

Bubbles and Busts: Lessons Learned From China

Recent stock market conditions in China present a classic illustration of the boom/bust cycle that periodically disrupts financial markets. While bubbles and subsequent busts occur in the investment world from time to time, there are typically some telltale signs to help investors recognize when there is trouble brewing.

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"Fasten your seatbelts, it's going to be a bumpy night." Hollywood's famous line could well apply to anyone invested in Chinese equities. After hitting a high on June 12, 2015, the Shanghai Composite Index tumbled about 30% over the next month and experienced its steepest one-day drop in eight years on July 27, 2015. This follows a dramatic run-up that saw the same index gain more than 150% over the preceding year.¹ The bubble and subsequent bust, as many analysts are calling it, offers a cautionary tale for momentum investors.

Largely driven by speculative investors looking to make a quick buck (or, more precisely, renminbi), China's latest run-up was stoked by the Chinese government, which loosened margin requirements and encouraged investment. Although China subsequently tightened restrictions, it did not prevent the ensuing selloff. But the boom/bust pattern is not the first China has experienced in recent years. The Shanghai Composite Index tumbled by 71% between October 2007 and October 2008, following a 223% run-up in the preceding year.¹

In both instances, valuations, as measured by the price/earnings (P/E) ratio, climbed precipitously. At its March 2015 peak, the P/E ratio for the Shanghai Composite Index climbed to over 40, a level that has been breached just twice during the past decade. By comparison, the Standard & Poor's 500 Index has a median P/E ratio of about 20.²

When Is a Bubble a Bubble?

Most investors now agree that the U.S. stock market boom of the late 1990s -- particularly the boom in technology stocks -- represented a classic bubble. That cycle saw the NASDAQ Composite index grow more than 200% between February 1997 and February 2000, and then fall 66% by August 2002.¹ But at what stage was it considered a bubble? In 1996, Alan Greenspan famously accused investors of "irrational exuberance," yet markets went on to score strong gains for three more years. Investors who heeded Greenspan's warning at the time would have missed out on one of the best performing periods in market history. But they also would have avoided the subsequent bust. The key, of course, is timing.

While even the experts cannot time markets, there are some warning signs that may point to a bubble in the making:

- **High valuations:** When valuations, measured by P/E ratios, rise significantly above their long-term averages, this should raise concern. Over the long term, valuations tend to revert to the mean.
- **Disconnect with fundamentals:** In general, a company's stock price is based on its sales, earnings, financial strength, and future prospects. When these fundamentals go in a different direction from prices, it should wave a red flag.
- **Hype:** Beware whenever you hear the words: "This time it's different." Those who lived through the tech bubble in the late 1990s may recall "the new paradigm" that was often cited by hawkers of overpriced stocks.

Of course recognizing a bubble in the making is the easy part. Determining when it is about to burst is a different story. For long-term investors, the important point is to put performance in perspective and know that sharp increases in prices, in aggregate, are generally not sustainable over longer periods of time. So if you do spot a bubble in the making, use caution and be sure to work with a professional.

¹[Yahoo! Finance](#) and *The New York Times*, "[Chinese Shares Tumble Again.](#)" July 27, 2015.

²Bloomberg Business, "[Shanghai Composite PE Ratio Reaches 44X--The Price-To-Whatever Bubble.](#)" March 26, 2015.