Buying Panic: A Tsunami Warning

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Anyone growing up in the Upper Midwest knows that the month of March is the favorite time of year for travel, and no destination is more popular than getting to a warm sunny beach. It's always relaxing to stroll the water's edge and watch the lapping of the waves, at times trying to dodge the incoming surges and at other times just resigning one's self to getting wet. Who among us hasn't tried to determine when and where the high tide will crest by the watermarks in the sand? (Just writing this is inspiring me to head south!)

It's not a stretch to make a comparison of the ocean's lapping waves and various tides to movements in the stock market. A typical trading day will involve slight up and down movements of nearly every stock or index, which is similar to the incoming and outgoing ocean's waves. Stocks might make a more sustained move over a longer period, followed by a proportional pullback, just as tides crest and reverse. But every once in a while, stocks (and indexes) can move upwards and on rare occasions go vertical. These movements are most often followed by dramatic corrections or crashes on the other side. With the benefit of hindsight we can recognize them for what they were, a bubble formation that popped, or in what I believe is the nautical equivalent of a tsunami!! Tsunamis crash onto the shore creating massive damage, while the successive undertow drags articles large and small back out into the ocean as they recede. Tsunamis give little warning, and the level of destruction can scar victims for life. Stock market bubbles are equally unpredictable but once formed, they can burst too and leave a trail of financial destruction that scars some victims for life.

A Short History of Stock Bubbles[1]

The UK Railroad Bubble: There was a rapid expansion of rail transportation in the UK in the mid-1840s. The possibilities of riches from a future of mass transportation danced in the heads of investors, propelling the sale of new issues of stock. This cheap source of financing led to the rapid expansion of rail infrastructure. Early investment success led to ever more stock participation. Soon enough, hundreds of kilometers of track were laid, precipitating an escalation of share prices to unsustainable levels. Eventually, even small investors couldn't resist the urge to participate. Once it was realized that too much capital was chasing an already over-built thousands of kilometers of under-utilized track, it precipitated a stock market crash that would alter the entire UK economy for a generation.

The Crash of 1929: "The Roaring Twenties" was fomented in part by the rapid adoption of radio broadcasting and air travel, two giant developments of that era. Further, it was a time in which there was a relatively robust industrial economy. The imagery of a future of unlimited prosperity fueled by the availability of cheap capital was met with willing stock buyers, over-investment, and an eventual over-building of infrastructure. The 1920s stock bubble is well-documented, while the 1929 crash that followed resulted in steep losses to investor capital, wiping out 89% of the value of the Dow Jones Industrial Average top to bottom. "The Great Depression" followed.

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[1] Source: https://stocksoftresearch.com/bubbles-crashes/

The Japan Bubble: Although the 1989 bubble in Japan is not as well known here in the U.S., it was a glaring example of the same. Japan in the late 1980s was at its' zenith of automobile and electronics manufacturing, while their stock market (as measured by the Nikkei 225 Index) multiplied by nearly five-fold over a five-year period. It was yet another example where investors imagined an unending period of prosperity driven by its industrial innovation and fueled by cheap capital. The result was a nearly unparalleled stock (and property) mania. The astonishing climax in both stocks and property would lead to a crash on the other side that resulted in a nearly two-thirds loss of value. It was so damaging that it would take more than three decades to recover.

The Internet Bubble: Perhaps no bubble was as predictable as the Internet Bubble *(aka "the Dot Com Bubble").* This particular market mania event was the result of a massive hyping on the future of internet utilization, which interestingly, would actually come to fruition. In the moment though, there was simply too much cheap capital that allowed for a massive build-out of fiber-optic cable, one of the primary components of infrastructure that would support future high-speed communications. There was already a million miles of installed cable by 1996, but this ballooned to more than 10 million miles by the year 2000[2]. The utilization rate had been stuck at around 20% to 30%, and it would remain there for a number of years into the future. By the late 1990s just about any stock that was issued as an IPO that had an even remote tie-in to "dot com" were chased to irrational valuations. *["Dot Com" was a slang reference to domain names and the access to websites.]* The bursting of the dot-com bubble would result in a loss to the NASDAQ-100 Index (home to most of the participating listed stocks) of nearly 83%. This defining collapse gave cause for the Federal Reserve to ramp up their easy money policy in an effort to re-stimulate a wounded market and a wounded economy. The stimulus would last for almost two more decades.

