FINANCIAL MANIAS AND THE TRADE OF A LIFETIME

By Peter Kendall

Stock markets shifted from the usual up-down-up rhythm of a bull market back in 1997 to something bigger and more exciting—a straight-up run in prices that is the most magnificent of all market animals. It's called a mania.

Manias are rare episodes when ever-higher prices create a carnival atmosphere in the financial realm that eventually moves outward to society itself. An extreme, self-reinforcing optimism marks financial manias. This unremitting optimism makes people believe in a new era of uninterrupted economic growth and leads them to demand luxuries of all kinds.

By studying past mania experiences, traders can gain valuable insight into the collective emotions that drive their markets. It's possible to make significant money in the advancing stages of a mania with no knowledge of its existence. But there is nothing like recognizing a mania for what it is in real time to help a trader keep those gains and deal with the relentless crash after it peaks.

DEFINING A MANIA

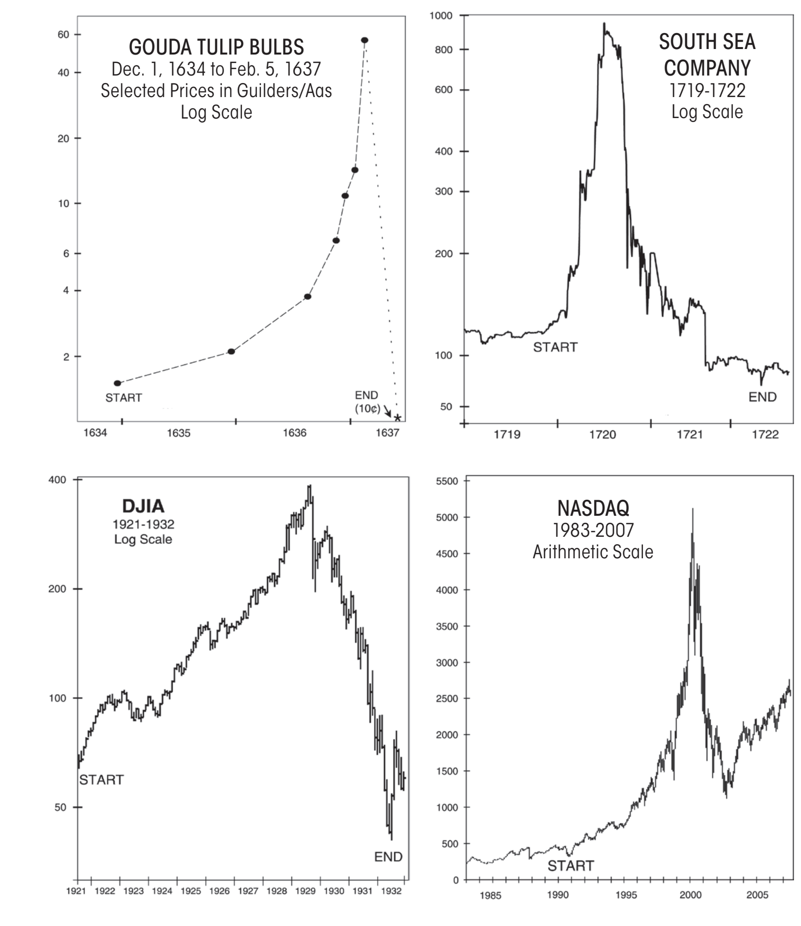
The most important sign of a mania is a lack of upside resistance. First and foremost, a mania is a powerful and persistent rise in prices that is offset by shallower and increasingly infrequent corrections. Once the rise surpasses all expectations, people begin to universally accept that it will be a perpetual rise. The longer the mania lasts, the more they simply forget that markets also fall—and sometimes crash.

Once the belief that the market will always rise becomes widespread, it actually signals the start of a price swing that tends to be a career-breaker for any trader who tries to oppose it. Historically, the decline takes the form of a relentless fall; one that John Kenneth Galbraith called a "mass disillusion and crash."

"It never comes gently," Galbraith said, and it "is always accompanied by a desperate and largely unsuccessful effort to get out."

Thus the famous skyscraper pattern on stock charts exhibited by history's four most renowned cases, shown in *Figure 1*. They include the Dutch Tulip mania, which culminated in 1637; the South Sea bubble of 1720, which gripped London in a feverish speculation in New World enterprises; the Roaring '20s stock advance and crash of 1921-1932; and the NASDAQ boom and bust of the 1990s and early 2000s.

