Joseph Patterson
Housing Economics and Finance
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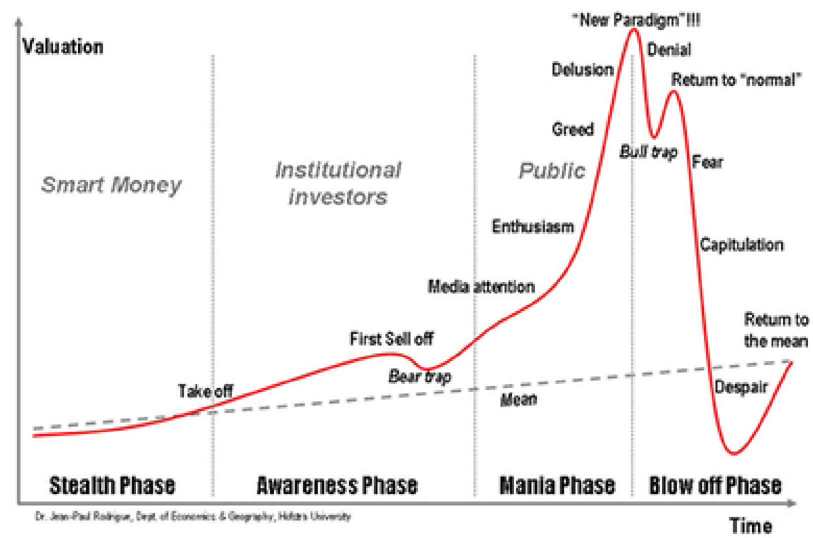
Economics Topic #2
Dr. Bill Herrin

It's Gotta Be Worth More Than That:
Psychology of Price "Bubbles"

In this paper I will try to explain more about price "bubbles". What are they? How do they work? What is wrong with them? Why does it seem like things are going so well and then they can suddenly change? What value does it really have? Why do they invest and buy more if the price is increasing? What are their expectations? Why are they in such a rush to sell those things they were so eager to buy? Does it have something to do with people's desire to get rich quick? Do people understand what they are purchasing?



What are price bubbles? "An **economic bubble** (sometimes referred to as a **speculative bubble**, a **market bubble**, a **price bubble**, a **financial bubble**, or a **speculative mania**) is "trade in high volumes at prices that are considerably at variance from intrinsic values" (Wikipedia) So … what is wrong with lots of trading at prices that are different from the intrinsic values? "A rally does not prove a bubble, but it is necessary to one." (Peterson "Bull") As seen in the chart above there are a lot of different emotions leading up to and resulting from a bubble. As the prices begin to take off people get excited. As it advances, it gets more media attention and the public begins to see it as an easy way to make money. Group mentality

you should define this HERE

they can if they sell in the mania phase right?

and ignorance leads these people to chase the dollars right off of a cliff. At first, they don't recognize that they have overpaid and can never recover, then they do realize and are terrible afraid of how much they can lose, which helps explain the steep falloff.

A lot of trading at prices different from the value creates the height that can lead to a terrible fall. The risk of injury from falling is greater they higher one climbs. The problem is that someone eventually gets stuck with the "Old Maid" and when the game ends they are the loser because they have the card that they can't get rid of. Large amounts of people have bought something at a price ~~that~~ from which they cannot recover.

Ok, that sounds really bad for some people. Why would lots of things be sold for a lot more, or less than they are worth? The simple answers to this question seem to be greed, herd mentality and liquidity. With greed, people are buying things at a higher price and they don't care about the cost as long as they can sell it to someone else. With herd mentality, people do not question the action because so many others are doing it. With liquidity it seems as the greater volume of money in the market is driving up prices. People feel richer because they have more money in their wallets, and borrowing is cheaper. Especially if they have an asset that they think keeps increasing in value they are more inclined to take on additional debt to buy more of that overpriced asset. good point

