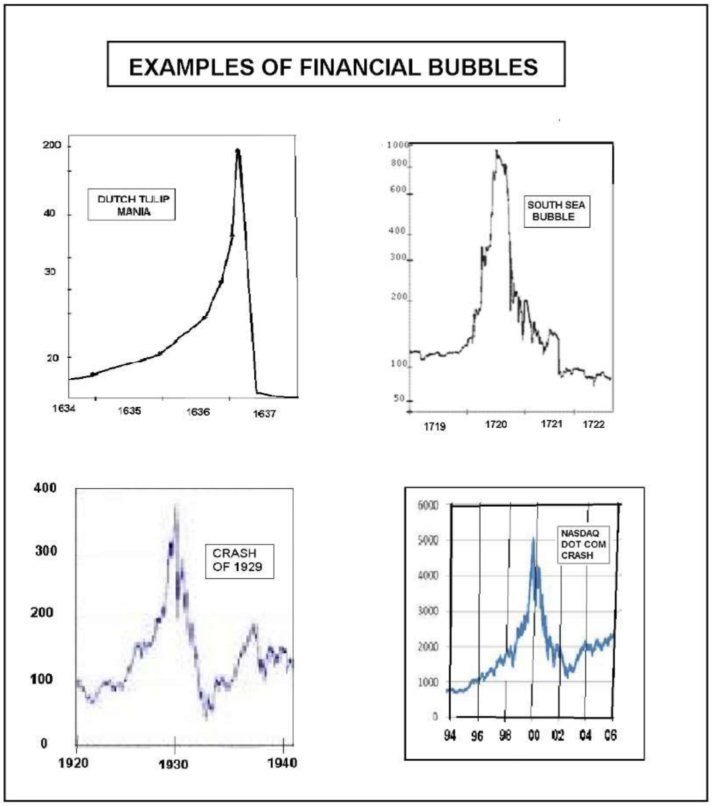
FINANCIAL BUBBLES AND HOW TO NOT BE CAUGHT IN THEM

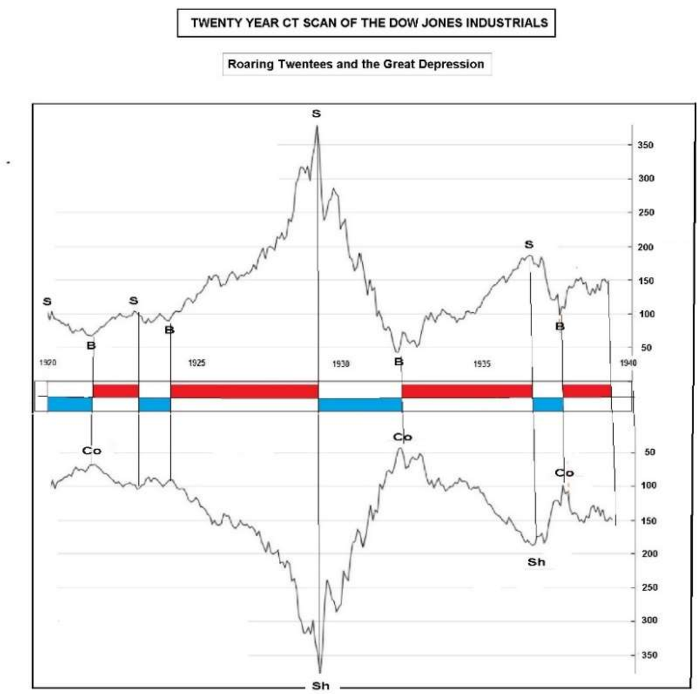
In recent years we have seen spectacular rises in stock and home prices. This has been mainly due to the quantitative easing policies of the Federal Reserve extending back for at least a decade. Their essentially zero interest rate policy has led to a real-estate boom , rampant inflation, and speculation in stocks and housing leading to the creation of huge financial bubbles. Such bubbles will form whenever the supply of money for investing exceeds the true value of equities or homes being bought. As a result of the Feds actions, they have painted themselves into a corner where the continued and needed immediate action of raising interest rates to much higher levels is likely to produce a major unwanted recession. It will also lead to a stock market crash producing a chart pattern closely associated with the shape of earlier financial bubbles. It is our purpose here to briefly discuss earlier financial bubbles, their growth and collapse. Also we show how to use CT scans to profit from them and not be caught in their downturns.

