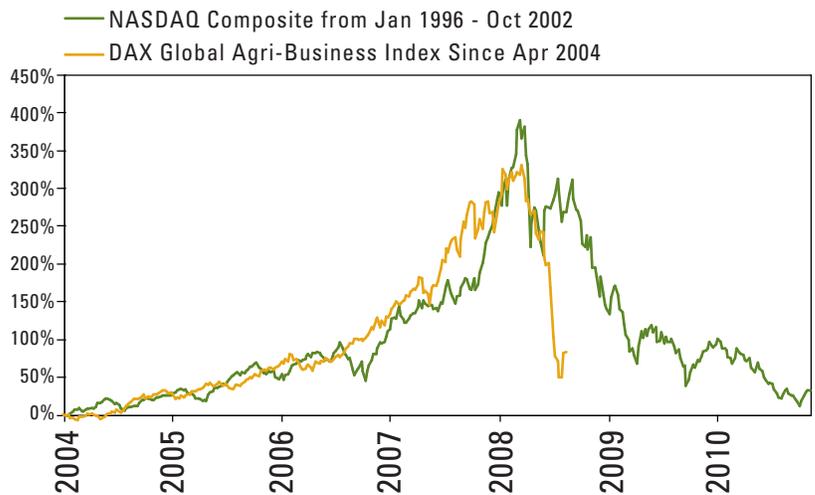
5 1990s Dot-Com and 2000s Oil Bubbles



Source: Bloomberg, LPL Financial

The stocks of agriculture companies have also followed the bubble pattern. The DAX Global Agri-Business Index, the world agriculture companies index with the longest history, ran up about the same amount in the four years leading up to the peak in agriculture stocks as the NASDAQ did before its peak. Soaring agricultural commodity prices drove up the shares of seed and fertilizer companies. As supply rebounded and demand growth slowed, this bubble began to burst and follow the classic pattern.

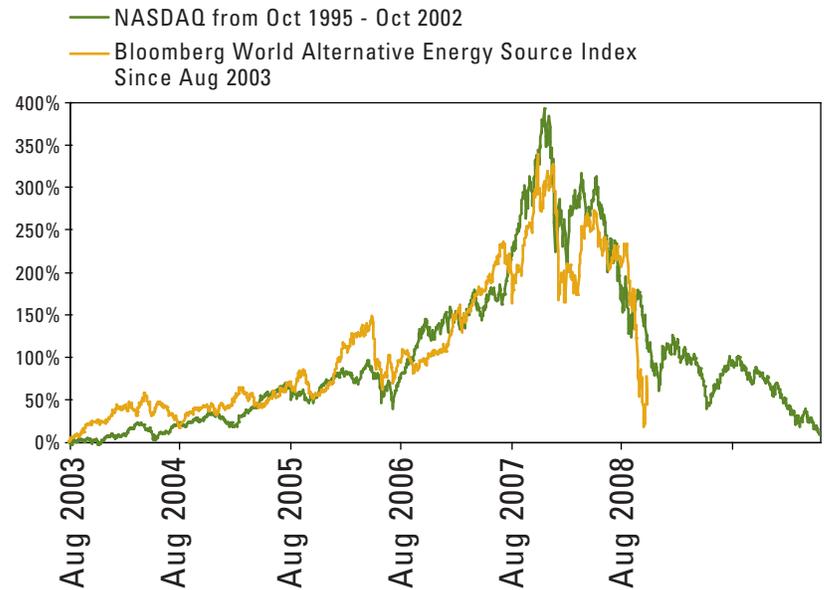
6 1990s Dot-Com and 2000s Ag Stock Bubbles



Source: Bloomberg, LPL Financial

Alternative energy or so-called “green” stocks, as measured by the performance from inception of the Bloomberg U.S. Energy-Alternative Index (the longest running index of “green” stocks – such as producers of solar and wind power generation equipment), has very closely tracked the classic bubble pattern defined by the NASDAQ.

