See How to Identify and Trade Stock Market Bubbles

Stock market bubbles often evoke fear among the general trading community. The phenomenon occurs every so frequently in the markets across different asset classes. While a stock market bubble can be scary for some, they also provide great trading opportunities for the rest.

Investing guru, Warren Buffett’s famous quote aptly captures the essence of a stock market bubble:

> *Fearful when others are greedy and greedy when others are fearful.*

The quote captures the undeniable fact that investors’ greed often leads them to making wrong decisions. It is therefore common to find investors buying at the tops and selling at the bottom.

Understanding what a stock market bubble is and the reasons why the bubbles form can help the average investor to make better investing or short term trading decisions.

Stock market bubbles – What are they?

A bubble in the market is formed when the asset becomes overvalued over time. This comes as investors start to ignore the basic fundamentals. Greed is another factor that plays a major role in a market bubble.

When a stock or a particular sector starts to show signs of steady appreciation investors often flock to such assets to make a quick buck. However, in most cases, this leads to placing risky bets.

Stock market bubbles can occur in two ways.

- The first type of a market bubble comes when the asset is rapidly expanding. You can often see this with the stock chart rising in a near parabolic fashion.
- The second type of a market bubble occurs over a prolonged period of time. The asset tends to trade sideways with the market valuation often failing to justify the price.

Obviously, the first type of a market bubble is easier to identify. This type of bubble lasts for a short period of time, often spanning a few months to a year. The second type of a market bubble is more difficult to trade. Technically, it does not qualify as a bubble and can also qualify as a mere market correction.

The Dutch Tulip Mania

When talking about market bubbles, the Dutch Tulip Mania requires a mention. The first ever documented market bubble in the history is the Dutch tulip mania. Tulip bulbs had a major role in the history of the Dutch ever since they were introduced to the Netherlands.

In the mid years of 1600, the tulip bubble burst as price of the tulip bulbs rose sharply. Prices were bid higher as speculators started to buy and overvalue the price. Because tulips were able to withstand the harsh winters, it was seen as a valuable resource for the Dutch to trade.

Soon enough as tulips became popular, derivative markets started to come up allowing speculators to gain access to the tulip market. Investors flocked to invest in the tulip markets to make a quick profit. As the optimism grew, investors soon started to sell their belongings in order to get a piece of the pie.

By some estimates, price of tulip bulbs exploded twenty fold in just a few months time. The events leading to the tulip bulb crash came on a default by a contract buyer.

As the news of the default spread, investors started to sell their positions. This quickly lead to more sellers in the markets than buyers and the price of the tulip bulb quickly imploded.

Anatomy of stock market bubbles – The Crypto currency Bubble

A market bubble has some unique characteristics. Of course this can only be seen in hindsight. However, there are some patterns that continue to repeat on and off. Let’s take a look at the Bitcoin chart below as an example of understanding the market bubble.

Bitcoin bubble – Anatomy of a stock market bubble

The chart above shows the typical phases in a market bubble. The main phases are as follows:

The stealth phase

This is the initial phase of the asset. At this point, the asset becomes a “good investment.” Valuations are not extraordinary and in most cases, the asset does not garner much attention. You can mostly find institutional investors accumulating in this phase.

The take off phase

The take off phase occurs when the asset begins to rise rather rapidly. In this phase, the asset still does not garner much attention. News about the asset is rather critical and dismissive.

The first sell off

In this phase, when the sell off occurs, the asset once again starts to gain attention. The initial dismissive claims of the asset are validated and the asset is once again written off. Investors who gained an early position often tend to exit their positions out of fear.

Market hype and greed

The market hype and greed occurs when the asset starts to pick up momentum again. This phase starts off with the same dismissive claims but soon picks up heavy media attention. You will find a lot of articles and news coverage at this phase. As the asset starts to rise further, analysts and gurus tend to become cheer leaders. This has a placebo effect as investors get drawn in.

The bull trap

The bull trap is the second sell off. However, due to the attention the asset gains, buyers enter the market buying the dip. This alone helps to push the asset briefly higher. A noticeable fact here is that the second top that is formed is often lower than the previous top.

Capitulation phase

In the capitulation phase, the buyers who entered in the bull trap phase are the first to exit the position. This leads to a steady decline that gathers momentum as more investors also start to exit their positions. The capitulation phase is when the bubble bursts.

Reversion to the mean

After a steady sell off, the asset tends to bottom out, reverting to the mean. Market valuations and the price of the asset returns to its mean price. This typically marks the end of the bubble phase before the cycle starts to repeat again. There are many ways to apply the reversion to the mean. The simplest of all is to use a 200 day moving average on a daily chart.

How to trade and profit from a market bubble

Stock market bubbles behave irrationally many a times. One of the common mistakes made by investors is timing the top of the rally. However, this can barely guarantee any success. In many cases, stock market bubbles are identified only after the market crashes.

There is a good chance that the asset class or a stock can remain in a bubble for prolonged period of times. Investors who panic and close their positions will find that they exit their positions prematurely. On the other hand, speculators preparing to go short will find that they have ill timed the market.

So what is the best way to profit from a stock market bubble?

For starters, profiting from a stock market crash works with short term speculation. Speculators or day traders can either short sell the stock or look to the derivatives markets. With many new products available as derivative, speculators can look at options and futures as a way to profit in a market crash.

Before you begin to even think of trading the market bubble you need to first look out for the signs.

Market sentiment

The most important aspect to get the bubble right is to look for tell tale signs. Still, this does not guarantee you a ticket to profits. One of the first things to look for in a bubble that is forming is the market sentiment. This can typically occur when bulls outweigh the bears.

