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Global Warning on the Greatest Financial Mania in History

The first step is to identify what the key market action really is. With America's change from a pro-business to a socialist administration, the popular alarm has been that "Inflation is back!", as in the 1970s. Even more hysterical is that some "name" hedge fund managers have been calling for "Hyperinflation", as afflicted Germany in the 1920s. Well, there has been some spectacular gains in commodities since the COVID Panic of early 2020, but the big action has been in financial assets which when it fails will be hazardous to most asset classes.

"Galloping inflation", such as occurred in the 1970s, or in the decade to 1920 seems unlikely.

This financial historian considers that this year's rise in commodities is part of the business boom attendant to the final stage of a great financial bubble. Indeed, this is the sixth such example since the first which was the South Sea Bubble of 1720, with 1929 being number five. Moreover, the most incredible events in financial history, the roaring climax, and reversal to severe contraction have been remarkably methodical, completing about a decade after a global mania in commodities.

An outstanding mania in commodities completed in 1920 and crashed, and out of the ashes of deflation the phoenix of soaring stock and bond prices became the rage in 1929. The previous example was the 1873 Bubble with the key high in commodities being set in 1863. Earlier, a magnificent Bubble completed in 1825, with commodities setting their peak in 1813.

The pattern has been methodical with the last big rush into commodities completing a decade ago in 2011. And the buying mania of financial assets has become extraordinary. The German Ten-year note declined to almost minus one percent yield. Just minus is without precedent. Over in equities, the percent gains for large-cap stocks have been away beyond anything in history.

The inflation in financial assets has been truly remarkable and the salient point is that after every great bubble, most asset prices have deflated. That's for all five previous bubbles as they occurred in the senior economy and four were followed by lengthy post-bubble contractions.

It seems that every generation gets to invent sex, but the "invention" of a great financial bubble is limited to only every other generation.

So let's go through the main characteristics common to great financial manias and their failures.

The key features of great financial bubbles have been Real Long Interest Rates going down, as Copper's Real Price goes up. Another is Gold's Real Price going down as the

Senior Currency weakens. As our regular publications have been noting, these patterns have worked out and in reaching excesses could be ready for the reversals that have followed the climax of all five great bubbles.

Recent speculative frenzies include the Dot-Com Bubble that completed in 2000, as well as the Cyclical Bull Market that completed in 2007. While very exciting neither can be described as a "Classic Bubble". One of the highlights would have a classic bubble completing at about a decade after a global speculation in commodities. On the present example the last big peak in commodities was in 2011.

The US rate of Consumer Price Inflation soared to 24 percent in 1920 and crashed to minus (-) 16 percent in 1921. Understandably, the Fed was concerned that inflation was not high enough and was "easy" with money supply during the 1920s bubble, not understanding the consequences of inflation in financial assets.

This time around and over most of the last decade the Fed has been concerned that inflation was too low and has been overly easy with its portion of the credit expansion that goes with a great bubble.

In May 2019, The New York Times headlined: "Inflation is Low. That's What Worries the Fed", and the article included: "How to respond to persistently low inflation". Just as in the 1920s.

Once again Mother Nature and Mister Margin are about to give a stern lesson to interventionist central bankers. While the prospect of a contraction is daunting, this time around the way markets really work could get into the textbooks.

Best to look to the practical side.

Quite simply, the pattern has been a global boom in commodities completed and a decade later the world enjoyed a fabulous mania in stocks and bonds, with an attending strength in commodities. And when the bubble completed most asset prices declined significantly. In so many words, the pattern has been Commodity Boom, Bust, Stock Market Bubble and consequent Contraction, with most asset prices declining.

And again in different words, inflation in tangible assets followed by inflation in financial assets, then deflation. Been doing it for 300 years.

The first chart records the pattern in Real Long Interest Rates through all of the great bubbles. And with the action again working out, we now look for reversals. Perhaps for interest rates the High-Yield could lead the reversal. With China's Junk Yield Index up to 25 percent this measure when adjusted for real interest rates is soaring.

Quite likely leading the action in London and New York.

Often a key reversal in Junk Bonds is one of the items signaling the end of the financial party and the beginning of a credit contraction. In this study we use the PHDAX, which is Pimco's High-Yield proxy for risk product, covering the cyclical bull market peak in 2007. The topping pattern has led serious setbacks in the stock markets, and one is being worked on now.

With even wilder speculation in financial and commodity markets now, the topping pattern is again evident, with this proxy for "Junk" rolling over.

Seasonal Influences

The following chart records that Credit Spreads typically narrow into around May and then widen into late in the year. Using the CCC Spread, narrowing ran into early July and reversed. As we have been noting the reversal has not been dramatic as speculative fevers in a new set of commodities was positive. However, action in the key one, crude oil, became measurably excessive and has taken the initial setback.

Crude oil rolling over to a possible dismal low in January would seriously damage the financial mania.

Another key event is that the Industrial commodity Index (XLI) is getting technically overdone. Now generating Sequential Sells and a decline in this sector would widen credit spreads:

As would a failure in copper, which chart of the nominal price shows the hot action compares to that accomplished in 2011. And the action is rolling over.

Of greater importance is that the chart for Copper's Real Price is somewhat weaker, and in failing would signal the post-bubble contraction.

Another feature of the transition from boom to bust has been Long Rates turning up, which is happening in China. We can't plot this adjusted for inflation but the Real Rate is soaring:

Although only early, the chart for U.S. Real Rates for Treasuries is trying to reverse. Half the pattern has been the decline, the reversal will be part of the contraction.

Gold is very much part of the equation and representing money its real price has declined with the final stage of a bubble. From recklessly overbought in 2011, the trend has been down with the bubble, and the following chart shows the pattern through all of the great bubbles:

And this is how it looks on the near-term:

Another feature has been the senior currency declining during a bubble and then chronically rising during the contraction. The DX has reversed to rising:

It has been fascinating that the Gold/Silver Ratio also records a methodical pattern in declining during the boom and turning up with the contraction. During the 1720 and 1772 Bubble, there was little change in the GSR. However, since the 1820s volatility began to increase with the Ratio getting higher on every serious contraction.

At 76 now, extending the trend will anticipate another financial contraction when the GSR could soar to somewhere around 130. We have called it the "Metallic Credit Spread":

Wrap

The items so essential so keeping track of yet another great financial bubble have done what they methodically do as the mania maxes out. Of concern is that in reaching excesses the action is beginning to reverse.

Having accomplished so much on the way up, any action that would complete the trend change could have dramatic results. The power would shift from central bankers and intuitional academic economists to very practical margin clerks.

Although speculation is wild, Mother Nature methodically runs the financial markets to excess and then Mister Margin cleans up the mess:

These key features are well-worth monitoring for drama. In the meantime, our "Line-In-The-Sand" for stocks has been taking out the last "Springboard Buy" on the S&P, which registered in early October. With that level violated, our tactics and strategies will turn to bearish.