~~Why do they sell?~~ If things are going so well and their asset keeps increasing in value, why do they sell? For one thing, the early sellers capture the surplus of ~~a good~~ an asset that is overvalued one needs to sell it. If someone will pay me $1000 for my shoes that is nice, but it doesn't benefit me unless I sell. Another reason is the uncertainty ~~to~~ of the market and expectations. People sell because they think the price will drop in the future. If someone offers me $1000 one day and I don't sell. Then $950 the next day … hm … I thought they were really valuable shoes, but they seem not to be as interested anymore. I better sell them while the buyer is still ready to pay. Also, many people who notice a small drop in the value are afraid of what could come next overreact negatively. As Peterson stated in his writing about stock market psychology:

> The stock market is an anticipatory mechanism. It has priced in a lot of pain to come. The real question is, will the pain be worse than the market expects? If not, then it is likely to rally. And in general, people anticipate more pain than is actually experienced. They will even <u>cause themselves greater pain</u> in the present so they can stop anticipating future (smaller) pain. (This is called the cost of Dread).

This is an important consideration.

If I really needed the money, I might even be willing to accept payment less than my purchase price if I think they will offer less tomorrow. After those early sellers give the signals that the asset cannot continue climbing at this pace, others notice the cliff they have just run off. Murtha makes a very interesting explanation of behavior with his comparison to a familiar cartoon. Most people in the market behave like Wile E. Coyote.

"… Wile E. Coyote would invariably pursue his elusive quarry off of a cliff. At this point, it became clear to the audience that the coyote was headed for a serious fall. And the more excitable among us were prone to yell things like, "Look out!" at the TV. The coyote; however, was blissfully unaware of his circumstances. In fact, breaking multiple laws of physics, Wile E. Coyote continued to churn his feet, levitating in the same spot, indefinitely free from all harm... until he did one thing; until he **looked down**."(Murtha)

Excellent!

Now that we discussed some of the downsides and brief theory of a bubble, I would like to provide some real life examples. Carl Rheuban believes that one of the reasons for the bursting of the housing bubble is rising interest rates. Those opportunities that were created by ease of borrowing and lack of accountability are now being removed. Lots of mortgages with adjustable rates are coming up for resets and that caused fewer people to be able to continue making those extremely low payments.

Per se, this does not explain all of the bursting. Fewer loans being made, more than rate resets, better explain the why prices stopped rising.

This reset and rising interest rate along with the higher prices from earlier price changes led to new homebuyers being priced out of the market and no longer able to buy their own homes. Another downside of the increased cost of borrowing is a disincentive to own a home. The price of homes should be related to the cost of renting. But rents have not been going up as fast as the price of homes. There is not an incentive for people to buy homes when there is so much cost and uncertainty in being able to sell them. Better to save the money and invest it somewhere where at least it can earn some guaranteed interest and maintain the principal. Even if one puts 20% down on a home, it can evaporate in this environment of freefalling home values. If new home buyers are not able to buy starter homes, then those with starter homes who are seeking to upgrade cannot afford to make the jump and it moves up the line. Some have compared the housing bubble to a pyramid scheme or a greater fool game. Those who are in it earlier can only continue the game and continue to increase their benefits as long as the game continues and more people join. But when the greatest fool joins and there is no one who will overpay for that asset the bubble bursts.

This is one common way to define the bubble.

who?

In the course of this paper I have learned quite a bit about the psychology of price bubbles and how they relate to the housing crisis and credit crunch in the United States. It starts as a small overvaluing of assets. Houses are basically shelter. People were just buying houses because it was cheaper than renting as rents were rising. Then houses increased in value at a higher rate, and it was cheaper to borrow, and more people were encouraged to invest in real estate as they way to create wealth. Then the media started to show how much people were making. Finally people started to look at the numbers and realize that they could no longer afford their payment or that renting wasn't so expensive considering the alternative. So the investment in house flipping stopped and people who had just bought and needed to sell had to take a loss. That drives down the prices for everyone. This begins the dread. People begin to sell now because their expectations have changed so drastically that they feel that the opportunity costs of waiting outweigh the loss of selling now. Eventually housing prices will reach a more rational level where the price of the home is related to its substitute, its intrinsic value (the value of having a roof over one's head) and housing will come nearer to the cost of rent. Essentially the cost of housing should be the value of shelter.

This is well-done. The role of the Federal Reserve in making it cheaper to borrow is also often cited as a cause of the bubble. This alone would be worth looking into.

You're going to enjoy the Shiller book!

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