7 1990s Dot-Com and 2000s “Green” Stock Bubbles



Source: Bloomberg, LPL Financial

What bubbles may be forming? Are they classic speculative bubbles?

There appear to be two asset classes forming what look like bubbles on the horizon. The first appears to be fully inflated and ready to burst, while the second has yet to inflate.

The asset class that appears to have formed a bubble is cash equivalents. Because investments in money market securities are unlikely to produce large losses on the downside of the bubble, the growth in demand for money market securities is not a typical financial bubble. However, a comparison to the dot-com bubble can help illustrate the opportunity cost when the cash equivalents ‘bubble’ bursts. During the Tech bubble, the market value of the Tech sector grew to about 35% of the S&P 500 index before returning to the mid-teens weighting it had averaged over the long-term. Money market mutual fund assets are now nearly as high as the market value of the S&P 500 Tech sector at its peak, about \$4 trillion. This amount of cash is equivalent to nearly half the value of the entire S&P 500. Prior to the enormous accumulation of cash in money market mutual funds over the past year, money market mutual fund assets were equivalent to about 20% of the value of the S&P 500. If this demand bubble bursts, the



classic pattern suggests a return to the 20% level that would result in an opportunity cost in the trillions for holding cash equivalents.

8 Another Sort of Bubble Has Formed

Tech Sector and Money Market Assets as a Percent of S&P 500 Market Cap

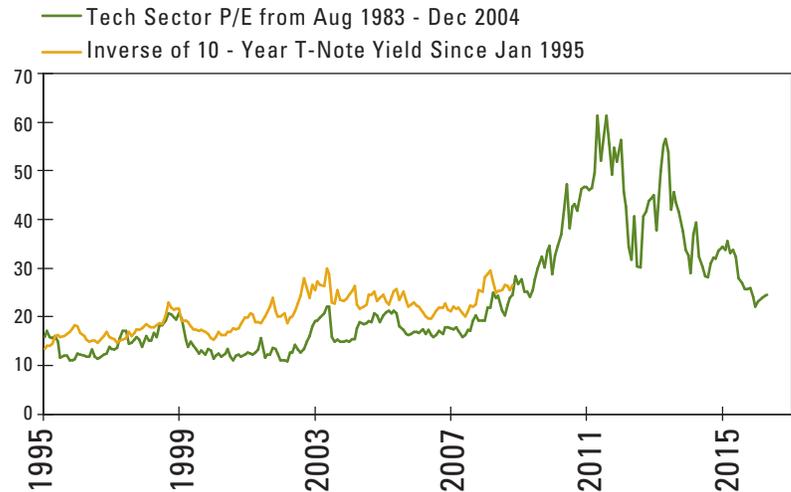


Source: LPL Financial, Haver Analytics

Another possible bubble may be set to form in another traditional safe haven in turbulent markets, the market for Treasury debt. While the market for Treasury debt is not likely to rise by hundreds of percentage points, it could eventually be seen as overvalued in the same way housing was during the upside of its bubble. If the yield on the 10-Year T-note, currently at 3.8%, fell to 1.4%, the price-to-yield ratio would be valued as highly as the price-to-earnings ratio of tech stocks during the peak of the dot-com bubble. We see a rally of this magnitude in the bond market and subsequent bursting of that bubble as very unlikely, especially given current deflationary and credit constrained conditions, but a prolonged and deep global recession combined with deflation from falling commodity prices in the coming years could inflate such a bond bubble.



9 No Bond Bubble Yet



Source: LPL Financial, Factset Research Systems, Bloomberg

The bursting of a bubble often brings to mind negative consequences for the financial system. Indeed, as in the case of the housing market bubble, the impact can be powerful and pervasive. However, in the late stage of the bursting of several asset bubbles, there is only limited additional fallout. There are potentially positive aspects of a bursting of the cash equivalents “bubble” as that cash is deployed again in other asset classes. So while bubbles always warrant a close watch, they need not always be feared.

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