What Bubble?

There is a constant stream of doom and gloom about the US stock market. Much of it focuses on a "bubble" in the NASDAQ stocks. Many people are pointing to bubbles all over the place now. So much so, that I seriously wonder whether the word is now so debased that it has no real meaning. This is something that happens from time to time with the language.

In stock markets we should be able to see a bubble forming on a chart of the market index. Bull markets in stocks very often unfold over many years in a trend channel. During that time, prices rise and fall within the channel, respecting the upper and lower boundaries of the channel. Some of these rises and falls will cause us to expand the width of the channel, but it should not make its slope any steeper.

The chart below is of the NASDAQ Composite index from 1970:

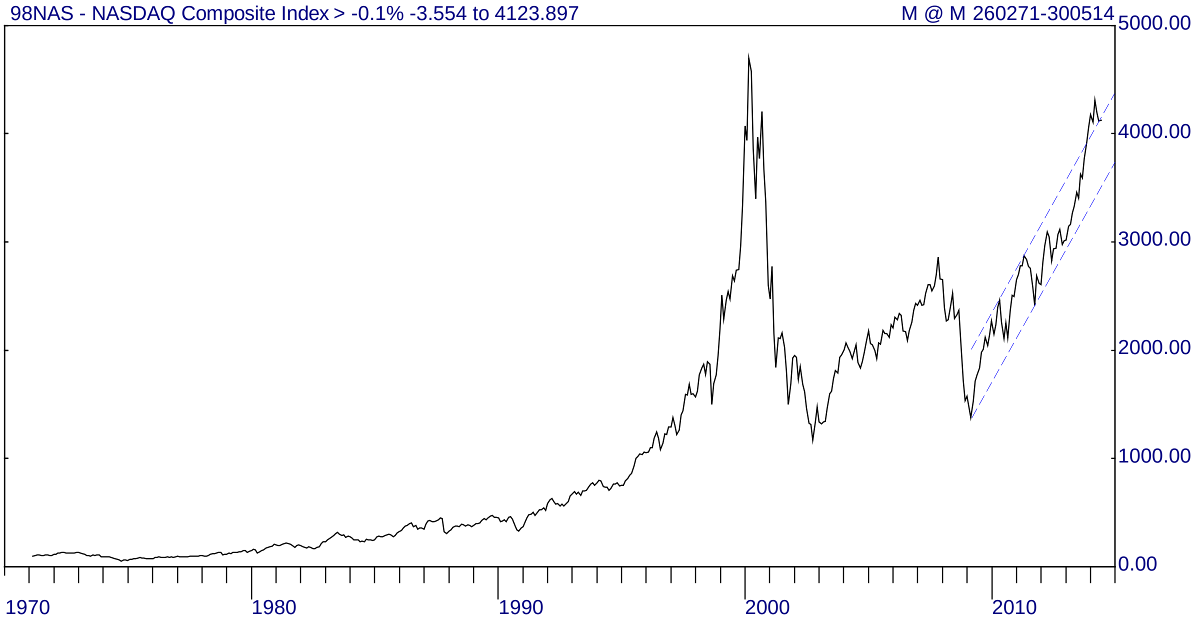
From the mid-1970s to the late 1990s the NASDAQ Composite index fluctuated within a trend channel. As the 1990s unfolded, the index began to travel towards the top of the channel. Then it broke out of the channel and began to soar upwards almost vertically. That is the bubble: when the market begins to rise at an unsustainable rate driven by wild speculation.

Now look at the present trend. Our trend channel is still somewhat tentative as far as its width is concerned. There will be some significant corrections along the way. At the moment, its slope is a bit steeper than the 1970s to 1990s period, but a correction or two is likely to dampen that slope and widen the channel. It is early days.

The important thing is that there is not yet any sign of acceleration out of the top of the channel in a true bubble.

It is important to keep in mind that all bull markets do not develop into bubbles and can end in other ways. Anything can happen, so it is always dangerous to form a fixed idea that there must be a bubble at the end and if you can't see one yet, then everything is fine.

Of course, if you want to find a bubble in almost any market, it can be done with a change to the scale. If we take the above chart of the NASDAQ Composite index and switch it to linear scale, we might have a bubble forming:



However that is simply an improper use of scaling. The first chart had a logarithmic price scale, which should be used whenever our chart has a wide dynamic range in the price. It is called a semi-log chart because the time scale is linear, as it should be, but the price scale is logarithmic. The logarithmic price scale means that every price change on the chart is represented by the same distance up the scale in percentage terms. This can be seen on the first chart: a move from 200 points to 400 points, a 100% growth, is represented as the same distance as a move from 2,000 points to 4,000 points, because it is also a 100% growth.

However, with a linear price scale, every price change is the same in units. So, on the second chart above, with the linear price scale, a move from 1,000 points to 2,000 points is the same as a move from 3,000 points to 4,000 points. But the move from 1,000 points to 2,000 points is a 100% rise, while the move from 3,000 points to 4,000 points is only a 33.3% rise.

Next time you hear someone tell you there is a bubble in a market, have a close look at the price scale on their chart. If it is a linear price scale, they are maybe manufacturing a bubble for you. Makes a good story, but the problem is that you are being misled!

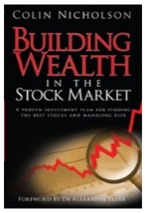
To read more of my work

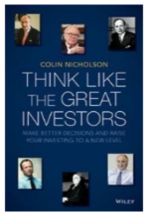
Previous Articles

All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

Books

I have written two books, both of which are available for purchase from the ***Buy Books*** menu:





BUILDING WEALTH IN THE STOCK MARKET – A proven investment plan for finding the best stocks and managing risk

THINK LIKE THE GREAT INVESTORS – Make better decisions and raise your investing to a new level

Members Website

Follow my thinking on my own investments, disclosure of my portfolio as I go, weekly market scans, weekly market charts and analysis plus many more articles about investing and analysis

I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website