FIGURE 1: The Historic Mania Model



Source: Elliott Wave International; data source for South Seas, Global Financial Data

As Robert Prechter, editor of *The Elliott Wave Theorist*, observes: "Regardless of extent, every mania is followed by a decline that ends below the starting point of the advance." This is the critical point for traders to understsand, because it means that whatever the mania creates, the corresponding bust will take it all away.

CURRENT MANIAS

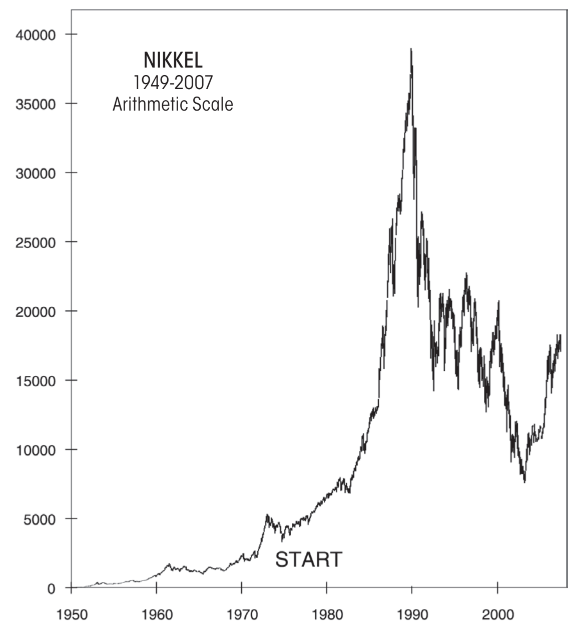
These four manias have come and gone, but they have great relevance to today's markets. *Figures 2* and *3* are pictures of a mania/bust-still-in-the-making. Their most prominent feature is an important departure from the standard straight-up-and-straight-down pattern.

Figure 2 illustrates the Japanese Nikkei, which has yet to return to its start after a manic rise to its all-time high in December 1989. *Figure 3* shows the Dow Jones Industrial Average, which reversed in 2000. It appeared to be beating a standard post-mania retreat until it made a sudden U-turn in October 2002. Since then, it has actually returned to a new all-time high. Also, look back at the NASDAQ chart in *Figure 1*, notice that the speculative core of the rise that ended in 2000 has yet to take out its Jan. 14, 1991, bubble-era starting point.

THE MOMMA OF ALL MANIAS

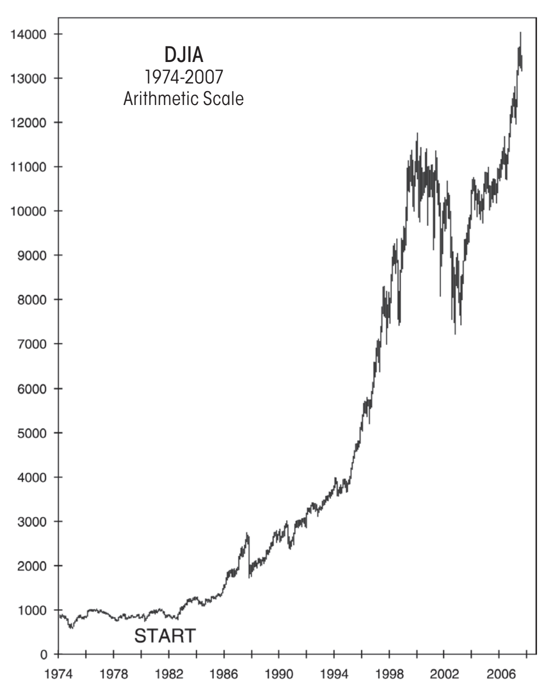
What's going on? Has history granted an exemption to the rule of complete mania retracement? I think not. The trip back to the finish line is not canceled but suspended by a series of intervening bubbles. Together, these successive and ongoing financial flare-ups that are carrying into 2007 rank as the biggest financial mania of all time.

FIGURE 2: The Nikkei's Ongoing Mania



Source: Elliott Wave International

FIGURE 3: The Current Dow Mania



Source: Elliott Wave International

To fully grasp the premise, traders need to familiarize themselves with the traits of a mania versus a bull market. In addition to the quantitative difference of a rapid rise that resolves in an even faster fall, there are many qualitative characteristics common to manias. In fact, more than I have room to cover in this article. Robert Prechter and I are working on a book, *The Mania Chronicles*, in which we hope to offer a comprehensive real-time record of the current boom. It already runs more than 500 pages, and the recent wildness of the financial world is adding content at a furious rate. But a few key parallels to the historic models illustrate the presence of a financial euphoria that is truly global in scope.

