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'POP!' GOES THE MARKET? IDENTIFYING BUBBLES

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◆◆ *I can calculate the motion of heavenly bodies, but not the madness of people.* ◆◆

Isaac Newton

N<sup>o</sup> 1704 The 7<sup>th</sup> day of June 1720.  
Pursuant to One Act Anno 6. Geor<sup>g</sup>. Regis;  
for making forth new EXCHEQUER BILLS, not  
exceeding One Million; And for lending the  
same to the SOUTH SEA COMPANY, &c.  
This Bill entitles the Bearer to One Hundred  
Pounds with Interest at one penny a Day,  
and is to be current in all Payments to the  
Crown & to be Exchanged by Trustees at or near  
the Exchequer for Ready Money upon demand.  
Halifax



Image source: The Trustees of the British Museum

# WHAT DEFINES A BUBBLE?

- ▶ “Bubble” came into parlance from the British 1720’s “Bubble Act” following the South Sea Bubble
- ▶ Securities traded considerably higher than their “intrinsic” value (as opposed to price/current or book value)
- ▶ Investors buy not for their fundamental value, but because they plan to re-sell at a higher price to the next investor
- ▶ A bubble is followed by a ‘bust’ or ‘crash’
- ▶ Bubbles are only identified in retrospect due to the inherent difficulty of intrinsic valuation in real time



# WHAT MAKES IT A BUBBLE?

## ▶ **An initial ‘story’ that sparks demand**

- ▶ Craze or fashion: Tulips introduced to Holland in 1620s
- ▶ Government policy: Mississippi & South Sea bubbles
- ▶ This time it’s different: “Economic new era” Coolidge 1920s; technology driven productivity growth 1990s

## ▶ **Leverage**

- ▶ Tulip mania: investors mortgaged houses and businesses
- ▶ Roaring 20s: expansion of consumer credit, including consumer margin lending credit
- ▶ Japan 1990s: financial market deregulation, loose monetary policy and zaitech

## ▶ **Crash**

## ▶ **Hubris**

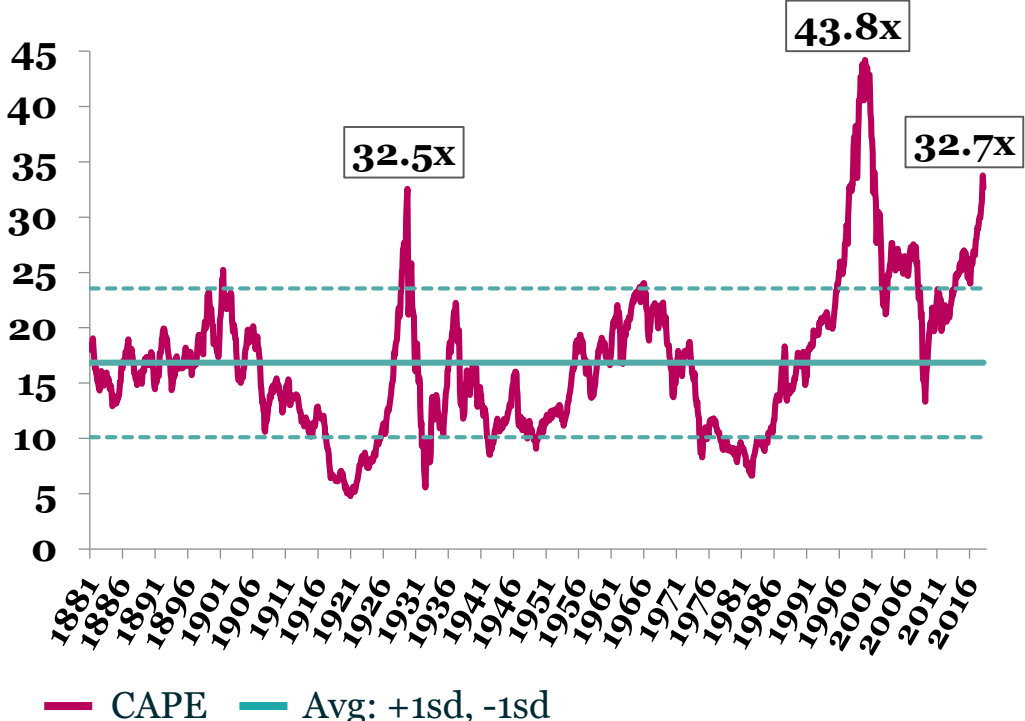


◆◆ *...a company for carrying on  
an undertaking of great  
advantage, but nobody to  
know what it is!* ◆◆