Another Bubble?

Many market observers insist we are in a stock bubble right now. I have chronicled the steady ascension of large mega-cap stocks that appear (to some) to have already priced in potentially decades of future sales and profits. To date, they continue to defy gravity. To me, this group of stocks display many of the characteristics that define bubble behavior. This particular episode is unquestionably centered on "all things AI," Artificial Intelligence. I believe Wall Street has staged a massive AI hype campaign. There's no doubt that AI is real, transformative, and can create more efficiency across a spectrum of applications. Like other life-altering technologies that have preceded this one, we've likely not even begun to realize all of its potential benefits as a society. However, unlike many revolutionary concepts of the past (rail and auto, tele-communications, radio and TV, the internet) wherein the earliest introduction almost immediately captured the imaginations of investors and speculators alike, AI has been with us for decades and It's already changed society.

A lot of the current buzz surrounding the latest technology advancements has to do with higher speed capabilities of processing power and how that can promote a new generation of useful applications. There have been many other stock market bubbles of varying size and intensity in the past, but those four listed above might be the closest illustration to what may be happening currently. Innovation paired with access to cheap sources of capital, a vision of a "new era" of prosperity, and the opportunity for massive wealth accumulation driven by a plausible storyline

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[2] Source: https://www.linkedin.com/pulse/disruptive-strategist-ai-capex-bubble-history-repeating-edtfe

can all work in concert to draw in heavy participation by speculators and investors alike. I believe the current hype surrounding the latest innovations in technology has all of that.

We got some good news in February regarding the ongoing frenzy within the high tech sector. Up until recently a lot of the more speculative activity was targeting mega-cap names along with a garden variety of other fairly well-known companies just below mega-cap size. But in February, we witnessed an acceleration of media hype focused on the potentially new era of technological prosperity and it spread to include much smaller companies, many of which are unknown to most and which may only have a somewhat suspicious tie-in to these latest technological advances. Speculators couldn't get enough of these new "sweethearts" fast enough. Gains of 50% and more were occurring with regularity last month with the common denominator being "micro-cap" and thin liquidity. Media-hyping headlines was one catalyst driving these stocks. In my opinion, it was nothing short of a "BUYING PANIC", and it left little doubt that we may have entered a new phase of this long-running tech-based bull market. When speculative behavior becomes fever-like, as witnessed in past eras of stock bubbles throughout history, some market observers would say we have potentially arrived at the "the terminal phase", or, the beginning of the end (but of course, no one can predict or time any market trend with certainty). However, certain patterns of market behavior can certainly take on bubble characteristics and the one lesson taken from history is that they historically have popped. It is up to each individual investor to determine for themselves if we are even in a bubble presently, as well as to what degree their equity exposure should be based upon their individual opinions.

Conclusion: In my opinion markets are all about price discovery and the current environment may be ideal for those who enjoy high-level trading and speculating. But, for those whose long-term investment objective includes protection of your base capital, and considering all that we know from bubbles past and present, the current environment is looking increasingly hostile from a volatility and liquidity standpoint, an environment where it may make better business sense to reduce exposure to technology and related names for the foreseeable future. The term for this is "de-risking", and the objective would be to side-step a potential market correction (or potential collapse) despite that the general market sentiment is broadly bullish and may remain so for longer than anticipated. Then there is the sage quote from the Oracle of Omaha himself (Warren Buffett), ***"Be greedy when others are fearful, but fearful when others are greedy."***

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Indices are unmanaged and are not available for direct investment. Past performance is no guarantee of future results and no one can predict the markets with any certainty. Index returns include the reinvestment of dividends but do not include adjustments for brokerage, custodian, and advisory fees.

The Dow Jones Industrial Average (DJIA) is an index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The Nikkei 225 is a price-weighted index of the 225 top Japanese companies listed in the Tokyo Stock Exchange. The NASDAQ-100 is a modified capitalization-weighted index that is comprised of the largest non-financial companies listed on the National Association of Securities Dealers Automated Quotation System stock market. It includes both foreign and domestic companies, and does not include any financial or investment companies. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies.