Five Features Of Market Madness

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Nobody knows whether John Maynard Keynes actually said "the market can stay irrational longer than you can stay solvent." But anyone old enough to remember the 1998-2000 dotcom bubble will know that these words can sometimes account for seemingly inexplicable stock market behavior more convincingly than any analysis of valuations, monetary policy or economic data. Those of us who still believe that the new bull market is unjustified by any economic or financial fundamentals (see **Four Reasons To Fade The Rebound**) can stop racking our brains with complicated conspiracy theories and monetary rationalizations. After last week's trading, reinforced by Monday's powerful rebound on Nasdaq, the motive force behind the biggest equity rebound in US financial history has become perfectly clear. It is the irresistible power of herd behavior immortalized 180 years ago in Charles Mackay's *Extraordinary Popular Delusions And The Madness Of Crowds*.

Nominative determinism

Suddenly, the signs of overconfidence that skeptics like me have been seeking in surprisingly complacent measures of investor sentiment and equity valuations have turned into blatant displays of popular delusion. Who would have thought, for example, that US equity market prices would be set by nominative determinism? Last Monday, a Chinese property company's value jumped from US$800mn to US$10bn in four hours of trading, after a storm of social media messages noted that its name, Fangdd Network, made it sound like a cheap ETF for the FAANG technology giants. On Tuesday, Nikola, an aspiring electric vehicle manufacturer with no revenues that launched three months ago on Nasdaq saw its value spike to almost US$30bn, up from US$300mn at its March IPO, mainly because, like Elon Musk's electric car company, it was also named after 19th century Serbian-American inventor Nikola Tesla.

Fangdd rose 1,100% on its name alone...

Or what about the insatiable retail appetite for the equities of bankrupt companies with zero intrinsic value? On Thursday, Hertz announced the first-ever US$1bn stock issue by a company in Chapter 11 bankruptcy protection. According to the Hertz regulatory filing, this action would:

...while the bankrupt Hertz raised US$1bn in equity

> "...provide a unique opportunity to raise capital on terms that are far superior to any debtor-in-possession financing because the stock issuance would carry no repayment obligations, would not pay any interest or fees to those who provide the funding by buying shares at the market... [and] would include disclosure... highlighting that an investment in Hertz's common stock entails significant risks, including the risk that the common stock could ultimately be worthless."

In other words, this stock issue will offer a "unique opportunity" for new investors to hand US$1bn directly to the hedge funds and banks which own US$17bn of Hertz debt currently trading at less than 40 cents on the dollar, and which are "ranked well ahead of shareholders."

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In short, it is now quite clear that many of the participants in the new bull market are certifiably crazy. However, the investment implications of this diagnosis are much less clear.

The blow-off phase of a bubble can be enormously rewarding

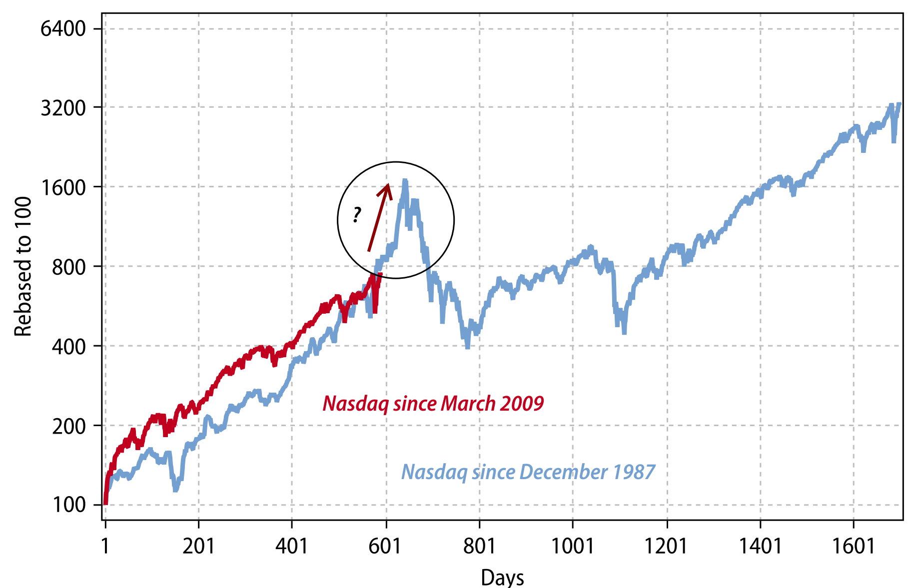
Those of us who lived through the 1998-2000 dotcom boom know that a bull market powered by nothing but crowd psychology can overwhelm anyone who stands in its way. We also recall that the final explosive expansion of the bubble can be immensely profitable. So, whatever rational investors may think about the bull market's lack of reason, they may still want to follow momentum players who happen to be brave (or foolish) enough to ignore all fundamentals, and just enjoy making money, as in 1998-99.