KEYS TO A MANIA
1. EVERY PERSON'S AN EXPERT

One key to deciphering whether a run-up is a mere bull market or a true mania is to notice how financial experts are treated. Usually in a mania, investors and traders give experts short shrift, preferring instead to get their investment advice from amateurs.

Indeed, when a mania is nearing completion, people actually treat professionals who are knowledgeable about history and value as impediments to their success. We saw this back in 2000 when many a broker complained that he or she could not tell clients anything, as more cautious financial experts were dismissed as curmudgeons. Even after the NASDAQ began its historic collapse, professional wrestlers offered up stock picks on CNBC. Professional baseball player Jose Canseco, whose stock tips were also featured on CNBC, opened his own brokerage, called Canseco Financial Group. "I love this," he told a *St. Louis Post Dispatch* reporter in 2000. "It's like gambling." The slugger bragged that 90 percent of his portfolio was in technology stocks and forecasted that the NASDAQ would rise to 5,000 by the beginning of 2001. Seven years later, the NASDAQ is only half that high—and that's after a four-and-a-half year rally.

Galbraith refers to this magical belief in amateurs' advice as "the illusion of insight." He suggested that it was "protected by the public impression that intelligence marches in close step with the possession of money. Out of that belief comes action—the bidding up of values, whether in land, securities or art. The upward movement confirms the group wisdom."

If anything, investment I.Q.s are down from the levels of mid-2000. Look at China to see how dumbed down

IT'S A MANIA IF...

- there is no upside resistance and rising prices seem perpetual.
- everyone in the market looks like an expert.
- there is a flight from quality investments to riskier investments.
- financial bubbles pop in one area while bubbling up in others.
- the crash after the peak takes back all the gains the mania made.

financial analysis has become: stock prices appear to be near the pinnacle of an exponential advance. There, the preferred stock-picking strategy is to buy ticker codes containing a double eight. "Numerology is a basic trading strategy in China," reports *The Wall Street Journal*. Trading tips include wearing red clothes because they represent a hot market, eating beef to sustain the "bull" run and avoiding references to "dad" because the word in Chinese is a homonym for "drop."

"We often choose stocks very blindly," a Shanghai investor told *The Wall Street Journal*.

2. THE FLIGHT FROM QUALITY

Another critical attribute of manias is something we at Elliott Wave International have identified as the "flight *from* quality." The year 1999 saw a revolving shift in the nature of the stocks that led the market to its historic top. To start the year, the fastest rising stocks were firms with profits. However, leadership shifted to initial public offerings of companies with revenues, but no profits. The cycle continued as IPOs with a business plan took the lead and finally ended with deals in which promoters promised "to worry about the business plan later."

In 2000, this same sentiment was expressed best by the "stealth launch"—initial public offerings in which the offerers refused to identify the business strategy. Their ability to whip up investors' anticipation marked an even crazier extreme than was seen in the South Sea bubble. In *Extraordinary Popular Delusions and the Madness of Crowds*, author Charles Mackay records only one stock offering for a stealth company during that mania, which he described as a "company for carrying on an undertaking of great advantage but nobody is to know what it is."

The latest manifestation of a stealth launch is known as a special-purpose acquisition company, or SPAC. SPACs create pools of capital for which there is no specific purpose. In just the first six months of 2007, $4 billion in SPAC money was raised. Mackay said the lone 1720 mystery offering illustrated "the utter madness of the people." This time around, it's happening in scads of issues in two extended phases of the mania.

3. FOLLOW THE BOUNCING BUBBLES

Perhaps the most important trait with respect to the current situation is that bubbles can cool in one area while heating up in others. The South Sea bubble offers an example. It was immediately preceded by the Mississippi Scheme, which also involved frenzied trading in companies that were expected to exploit the promise of the New World. Shares in the Mississippi Co. faltered as the South Sea bubble was moving into its most extreme phase of price acceleration.

According to the book, *Millionaire*, by Janet Gleeson, Mississippi Co. shares peaked in late 1719 and created a run on hard assets. "Investors turned to silver and gold, candelabras, tureens, dishes, plates, even furniture made from precious metals," writes Gleeson.

