Thoughts Approaching the Top of a Bull Market

This is a conflation of two articles written in late December 1999 and early February 2000 as the world approached the top of the tech and internet boom. I had been giving a similar message for many months. It is an excellent example of the thinking around phase analysis that has enabled me to avoid many bear markets by reducing exposure to the market once we see rampant speculation around us.

Is the Stock Market due for a Correction?

The evidence seems to be all around us as 1999 closes that the stock market is in the terminal phase of a bull market and I have for some time been warning of the "lateness of the hour" in articles and at my seminar. My primary technical tool for identifying market risk and adjusting my asset allocation to shares is Dow Theory phase analysis. This was outlined by Robert Rhea in his book The Dow Theory in 1932 and remains as incisive a tool today as when it was first written. Rhea described the development of bull and bear markets in terms of the phases they most commonly moved through. By identifying which phase we are in at any time, we can adjust our strategy to take advantage of opportunities and protect ourselves against risk, as I teach in my seminars. Bull markets form in three phases. The final phase is called "rampant speculation", an excellent description of what will be happening at that time. It is useful to review some of the evidence which is very plain to see all around us:

General overvaluation of shares

Price Earnings Ratios are currently high by historical standards at over 23 times at end November. While low interest rates accommodate higher PE ratios, the current level is still high and threatened by inevitable increases in rates as economic managers deal with rising inflation which will be triggered by the GST, rising oil prices and tightening employment.

The current boom in prices of Internet, communications and technology stocks

Price movements seem to have departed from rationality, jumping by extraordinary amounts, sometimes in a single day.

Participation of the public in the stock market to an unprecedented extent

Some of this is statistically due to large privatisations, but these are in themselves a marker for over valuation. Governments only sell assets when they can sell them to the public for more than they are worth.

Great numbers of new companies are being floated

Many of them with dubious prospects and no history of profitable operation. There is a stampede of private investors to get allocations in floats, with few if any bothering with the prospectus. This flood of floats is telling us that the owners of businesses are seeing prices on the stock market that are in excess of what they know their businesses are worth. There is no other rational reason for them to sell part of their equity.

Speculative mining companies are changing their names and raising new capital

This is always seen in the terminal stage of a boom in this country.

There is a media orgy in covering markets
The stock market is reported in every TV news, there are TV programs about the markets and trading, newspapers have expanded their financial coverage, new specialised magazines have been launched.

Stock brokers are interested in private clients again
There is an incredible volume of advertising and promotion to private investors and blatant encouragement to trade rather than invest.

Trading systems are being intensively advertised and promoted
Most of these people are telling would-be traders what they want to hear – that trading is easy and an attractive life style.

The evidence is all around us that we are in phase three (rampant speculation) of a bull market. This does not mean it will end tomorrow, or next week or even next month. No one knows when that will be, though the pundits (aka fortune tellers) will make all sorts of forecasts. However, the answer does not lie in forecasting, but in the way we deal with the elevated risk. This is done by a reduced asset allocation to shares and concentration on defensive situations.

Remember two enduring pieces of stock market lore:

- Professionals buy undervalued stocks at the start of a bull market and sell them to the public at the end of a bull market. Ask yourself whether this is happening now.
- The public are always wrong at the turning points. Join them at your peril.

May 2000 be kind to those of you who managed risk appropriately for the circumstances.

Is It Really Different This Time?

We live in interesting times. Of late many have been saying that we live in times that are unprecedented in history. The strange thing is that the longer I spend in the markets, the more things I seem to have seen before come around again. Not only that, but I also recognise them in books on the history of markets.

Much is made of the new age of information, communications, and biotechnology etc. Yet there have been similar eras in the past, some of them in my lifetime, many before. Those that spring readily to mind, in no particular order, are the internal combustion engine, electricity, radio, television, the printing press, the telephone, computers, the transistor, electronics, air travel. I am constantly struck by the similarity of the current internet boom and the age of electronics in the 1960s.

Then again much has been made of the low inflation, low interest rate environment. However, such periods have been seen many times in the past and they are always followed sooner or later by excesses that lead to inflation.

Also much is made of the ability of modern governments to manage the economy based on lessons learned in the past. As an economist by training, I am here to tell you that I have no such faith in our political masters or my fellow economists. Economics is a frightfully inexact *science* and the economic system is only vaguely understood, partly because it is incredibly complex, with dynamic interrelationships of variables, does not lend itself to real-time measurement of parameters and is evolving constantly.

One of the seductive untruths about the forecasters is the conviction many mistakenly believe that if a person can explain the past, they are qualified to forecast the future. However, the two are completely different things. Well after the event, we have access to information and insights born of perspective that are simply not available at the time events are being formed.

Of much greater importance is the idea that markets are driven by the psychology of human beings. Even worse, especially in a stock market boom, they are acting as part of a crowd. Crowd theory tells us, among other things that we all tend to lose our capacity for individual thought and action in crowds. Instead the lowest common denominator and the opinion leaders become our guides, to our peril. The interesting thing is that humans, as a group, have never so far learned from previous episodes, but continue to act the same way each time a situation occurs.

So, what can we do to avoid damage to our financial health when the bull market ends, as it most certainly will, sooner or later?

The most important thing is to be aware of history
Get the books and read them. Talk to the older traders about the 1960s, the 1970s and the 1980s. Ask how similar current conditions are, rather than seek to magnify differences – that is called rationalisation, or trying to select evidence to confirm what we want to see and hear. Stay aloof from the crowd. Question everything you read or hear, no matter how imposing the source.

Develop strategies now to ensure that you will be a survivor this time

Those who develop a capacity to take an independent and objective view around turning points in the market will be the great survivors. To quote Rudyard Kipling:

If you can keep your head when all about you
Are losing theirs …

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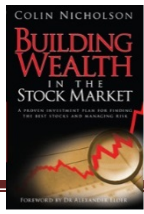

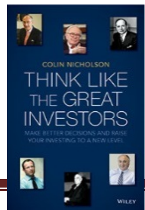

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