# VALUATION

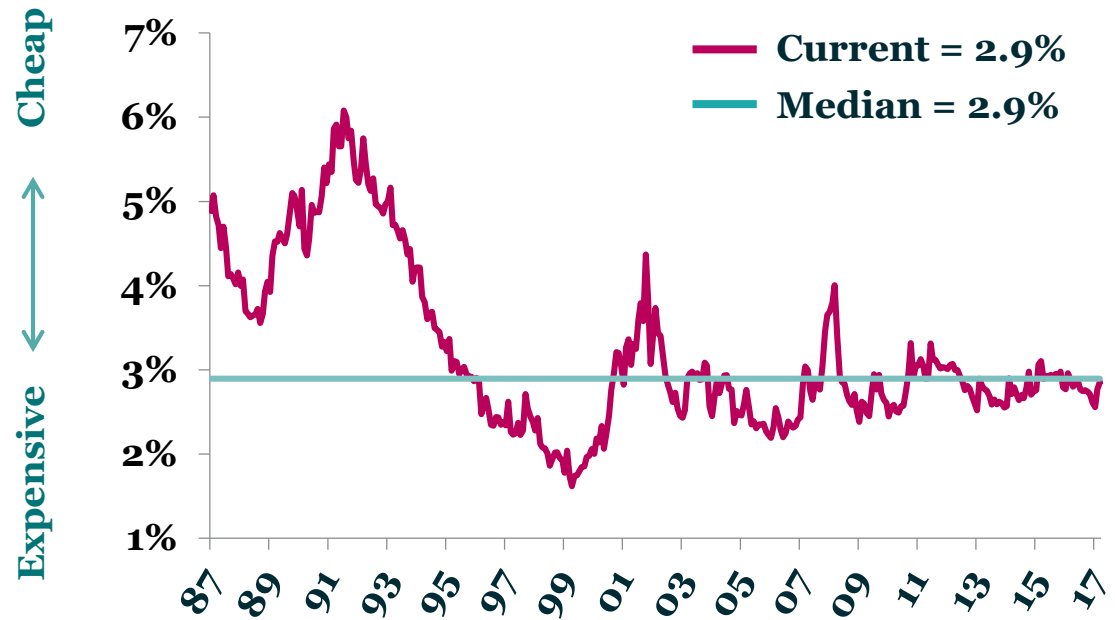
Shiller PE close to the highest level ever bar the tech bubble...

Cyclically adjusted PE ratio: 1881 - 2017



Equity risk premium not yet at extreme levels...

US: DDM implied equity risk premium

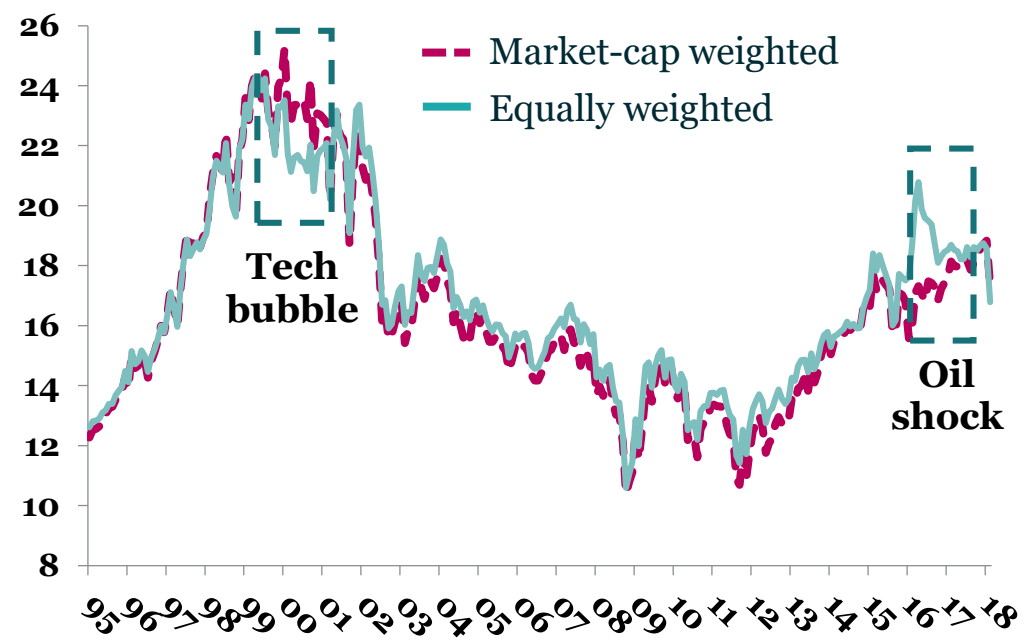


Source: Robert J. Shiller online data and AXA IM Research, March 2018. PE = Price/Earnings and DDM = Dividend Discount Model.

