Is this Tech Bubble 2.0?

Twenty years ago, Warren Buffett used the analogy of Cinderella's ball when describing investors in the midst of the tech bubble. They were "giddy participants [who] all plan to leave just seconds before midnight", he said. "There's a problem, though: they are dancing in a room in which the clocks have no hands."

Today, with valuations of the large tech stocks soaring to record highs, one could rightly wonder if we are in another tech bubble.

There are, of course, all kinds of plausible justifications for the current elevated valuations of tech stocks. These include record-low interest rates, due to central banks printing money like mad; lockdowns that have accelerated the widespread adoption of numerous technological services; and the strong balance sheets and gushing cashflow generation of the current market darlings that were absent in the tech bubble of 2000.

But to assess the danger of our current stock investments turning into the proverbial pumpkins and mice, we should perhaps look back even further into the past. The go-go era of the "Nifty 50" stocks in the US, half a century ago, is instructive. In the early 1970s, the dominant narrative was that a group of roughly 50 blue-chip growth stocks were going to be inevitable long-term winners and could comfortably be bought at very high valuation multiples.

These companies included Coca-Cola, Procter & Gamble, Johnson & Johnson, Pfizer, Philip Morris, IBM, Walmart and Gillette, all of which traded at sky-high p:es.

There too, investors justified these expensive share prices on the basis of strong long-term growth prospects. And, in the two years following the market's peak in early 1973, earnings did indeed grow strongly, but the market (including the share prices of the Nifty 50) roughly halved.

The reasons for this sudden bear market included an oil price and inflation shock, political turmoil globally, the end of the global monetary system and a jump in unemployment.

Now, I don't believe that anyone can forecast the exact timing of the next bear market's arrival. But we can look for signs of just how rowdy the current tech party is, to assess how close we are getting to the midnight peak.

At the moment, the elevated valuations are being justified on the basis that "this time is different". The argument goes that because we have never seen global interest rates so low, and there is therefore no investment alternative, these valuations may be sustainable.

It's true that we've never seen interest rates this low, but countries that have experienced ultra-low interest rates before – such as Japan, Sweden and Switzerland – did not have roaring domestic equity markets after their real interest rates turned negative.

Also, late-stage bull markets tend to be associated with low breadth – only a handful of stocks are responsible for the final surge in the index level. Current market breadth is particularly low, as represented by the "S&P5" vs "S&P 495" performance gap.

Usually, there is a surge of popular public participation in stock market bubbles, with apparently easy money being made by many – an ominous similarity to conditions today.

Back in 1969-1972, 1985-1987 and the late 1990s, we saw a wave of IPOs just before the crashes. Interestingly, there is a significant increase in IPO filings for the last quarter of 2020. This includes many special purpose acquisition companies, for which persuasive promoters are making optimistic promises about future prospects.

Investors who advocate for not selling growth stocks even when valuations seem very stretched would, counter to my cautious stance, cite a study done by Jeremy Siegel more than 20 years after the 1973 crash.

Siegel's conclusion was that the Nifty 50 stocks did not perform worse than the overall market from the early 1970s up to the late 1990s. Trouble is, a later study by Jeff Fesenmaier and Gary Smith showed that just one exceptional stock, Walmart, was mostly responsible for the Nifty 50 catching up with the general market two decades later.

Had you excluded Walmart, you would have done substantially worse than the market if you had bought the market darlings at their peak in January 1973 and held on for the long term. And this is so despite the fact that the Nifty 50 grew their profits at an above-average rate and were, generally speaking, the long-term winners in their respective industries.

Of course, it is true that selling in anticipation of the next market crash has historically cost investors more than the crashes. Nevertheless, this does seem to be one heck of a tech party. We can't tell the exact time, but the clock is ticking closer to midnight. If you plan to stay, I suggest dancing close to the exits.

Otherwise, if you can stand the Fomo (fear of missing out), it might be a prudent time to decrease your exposure to expensive global tech stocks. x

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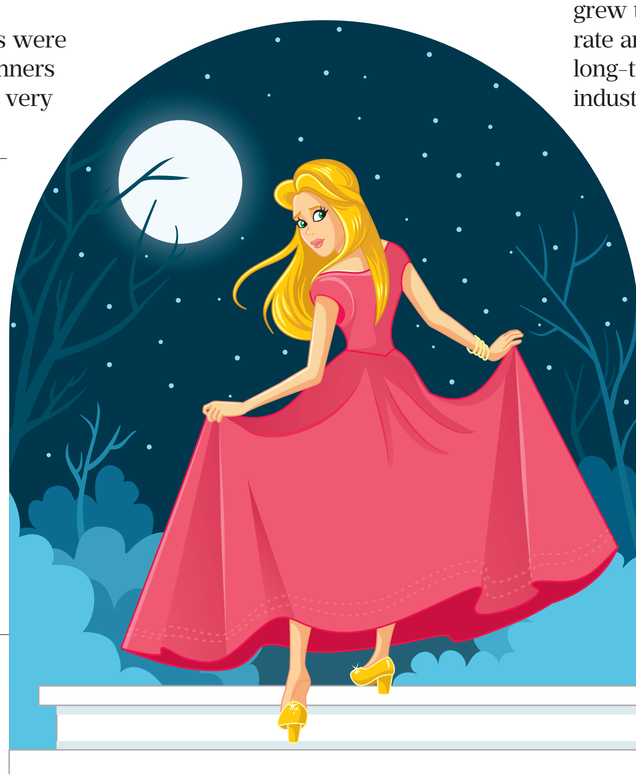

The clock is ticking closer to midnight at Cinderella's Big Tech stock ball

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