Seeking Alpha

How Does 2017 Compare To Historical Bubbles?

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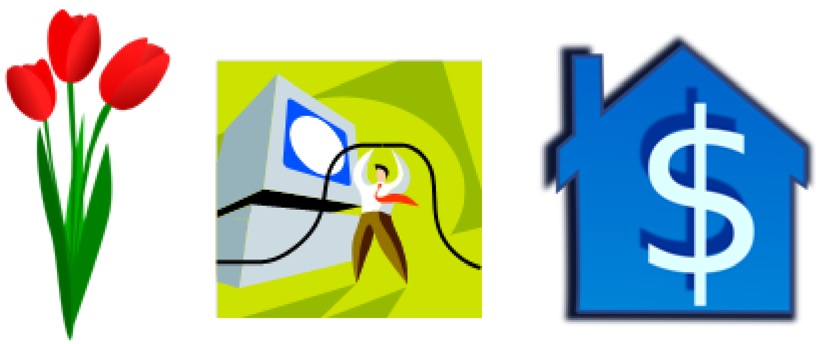
Summary

- Asset bubbles tend to follow similar scripts.
- Is the 2009-2017 market following the bubble script?
- Is everyone already fully invested in the stock market?

Greed And Fear Are Constants



Since greed and fear have remained constant throughout human history, asset bubbles are not a recent phenomenon. The Dutch tulip bubble that occurred in the 1600s shared many of the same attributes of both the dot-com and housing bubbles. From Investopedia:

> *The Tulipmania that gripped Holland in the 1630s is one of the earliest recorded instances of an irrational asset bubble. By one account, tulip prices soared 20-fold between November 1636 and February 1637, before plunging 99% by May 1637, according to former UCLA economics professor Earl A. Thompson. As bubbles typically do, Tulipmania consumed a wide cross-section of the Dutch population, and at its peak, some tulip bulbs commanded prices greater than the prices of luxury homes.*

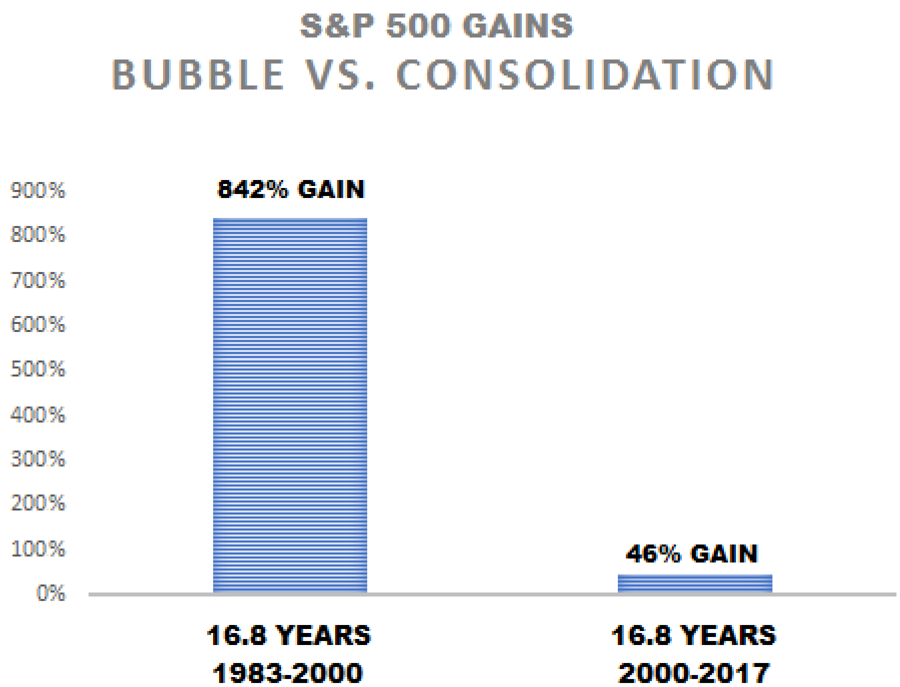
Common Traits Of Bubbles

In all three cases (tulip, dot-com, and housing):

1. Asset prices experienced extraordinary gains.
2. A wide cross-section of the population participated near the latter stages of the bubble.
3. Investors felt "this time is different".