# SECTORS

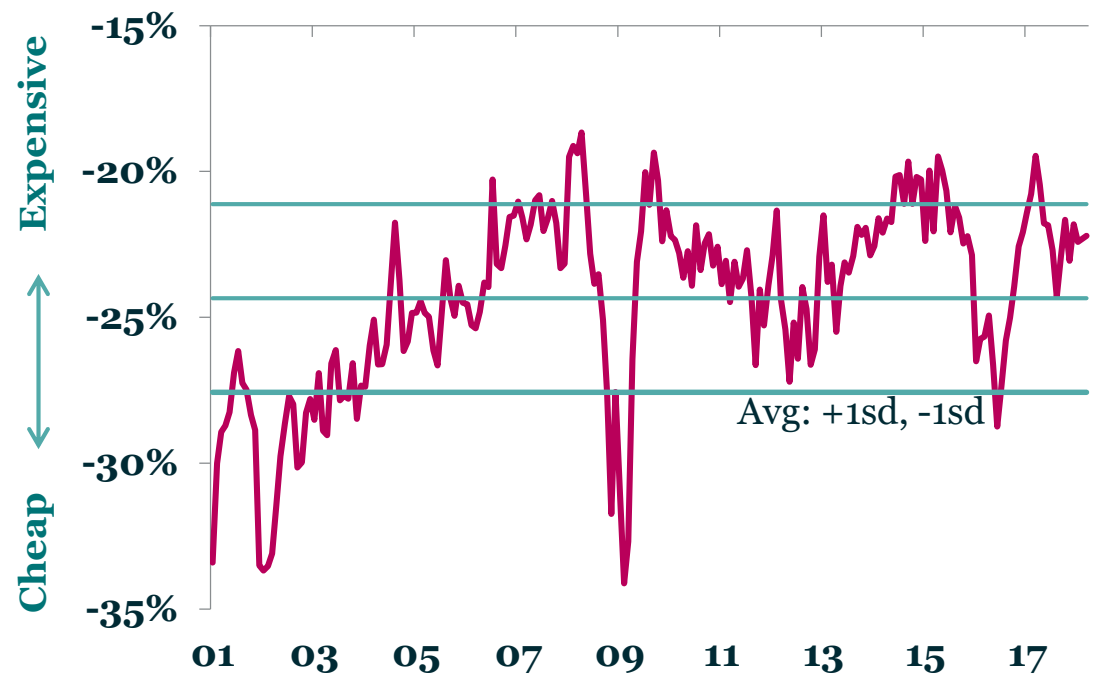
## Sector composition doesn't change much...

