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Anatomy of a Stock Market Bubble

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This past February, the US market-cap-to-GDP ratio—the value of all common stocks in relation to the fount of the income that publicly listed and traded companies can earn—reached 195 percent. The ratio had never surpassed 100 percent until the dot-com bubble in the late 1990s, when it peaked at 149 percent. And much like the dot-com period, there is a broad subset of stocks (mostly in technology) that have become completely untethered, particularly since the summer of 2020, from business fundamentals like earnings and even sales—driven higher only by euphoric market participants extrapolating from a past extraordinary trajectory of prices. A lot of today's US stock market has become what I call a "pure price-chasing bubble."

Examination of the history of comparable pure price-chasing bubbles shows there has been a set of key causal factors that contributed to these rare (I have found nine in total) market events; the presence of most of these factors has usually been necessary for markets to reach the requisite escape velocity. The most extreme instance of such a pure price-chasing bubble was one I had the opportunity to study firsthand in the early 1980s as an adviser to the central bank of the United Arab Emirates: an over-the-counter market in Kuwait called the "Souk al-Manakh," which, at its peak, had a market capitalization behind only that of the US and Japanese stock markets and greater than that of London. Studying this exemplar may shed light (albeit unflattering) on the current US equity market.

Such bubbles are always preceded by a multiyear period of extraordinary price appreciation in shares and, in most cases, a period of extraordinary economic expansion, giving rise to optimism and euphoria. Indeed, income growth (driven largely by oil) in the Gulf states in the decade leading up to the 1982 Kuwait market peak was unparalleled. In addition, moral hazard had come to skew perceptions of risk: intervention by the Kuwaiti government to arrest a normal market correction in 1977 spawned a belief among market participants that support would always be forthcoming. To fuel the bubble further, there was a rapid expansion of bank money beginning three years before the market peak—but the expansion of credit was even greater, owing to an explosion of margin credit (with implied annualized interest rates sometimes reaching 100 percent) through an informal system utilizing postdated checks. Moreover, a small group of highly indebted bullish traders, along with the Souk al-Manakh companies themselves who speculated in the market, manipulated the Souk al-Manakh stocks ever higher. Finally, the concentration of these events in a small geographical domain contributed to contagion and herding effects.

The US market certainly exhibits an exceptional record of price appreciation, with the S&P 500 having risen by almost 500 percent over more than a decade. In contrast to most other bubbles, however, it is notable that US economic growth over this period has been relatively anemic. With respect to moral hazard, the bailout measures during the 2007–9 crisis along with the quantitative easing policies that followed are just the most recent instances in a half-century pattern of ever-greater policy interventions that have distorted risk perceptions. Although low interest rates have not played a major role in past price-chasing bubbles, very low rates contributed to the duration and amplitude of the stock market's trajectory over most of the last decade, and have operated as a signal to market participants that reinforces the moral hazard dimension. Regarding the growth of credit, although the Federal Reserve's statistics do not reflect it, the United States has experienced a massive increase in nonfinancial enterprise debt. Due to a sustained high rate of corporate equity purchases financed with debt, this overarching expansion of credit has also made its way into the last decade's bull market and steepened its price trajectory. While geographical concentration played a role in the Souk al-Manakh's contagion and herding effects, in the US case it is social media in the internet age that has acted as the accelerant. The role of message boards and chat rooms—with their millions of participants, all in instant real-time contact—has created crowd dynamics in speculative stock market favorites at a pace without parallel in other pure price-chasing bubbles.

For the Souk al-Manakh, prices crashed in August 1982 to a point where there was a giant collective margin call on the network of postdated checks that could not be met. The likely outcome for the US bubble will not be as catastrophic, but the lesson of these rare price-chasing phenomena is that a peak will be reached, a decline will follow, and the psychological dynamics in play on the way up will go into reverse and will accelerate the fall. Moreover, in the context of a grossly underestimated mass of corporate debt, history tells us the consequences of the bursting of the US stock market bubble should be another financial crisis and another recession.

A more detailed discussion of the issues can be found at levyinstitute.org/publications/the-souk-al-manakh-the-anatomy-of-a-pure-price-chasing-bubble

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