How Does The Present Day Compare?

It has been 16.8 years since the end of the dot-com bubble. Have stocks experienced gains similar to the period that ended with the speculative dot-com blow-off peak in 2000? If we compare stock returns in the last 16.8 years to the returns in the last 16.8 years of the tech boom, the gains are significantly different (see bar chart below).

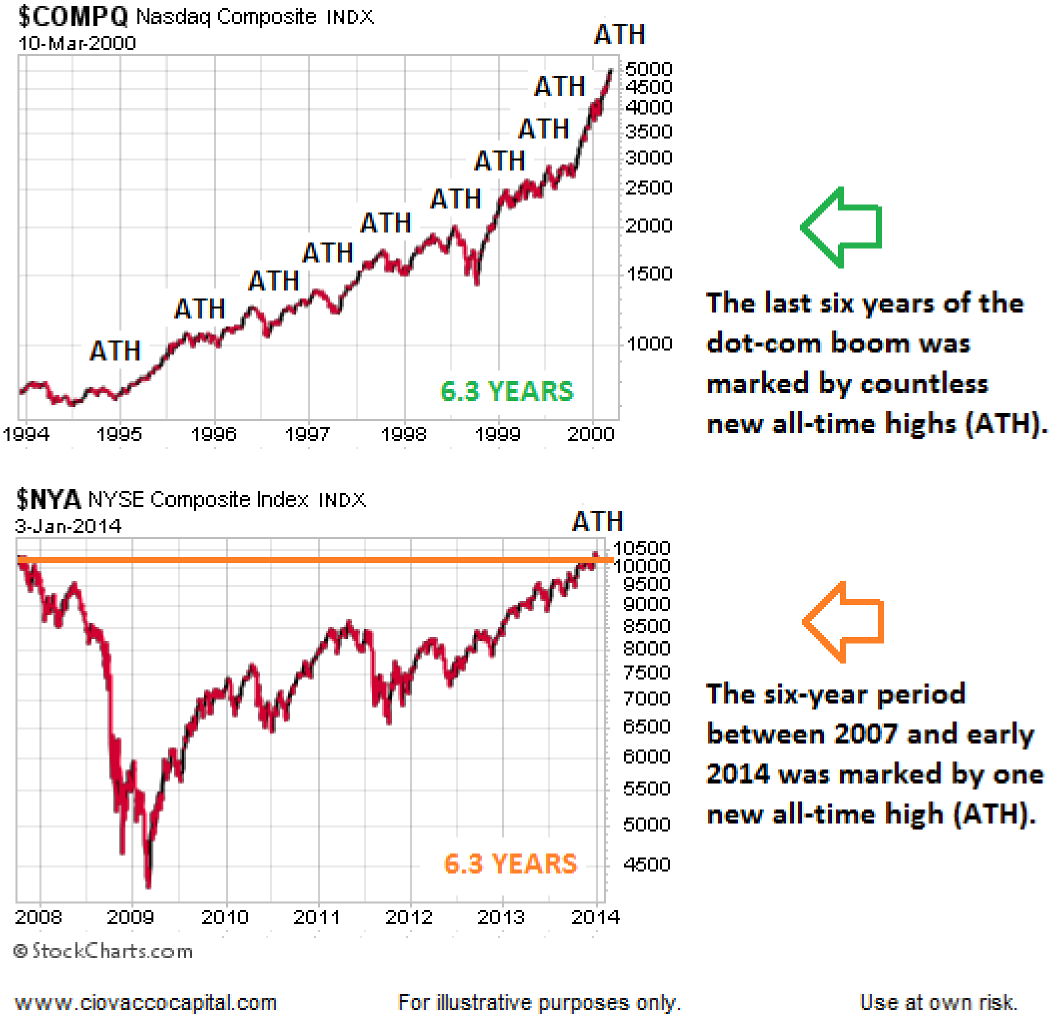


An 18-Fold Difference In Returns

Over the last 16.8 years (2000-2017), the S&P 500 (NYSEARCA:VOO) gained 46%, which really doesn't look anything like the eye-popping 842% gain that occurred in the prior 16.8-year period (1983-2000). The 842% gain represents an 18-fold increase over the 46% gain.