US valuations: market-cap weighted vs. sector neutral



## Value spreads remain close to historical norms...

S&P 500 PE spread: cheapest quartile vs. median



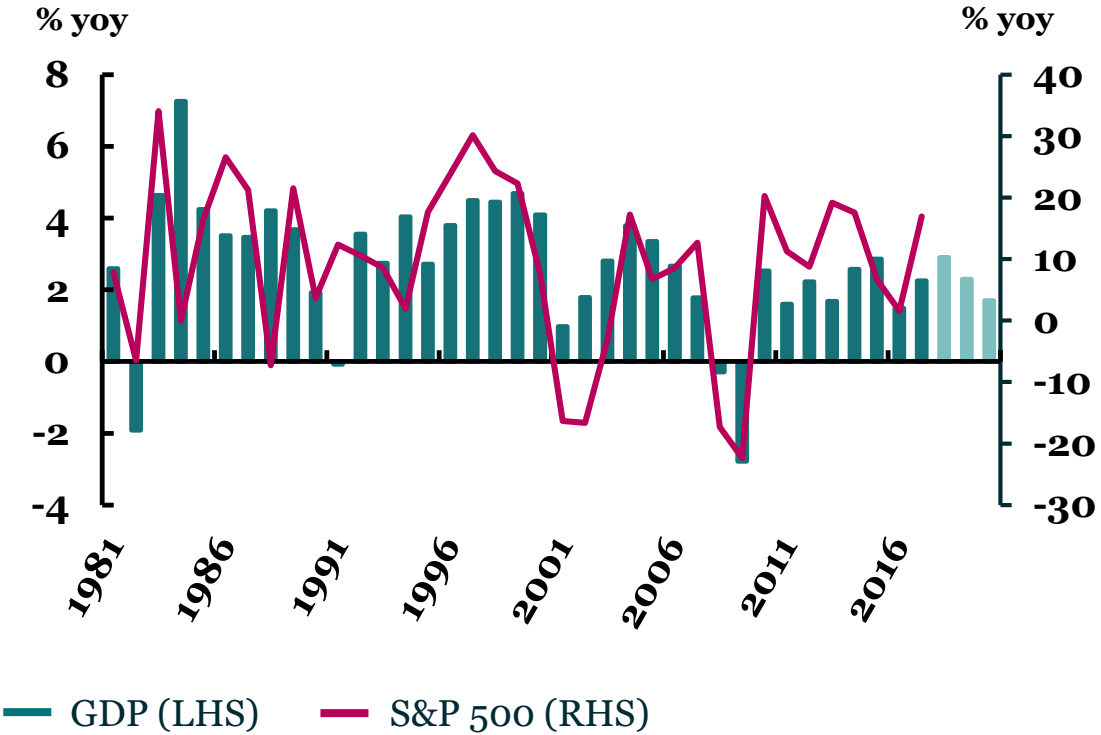
Source: Datastream, IBES, Bloomberg and AXA IM Research, March 2018



# THE CYCLE

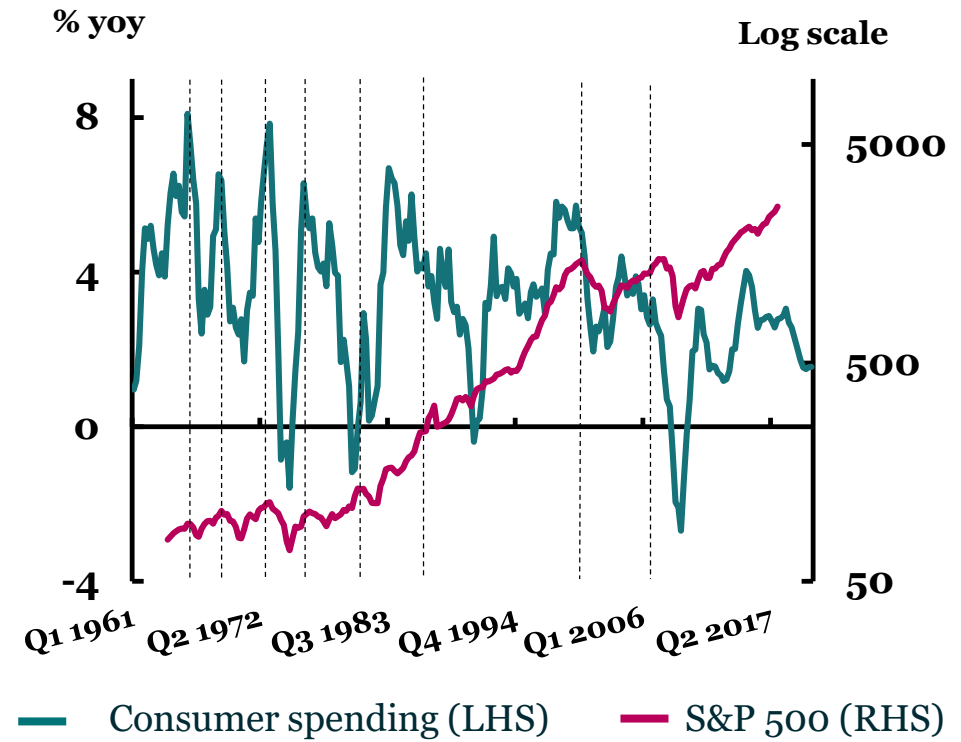
## Outright declines in stocks tend to arise with recessions

Equity performance & the economic cycle



## Peak in consumer spending precedes stock declines

Peak consumer spending and S&P 500



Source: Datastream, BEA and AXA IM Research, March 2018

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