Crowd psychology

Even if we believe that the bull market is now driven by nothing more than retail crowd psychology, the question for investors is whether last week's extreme outbreak of madness marks the climax just before the bursting of the bubble, or the speculative transition point from linear to exponential growth. Nobody can be confident of the answer and every bubble is different, but there could be some instructive parallels between the present situation and the dotcom bubble that started to inflate exponentially after the Russian default and Long Term Capital Management hedge fund panic in the summer of 1998. The 1998-2002 analogy is illustrated by the chart below, which I used in client presentations in the month before the present panic, but abandoned prematurely when the scale of economic devastation from Covid-19 became obvious.

Today's run-up in Nasdaq is reminiscent of the dotcom bubble

Nasdaq since 1987: a tale of two bubbles?



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The 1998-2002 experience (detailed in the appendix at the end of this paper) suggests at least five features of market madness which may be worth recalling as we try to understand why the new Nasdaq bubble could burst tomorrow or could keep expanding for months (or years?) to come.

1) **While monetary easing usually starts a bubble, a reversal in monetary policy is unlikely to deflate the bubble once the speculative momentum builds.** The dotcom bubble started when the Federal Reserve unexpectedly eased monetary policy in response to the Russian default and the collapse of LTCM, a systemic threat that was as serious at the time as the one eventually created by Lehman. After collapsing along with LTCM, equities started to recover in response to the second Fed rate cut, and by the time the Fed cut again a month later, they had rebounded to their previous record. The Fed then stopped cutting, but the bubble continued to expand and inflated even faster as the Fed hiked over the next 15 months.

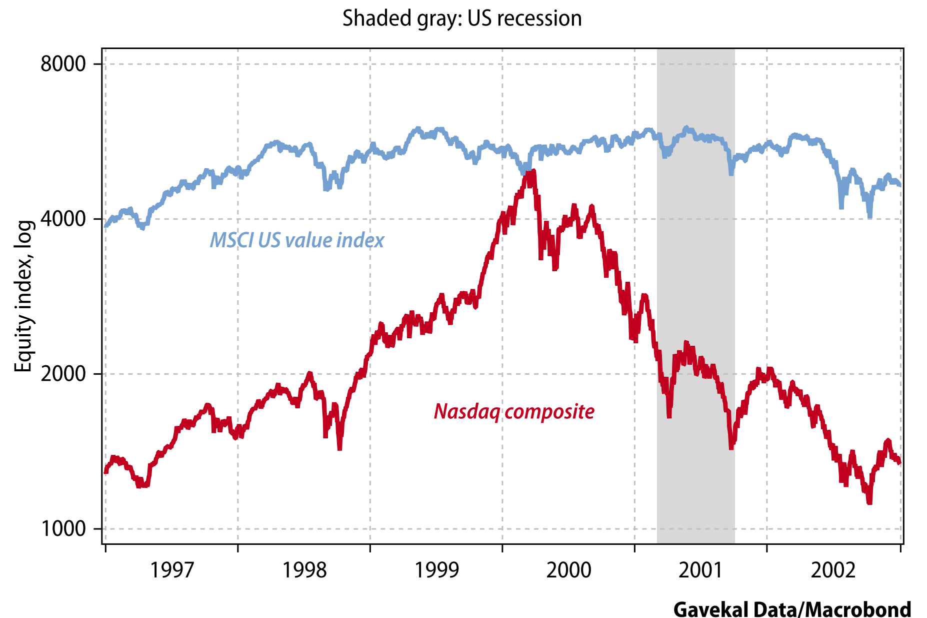
Interest rates cuts cannot reflate a bubble once it bursts

Once the bubble bursts, low interest rates and discounted cash flow calculations become irrelevant as supports for share prices. For example, the price-to-earnings ratio of Microsoft, the only big tech company to emerge almost unscathed from the dotcom bust, collapsed from 80 at the end of 1999 to 24 in late 2003, despite the plunge in 10-year treasury yields from 6.7% to 3.1% over the same period. And Microsoft's P/E never rose again above the low 30s until 2016, even though bond yields continued to fall all the way to 1.5% (see the chart below).

2) **Valuations do not matter while a bubble is inflating, but they become very important after it bursts.** From March 2000 onwards, investors quickly rediscovered their taste for cheap value stocks. While the overvalued Nasdaq index plunged -78% between March 2000 and October 2002, the MSCI value index declined only -26% (see the chart overleaf). And this value index actually gained 8% during the first two years of the Nasdaq collapse, until the Enron and WorldCom frauds triggered a final capitulation for all equities.