New All-Time Highs vs. Consolidation

Bubbles see participants push asset prices to never-seen-before heights, which is exactly what occurred between 1995 and 2000. Consolidation periods are marked by a very low number of new all-time highs (ATHs), which is exactly what occurred between 2007 and early 2014. Both graphs below span the exact same number of calendar days (2,286).



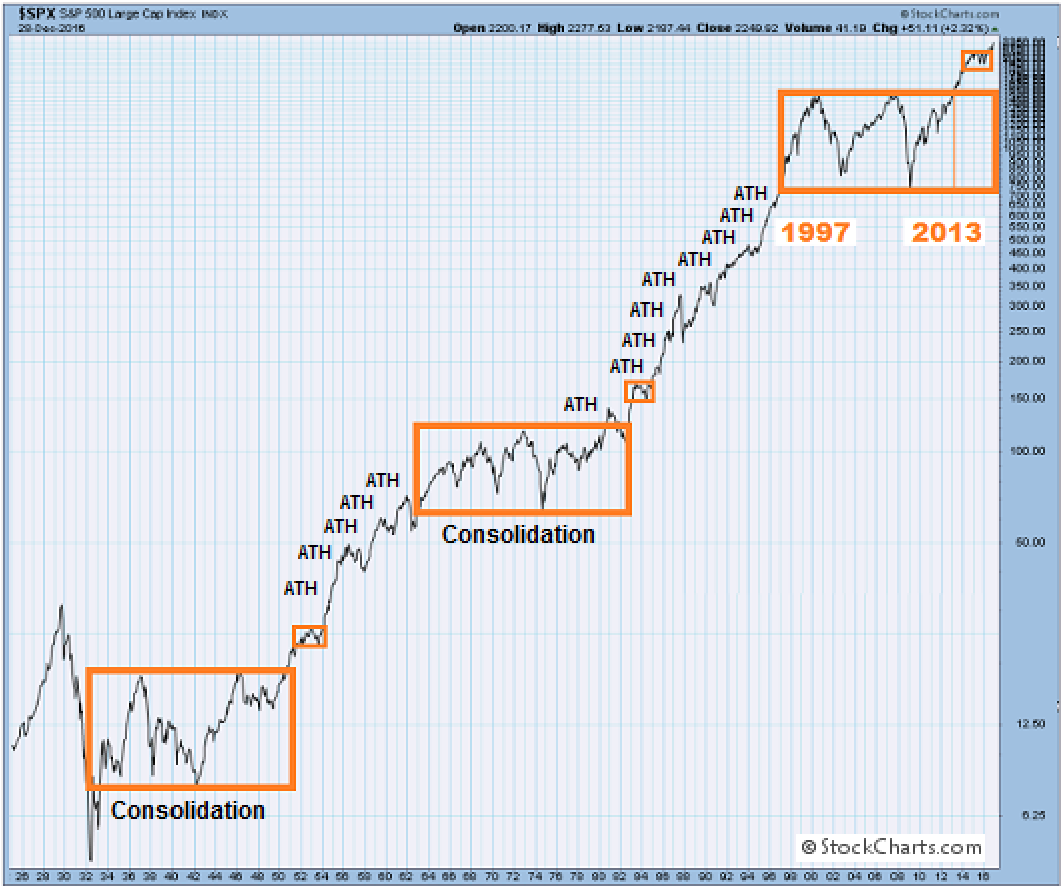
Bubble vs. Consolidation

On October 31, 2016, the NYSE Composite Stock Index was trading at the same levels seen nine years earlier. Contrast the "zero progress" look of the nine-year period on the bottom portion of the image below (2007-2016) with the 1,026% gain that occurred during the last nine years of the tech boom era (top portion). The top portion looks like a bubble; the bottom portion looks like consolidation.

