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THE RETURN OF RISK: OVERVALUED ASSET CONCERNS

Asset Bubble: "An economic development in which the price of a class of physical or financial assets (such as houses or securities) rises to a level that appears to be unsustainable and well above the assets' value as determined by economic fundamentals."

– Glossary of the Congressional Budget Office

This week in her testimony before the Senate Banking Committee, Federal Reserve Chair Janet Yellen cautioned about price bubbles forming in some market products including leveraged loans and lower-rated corporate debt. The alarm over 2007-type indicators has been sounded for several months by some analysts while others claim the shifts are not seismic but merely cyclical. Proponents of a recently published economic theory postulate that the sky may not really be falling.

Economic Echoes

Asset bubbles occur when investors purchase assets with the expectation of short-term gains due to rapidly rising prices of those assets; when investor enthusiasm for the asset or class of assets tapers off, the sharp decline in demand can suddenly drop the market for such assets. At the beginning of last quarter, Simon Derrick, chief currency strategist at a major financial institution noted, "A lot of the price action that we have seen over the last 20 months is a real echo of what we saw between late 2005 and the summer of 2007." He further added, "You can argue whether or not it's reflecting the same fundamentals, or whether or not it's a bubble, but the price activity itself — it's almost exactly the same as we saw in 2007."

Monitoring Lax Lending Risk

While maintaining that stocks are not overvalued, Yellen expressed concern over the lowering of lending standards: "We're seeing a deterioration in lending standards, and we are attentive to risks that can develop in this environment." She also testified that low interest rates contribute to the formation of asset bubbles —noting that the Fed will "not be able to catch every asset bubble" — but will be monitoring signs of increased risk-taking.

Just Another "Economic Episode"

Two years ago, economists Peter Phillips, Jun Yu and Shu Ping Shi authored an academic paper (out of which was born the "PSY Method") in which they tracked nine episodes of 20th-century stock-market bubbles in which prices deviated from fundamentals. About half of these bubbles were categorized as economic booms and half as crashes. Students of the PSY Method maintain that although the market may currently appear to be overvalued according to various traditional metrics, the lack of "explosive dynamics" indicates that we are not in fact in a bubble. According to one's perspective, it may or may not be time to break out the champagne.

CONTACT US!

DAVID KINNEAR
O: 212.913.0500 x565
M: 917.886.3222
E: DAVID.KINNEAR@GREENPOINTGLOBAL.COM

WILLIAM H. ANDERSON, ESQ
O: 212.913.0500 x586
M: 914.672.4975
E: WILLIAM.ANDERSON@GREENPOINTGLOBAL.COM

PETER K. OVERZAT, ESQ
O: 212.913.0500 x557
M: 917.807.1321
E: PETER.OVERZAT@GREENPOINTGLOBAL.COM

WWW.GREENPOINTLEGAL.COM