NASHVILLE NOTES

Grantham's 'superbubble' and crazy town

Wednesday, February 23, 2022 1:04 PM CT

By Jeff K. Davis

Jeff Davis CFA is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where he is the managing director of the financial institutions group; or StillPoint Capital, where he is a registered representative.

What is up with an assortment of high-profile stocks that are being crushed each week? Many are tech stocks, or a beneficiary of the work-from-home shift. It is very reminiscent of 2000 when the Nasdaq peaked in early March, though I do not remember as many stocks gapping lower day after day as has been the case with many once highflying stocks this year.

Roku Inc. fell 22% on Feb. 18 and is down 70% over the past year with most of the loss recorded this year. The list of decimated stocks is not confined to obscure companies either. Block Inc., PayPal Holdings Inc., Shopify Inc., Spotify Technology SA and Penn National Gaming Inc. are down at least 50% over the past year. Even mRNA vaccine manufacturer Moderna Inc. is down 43% year-to-date, though the stock is up 671% over the past two years.

Not all the companies that have seen their shares plunge the past several months lose money, though many do. One takeaway is that investing in companies that lose money is a risky proposition, and maybe it is an insane proposition when valuations are through the roof.

Another takeaway is that Jeremy Grantham, the founder of asset manager Grantham Mayo Van Otterloo & Co. LLC, or GMO, may be right that the "superbubble" he sees has begun to pop. GMO notes that all two-sigma deviation equity bubbles in developed countries, but a handful, broke and returned to trend. A few went on to become three-sigma or greater bubbles. GMO identifies U.S. housing in 2006 and U.S. equities in 1929, 2000 and 2021 as superbubbles.

I do not know if Grantham views the current housing market as a three-sigma bubble; however, it is crazy in Nashville.

I recently attended the annual gala for Nashville area Realtors with my wife, who is a real estate agent. Business has been strong in Nashville even before COVID-19 induced people to move and pay any price to escape locked-down coastal cities and Chicago. One thing that struck me about the conversation I heard was that the older real estate agents viewed most buyers as crazy for what they were paying for houses.

GMO's superbubbles offer two outcomes for banks that are worlds apart. The 1929 bubble that burst kicked off three years of asset liquidations that produced 25% unemployment, breadlines and depositor runs on banks that were not stemmed until the enactment of federal deposit insurance.

The bursting of the 2000 superbubble that I worked through was spectacular, but it was focused on tech stocks and large-cap "growth" companies. Its bursting did not take banks down like the bursting of the housing bubble would do eight years later.

The Nasdaq Composite peaked March 10, 2000, at 5049. Bank stocks, which could not be given away in 1999 and in early 2020, found their footing by February. The day before the Nasdaq peaked, I returned from lunch on what was an uneventful day to find our desk (I was then an analyst at J.C. Bradford & Co.) inundated with buy orders for banks, real estate investment trusts, industrials and retail stocks.

At the time, there was concern about a potential recession given the inverted yield curve; however, credit did not deteriorate too much during the shallow 2001 recession that later developed. Unlike the late 1980s when real estate and banks were crushed, real estate values held, and commercial losses of significance were mostly limited to leveraged syndicated transactions.

The benign outcome was helped by aggressive rate cuts by the Federal Reserve, which took the Fed Funds rate from 6.5% in mid-2000 to then unheard and today's aspirational rate of 1.0%.

Between March 10, 2000, and March 10, 2001, the Nasdaq Bank Index rose 43%. The Nasdaq, in contrast, fell 59% in one year from the peak and declined by 78% when the index bottomed in October 2002, compared to an 80% gain in the Nasdaq Bank Index.

No one knows for certain whether GMO is right about a superbubble today, though the term "everything bubble" used to describe stocks, real estate, cryptocurrencies, art and other assets may answer the question. If Grantham is correct, the Nasdaq and S&P 500 have a lot further to fall than the respective year-to-date reductions of 13% and 9% through Feb. 18.

The setup for banks is not so bad, however. Limited rate hikes may not dramatically change net interest margins, but asset yields will rise somewhat, while few banks will have to raise deposit rates much, if at all. Presumably, investors have priced this into the stocks because the Nasdaq Bank Index has risen 2% year-to-date and 14% from Sept. 10, 2021, when expectations for Fed rate hikes began to move forward, through Feb. 18.

More important for earnings will be credit, assuming the Fed can only engineer a few hikes before it is forced to step aside, lest it repeats 2019 when it was forced to cut rates three times after hiking four times in 2018. If asset values — especially real estate — more or less hold, then credit losses should not surprise by too much to the upside. Enterprise value-based lending may be a different story, however.

This article was published by S&P Global Market Intelligence and not by S&P Global Ratings, which is a separately managed division of S&P Global.

This article was published by S&P Global Market Intelligence and not by S&P Global Ratings, which is a separately managed division of S&P Global.

Published with permission. Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to S&P Global Market Intelligence, formerly SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.