With market sentiment being optimistic, one can find analysts cheering the stock. You can often notice this when you turn to the financial news networks. In many cases, you can associate market bubbles with exuberance as analysts give out their expert opinion. Relying on such “expert opinion” comes with consequences.

When you come across such a pattern, always be wary. Retail investors and day traders are famous for buying at the tops.

Patience

Patience can play a big role if you want to get it right in playing a stock market bubble. Speculators or day traders who get in too early will find that getting it wrong can be costly.

With the sentiment in the asset or the market at all time highs, more money starts to pour in. This tends to push the price of the asset marginally higher. Therefore, an ill-timed position can be disastrous.

Confidence

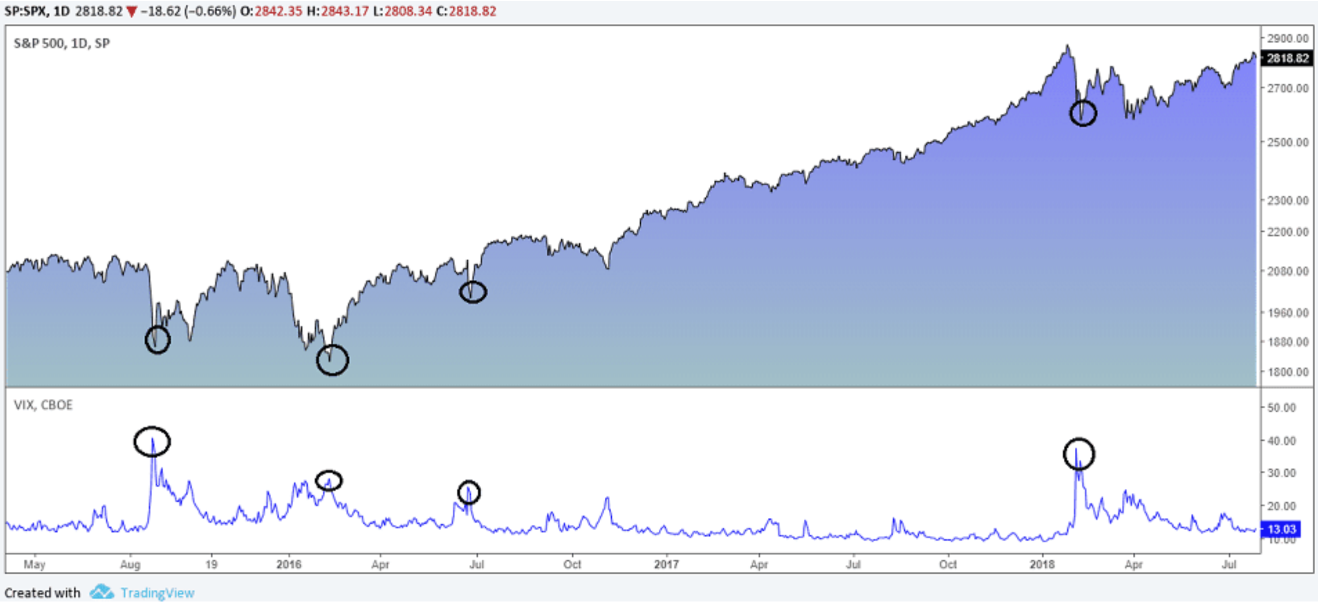
Confidence also plays a major role in getting it right when trading a stock market bubble. It is not difficult to fall under the influence of the market euphoria. More importantly, the so called "gurus" tend to appear on television sounding confident about a certain stock or an asset class.

If you are not confident in your own analysis, you can easily fall victim to the general recommendations. In many cases, blindly following the stock recommendations by such analysts can set you up for disappointment. There can be cases when your analysis is right. When you give in to peer pressure, a right position can be influenced wrongly by opinion pieces and articles from others.

Validation

Validating your bias can be a great way to improve your confidence. For example, the CBOE's Volitility index is a great way to validate your position when trading the S&P500 index. The volatility index, based on the option positions is a great indicator of gauging fear among investors.

Some of the major market turns are often associated with the VIX pushing higher. The chart below shows an example of the market turns and the behavior of the VIX index.



CBOE Volatility Index and the S&P500 Index

Speculators and investors can use similar methods to apply to other sectors as well. Looking at the index of the sector, such as the iShares Biotechnology Index ETF (IBB), it can allow investors to validate their positions on the individual stocks in the sector.

Derivatives

Derivatives are the best place to go to during a market bubble. Of course, not all assets are available and it depends on your investing or speculative goals. Still, some of the most popular derivatives are the futures markets for U.S. stock indexes, options for trading single stocks to name a few.

Due to the leverage that comes with most derivatives, speculators can trade the bear market in a bubble with relative ease.

Market bubbles and technical validation

If you look close enough, you can profit from a stock market bubble with an objective bias. For example, the different phases in a stock market bubble is similar to the Elliott wave theory. The third wave, which is the longest is based upon the human psychology. Markets tend to move in cycles and form repeated patterns over time.

Another way to look at a stock market bubble objectively is the reversion to the mean. Known as the mean reversion, it is a financial theory that postulates that the price of an asset and its valuation reverts to the mean in the long term. When there is a strong deviation from the mean price, you can expect to see a reversion occur at some point.

However, the trick is in understanding when the reversion to the mean occurs.

While market bubbles can seem scary, investors and speculators can form an objective opinion based on the various tools available. Human emotion and psychology plays an important part in the cycle of the market bubbles. It can be easy to panic during a market bubble. This is when emotions start to dictate investment decisions.

By closely observing the current markets and studying the previous market bubbles, an investor can gain better perspective. This will help ensure that when the next market bubble occurs, you are better prepared and know what to look for.