In the Tulip Mania, Mackay says price speculation in bulbs eventually extended into "houses and lands, horses and carriages, and luxuries of every sort, and for some months Holland seemed the very antechamber of Plutus."

This kind of drive into equivalent assets amid a more tepid demand for the focal point of an earlier bubble should sound familiar. It's exactly what happened after the dot-com bust in 2000. As the NASDAQ fell and retraced only a portion of its prior gains, a succession of bubbles into gold, silver, oil, most other commodities, luxury goods and real estate followed. Not to mention other countries' financial markets.

We can see remnants of the dot-com bubble still in Chinese shares, which continue to post new all-time highs. Just as share speculation leapt across the English Channel to London in 1720, the financial mania leapt across the Pacific Ocean to China. To an unprecedented degree, the Chinese bubble is fueled by "get-rich-quick stories and accounts of the extremes to which investors are willing to go to finance trading," reported Reuters in May 2007. Reuters quoted one Chinese investor as saying, "I only need to pay 9,000 yuan interest for the loan I got, but I think I can make at least 70,000 yuan a year by investing that money in stocks. So why not? I see almost no risk."

Can there be a better way to celebrate the final vestiges of a multiyear mania than for it to find its way to a communist country where the stock market is less than a generation old? Add in China's history of reliance on social engineering and huge amounts of leverage (no one is quite sure how much, because technically it's illegal to buy stocks with bank loans), and the stage is set for one of history's more interesting trips back to the starting point of the explosion.

IS CREDIT THE LAST BUBBLE?

A wellspring of credit fuels all bubbles, and the current Japanese carry trade illustrates how a deflation of the bubble in one area is actually extending its reach into other markets. The carry trade is a strategy in which investors borrow money at low rates in Japan and make a profit by purchasing vehicles in far-flung developing markets where interest rates are higher.

The Japanese carry trade boomed after rates fell sharply in response to Japan's stock, real estate and economic reversal in 1990. Similarly, the extraordinarily low U.S. interest rates of 2003 that followed the dot-com bust induced a borrowing binge that underlies much of the Dow's 2002-2007 revival. The trip from around 7,000 to 14,000 in the Dow was accompanied by an array of "easy money" instruments that pushed the circumference of the debt bubble past that of 1929. The unprecedented rise features everything from record-high margin debt to record-low credit spreads and a leverage buyout binge that is unrivaled in history. Thomson Financial reports that global corporate merger activity surged 53 percent to a record $2.5 trillion in the first half of 2007. The total breaks the record of $1.9 trillion in the first half of 1999.

As long as investors remain confident and convinced that the underlying economy is strong, the debt bubble can expand ever larger. But every credit boom has its bust; invariably, the bust comes suddenly when lenders and borrowers lose their nerve. Just such a shattering of confidence appears to be at hand as I write this article in early August, based on worries about housing and hedge funds. Here is how a recent story in *The Wall Street* Journal puts it: "An extraordinary credit boom that created many first-time homeowners and financed a wave of corporate takeovers seems to be waning."

ARE WE AT THE PEAK YET?

It's never easy to identify the peak of a mania, but many of the same things that happened in historical manias are repeating now. In particular, pundits who describe the current situation as a new era see it as "the best economy ever," according to a *Wall Street Journal* headline from July.

This kind of thinking displays the classic optimism that surrounds a mania peak. Such persistent enthusiasm from the pundits in the face of an ominous credit environment makes it more likely that the next decline will be a big one. Hints that markets that once seemed only to push higher can indeed swoop down like a rollercoaster are clear in the U.S. housing market. Housing stocks actually peaked back in July 2005, home prices turned in 2006, and the subprime mortgage meltdown brought the turn into the open earlier this year. Most commodities joined in May 11, 2006, when the Reuters/Jefferies CRB Index hit its peak. Crude oil topped in July 2006. The financial sector peaked in January 2007. The July peak of the Dow and most global stock averages may be the last gasp on the upside.

Knowing the traits of historical and current financial manias can help traders to position their accounts for a fall that will be even more relentless than the virtually across-the-board advance of the late 1990s and early 2000s. The speed and global scope of the unfolding credit crisis suggest that most of the fast-rising markets of the last decade will move back below their respective starting points in unison. And even though the flipside of financial folly is not as much fun as the run up, it can be just as exhilarating to those who are on the right side. ●

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