When a bubble bursts, value stocks can come into their own

After the dotcom bust, investors rediscovered their appetite for value



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The bursting of a bubble can erase good as well as bad companies

3) Bubbles typically end with the some huge corporate collapses (Charles's analogy of dynamite fishing), often tainted with fraud. In 2001-02, the corporate "whales" whose dead bodies eventually floated to the surface were the biggest energy and telecom companies of "the new economy": Enron and WorldCom. But when a bubble bursts, many good companies with genuinely unique or superior technologies tend to get swept away along with the bad ones. Lucent, Nortel and Sun Microsystems were among the genuine technology pioneers which vanished—and even Apple and Amazon came close to extinction. This time, could the companies with unsustainable business models include loss-making and negative cash flow companies SoftBank, Tesla, Netflix or even Amazon?

4) Bubble dynamics need not bear any relation to the strength, or weakness, of the economic cycle. Equity prices can continue to fall sharply long after the economy recovers from recession. In the dotcom bust, the Nasdaq collapse began a year before the US recession started, and prices went on falling for more than a year after the recession ended in September 2001.

When the market breaks through to new highs, speculation surges

5) Speculation increases dramatically when prices break through major highs. The dotcom bubble began to inflate in earnest in November, 1998 when the Nasdaq broke through its pre-LTCM high. And the final exponential stage of the dotcom boom got going in October 1999 when the Nasdaq broke decisively through that summer's highs. On the other hand, a failure to break major highs can be what punctures the bubble. This is what happened on March 24, 2000, when Nasdaq approached, but failed to break the record of March 10, triggering a -33% plunge over the next three weeks. A similar pattern of double tops occurred that September, when the Nasdaq failed to break the interim highs set over the summer—and instead collapsed by -46% in the next three months.

If the Nasdaq decisively breaks 10,000, get set for a fresh bull-run

Last Wednesday, the Nasdaq composite exceeded by 2% its pre-Covid-19 high of 9817, set on February 19, but then fell back sharply. If the Nasdaq now rebounds above last week's 10,000 level, history suggests that the bull market will resume—and many more intrinsically worthless companies will soar to unimaginable heights. If, on the other hand, the outbreak of madness on Nasdaq turns out to mark a double top, the post-Covid equity bubble could deflate very quickly and the next big event for investors could be a test of the March lows. Which will it be? I have no idea, but I am pretty sure that market psychology, rather than monetary policy or economic data, will decide the answer.

Nasdaq bubble timeline 1997-2002

Dates	Events
March 25, 1997	Fed hikes from 5.25% to 5.5% after years of rate cuts, and sets off the Asian crisis
July 20, 1998	Nasdaq hits a record high of 2,014 as the Asian crisis abates
Aug 17, 1998	Russia defaults and devalues, Nasdaq falls -19% in two weeks, then rebounds
Sep 23, 1998	LTCM collapses
Sep 29, 1998	Fed cuts from 5.5% to 5.25%, Nasdaq falls -18% in one week
Oct 8, 1998	Nasdaq hits low of 1419, down -29% from July's peak
Oct 15, 1998	Fed cuts from 5.25% to 5%, Nasdaq rebounds
Nov 24, 1998	Fed cuts from 5% to 4.75%, Nasdaq recovers to July's high
Dec 31, 1998	Nasdaq sets new record of 2192, 54% above October's low
Jun 29, 1999	Fed starts hiking, from 4.75% to 5%
Aug 26, 1999; Nov 16, 1999; Feb 2, 2000	Fed keeps hiking, to 5.35%, 5.5%, 5.75%, respectively
Jan 10, 2000	AOL and Time Warner announce biggest-ever merger
Mar 10, 2000	Nasdaq peaks at 5048, 256% above its October 1998 low
Mar 15, 2000	Yahoo-eBay merger collapses
Mar 20, 2000	MicroStrategy forced to restate accounts. In two weeks the stock falls -77% from its high, after rising 2,600% in 12 months.
Mar 21, 2000	Fed hikes from 5.75% to 6%
Mar 24, 2000	Nasdaq approaches March 10 high but falls back, making a double top
Apr 3, 2000	Microsoft found guilty of Sherman Act anti-trust violations
Apr 10-14, 2000	Nasdaq plunges -25% in one week, down -35% from March 2000 high
May 16, 2000	Fed hikes from 6% to 6.5%, Nasdaq keeps falling
Jan 3, 2001	Fed starts cutting, from 6.5% to 6%; Nasdaq down -55% from March 2000 high but keeps falling
Jan 31, 2001; Mar 20, 2001... Dec 12, 2001	Fed keeps cutting, from: 6% to 5.5%, 5%...1.75%; Nasdaq keeps falling
Apr-Sep 2001	US recession
Oct 2001	Enron restates earnings, stock collapses followed by bankruptcy
Jun 2002	SEC investigates WorldCom, stock collapses followed by bankruptcy
Oct 9, 2002	Nasdaq hits low of 1114, down -78% from March 2000 high
Nov 6, 2002; Jun 25, 2003	Fed keeps cutting, from 1.75% to 1.25%, and finally to 1%