Consolidation Can Be Very Relevant

The expression "the longer a market goes sideways, the bigger the move that follows" applies to the S&P 500 chart below, which dates back to 1925. The orange boxes highlight periods of consolidation marked by a small number of all-time highs. The periods between the orange boxes represent secular trends marked by a large number of new all-time highs. More detailed information on the concepts shown in the chart below can be found in this December analysis. The chart below was created using data from StockCharts.com.

S&P 500 1925-2016



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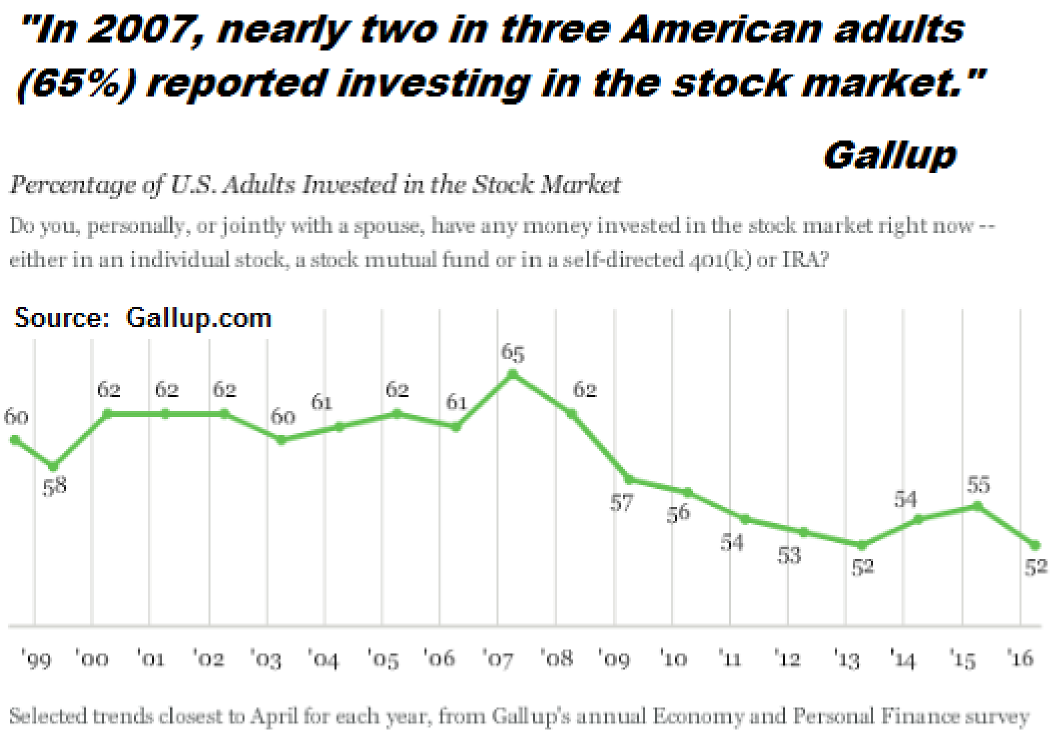
Do We Have Widespread Participation Today?

