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MARKET INSIGHT

A Stock Market Bubble Checklist: Are We There Yet?

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Market pundits have been talking bubbles lately. The broad market appears to be overvalued by many measures. The recent volatility involving GameStop and silver have increased talk of bubbles. But exactly what is a "bubble?" Is a bubble something we know when we see but can't describe? Maybe, but back during the tech bubble of the late 1990s/early 2000s, I did a study of historical manias and bubbles. One major take-away is that a "bubble" is a cultural phenomenon, and overvaluation is a necessary condition, but not a defining one.

Based on this research, I came up with the following checklist of characteristics common to financial bubbles. Going through these items, it appears that we are heading for an asset price bubble, but we're not quite there yet, even if the market is overvalued. So, let's go through the checklist and you can decide whether you agree!

1) Low interest rates and excessive leverage. Verdict: Check.

Every asset price bubble in the past occurred when interest rates were low, and we definitely have low interest rates. Low rates encourage people to borrow. While that's good if you want to stimulate investment in business and industry, low interest rates can lead to excessive buying on margin, a leveraged state Hyman Minsky called "Ponzi finance." Investors become so leveraged that even a modest decline in price can force a large number of investors to sell to meet margin calls, creating a downward de-leveraging cycle. Credit to GDP ratios confirm that leverage is currently higher than average. But leverage alone is not enough for a "bubble."

2) Significant economic innovation and productivity gains. Verdict: No.

Innovation is good, right? It is, but there can be issues. In a bubble, securities are overvalued historically, yet they continue rising, becoming even more overvalued. This unchecked trend is usually driven by some form of innovation that has changed the way the world works, leading investors to discard historical norms. But the

Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

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scale of the innovation has to dramatically improve productivity and profit margins enough for investors to rationalize high valuations. The internet served this function in the tech bubble of the late 1990s. In the 1920s, it was electricity. In 2021, we haven't seen a technological change of that magnitude. So the "this time things are different" mentality hasn't really developed yet, and there is a healthy nervousness about high valuations.

3) Innovations in securities markets. Verdict: Check.

The recent coordination among retail investors is the obvious example. Various platforms have made online day trading easier and more accessible. Zero commission trades and partial share holdings have also broadened out the incentives for less experienced investors. Social media has allowed these traders to share their successes with one another and egg on further speculation. In previous bubbles, similar innovations occurred. Online trading became available during the tech bubble and many thought with the right tools they could compete with Wall Street traders. In the 1920s, wireless telegraphs allowed investors to trade even if they were cruising the Atlantic. Robinhood and similar systems are just the most recent incarnation of past attempts to bring trading to the masses.

4) Mini-bubbles develop. Verdict: Check.

Mini-bubbles are a symptom of a growing bubble mentality. Before the Reddit crowd, we had and continue to have speculation in IPOs and cryptocurrencies. These assets have mostly gone to unrealistic heights based upon pure crowd behavior. Cryptocurrencies, for instance, have no intrinsic value and can't really be used practically for transactions, their original intended function. Instead, they've become an online betting system that is now beginning to draw institutional interest. There was a Florida real estate bubble that began in 1921 and collapsed in 1926, long before the stock market crash of 1929. In the 1990s, there were several unusual bubbles, including one on small limited edition stuffed animals called Beanie Babies. During its height, people were willing to pay up to $5,000 for a toy that retailed for $5.

IPOs have a similar history. Going back to the South Sea Island bubble of 1720, people paid high values for any corporation, even a company "For carrying-on an undertaking of great advantage but no-one to know what it is." In the 1920s, there was a run on any company that said it was going to produce light bulbs. And, of course, in the tech bubble, any company with dot-com after its name sold for high values during IPOs. It's a familiar narrative which we're seeing again: Companies with little history and no profits selling for high prices based upon a widely accepted story.

5) Moral Hazard: Investing is easy, downside is limited. Verdict: Not yet.

While there are signs of moral hazard developing, it has not yet achieved levels that define manias. During a bubble, there is widespread belief that the market can only go up. This view is a natural culmination of the first four items in the check list. JP Morgan said, "Nothing undermines financial judgment more than seeing your neighbor get rich." So a widespread sentiment develops that if you're not playing the market you're missing out. There is also belief that since markets go up in the long term, you should always buy the dip. This is when an overvalued market transitions to a cultural phenomenon which we call a "bubble."

On the mania side, there's the old story that Joseph Kennedy (JFK's father) pulled out of the market in 1928 when a shoe shine boy asked for a stock tip. I had my own shoe shine boy moment in 1999 when I noticed that sports bars were consistently showing CNBC on their wide screen TVs rather than sports. While the IPO market is similar, we're not seeing this kind of mania on a wide-spread basis. At least not yet.

The buy-on-the-dip (BOTD) mentality develops when the market survives a horrific drop, leading to a sense of invulnerability. The late 1980s

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Japanese bubble was fostered by the more modest pull-back and quick rebound of the Japanese market during the Crash of 1987. This supported a belief that the Japanese market was different than the rest of the world. In the 1990s, there were significant drops in 1997 (the emerging market currency crisis) and 1998 (the Russian Financial Crisis) prior to the tech bubble bursting in 2000. In the summer of 2007, there was the "quant melt-down," but the market recovered within two months – well before the global financial crisis of 2008. In each case, the market bounced back, so those who sold when the market went down finished with the largest losses. We may have a similar situation developing, though if so, we're in the early days. The stock market has largely come back from the horrific drop in Q1 2020. This could foster an increasing BOTD mentality, but there's still a way to go.

Conclusion: Bubble developing, but not yet fully inflated.

Moral hazard is really the culmination of the other items on the checklist and necessary for a "bubble." While we have checked three of them, we're not quite there yet. That doesn't mean the markets can't have a meaningful correction at this point. In fact, a quick market recovery from another leg down may create the moral hazard that is the final stage of a bubble. The market likely is overvalued, but a bubble is a cultural phenomenon, and 2021 does not yet qualify in my opinion. Let's hope it stays that way.

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