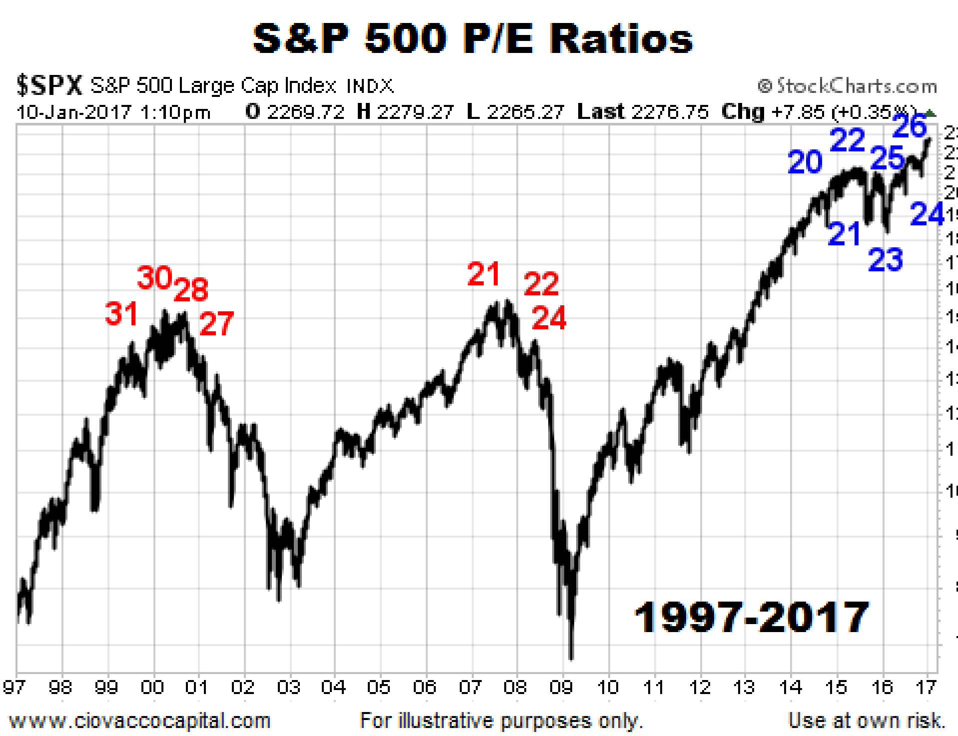
It was not unusual to go to a cocktail party in 2006 where 50% of the attendees worked as realtors, appraisers, developers, flippers, etc. It was not unusual to discuss tech stocks with your cab driver in 1999. It was also common to hear "you can't lose money on tech stocks" or "real estate is a sure bet."

The percentage of adults that own stocks has been declining since it peaked in 2007. Therefore, participation has been on a downswing rather than a bubble-like upswing in recent years. The recent decline in stock market participation may also provide a source for new funds in the coming years, as outlined on January 6.



Are Valuations A Showstopper?

Based on numerous valuation metrics, it is difficult to make a case that stocks are cheap in 2017. However, a recent analysis of P/E ratios at major peaks, major bottoms, and within the context of secular trends says present-day valuations, taken in isolation, are not a showstopper for stocks.



Historical Bubbles vs. 2017

The July 2016 description below of the current bull market hardly paints a picture of euphoric market participants with an "it's different this time" state of mind. From *The Wall Street Journal*:

> *The seven-year bull market in stocks still doesn't get much love. That is precisely why more milestones could be in the offing. The S&P 500 closed at a record on Monday-its first since May 2015 and the 109th of this bull market. Yet the higher stocks climb, the more skeptical investors seem to get, at least judging by where they put their money. That lack of exuberance and the market's increasing resilience could be exactly what propel stocks in the months ahead. Consider the reaction to Brexit. Investors pulled nearly $8 billion from U.S. equity funds in the week following the June 23 U.K. vote to leave the European Union, the fourth biggest weekly withdrawal of the year, according to the Investment Company Institute.*

Ultimately, personal opinions mean very little in the financial markets. Therefore, it is appropriate to leave the 2017 column in the table below blank. Only time will tell.

Common Bubble Trait	Tulip	Dot-Com	Housing	2017
Extraordinary Gains	YES	YES	YES	?
Widespread Participation	YES	YES	YES	?
It's Different This Time	YES	YES	YES	?

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Disclosure: I am/we are long SPY.

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