We begin by looking at the charts of four significant historical financial bubbles. These are the Dutch Tulip Mania of 1637, the South Sea Bubble of 1720, the 1929 Market Crash, and the 2000 Dot.Com Bubble. Here are their charts-



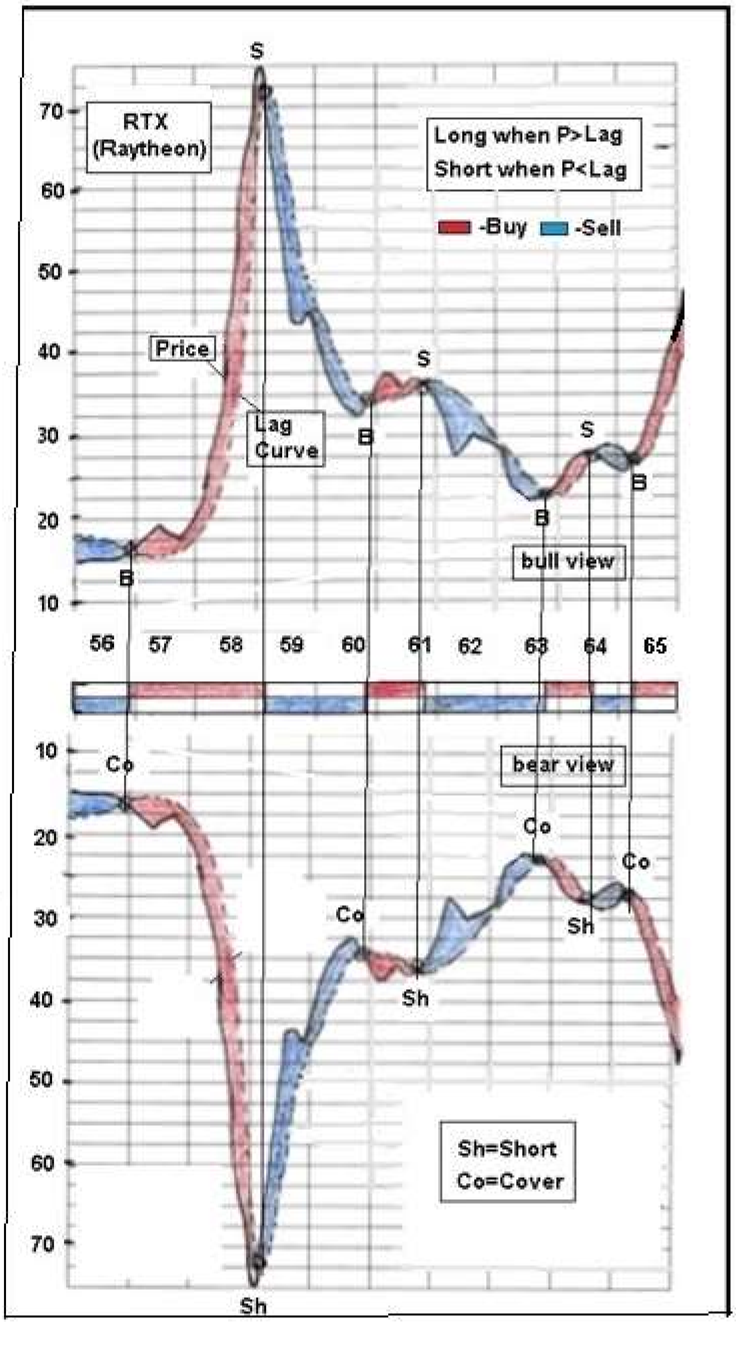
You can see that they all show the same pattern. First there is a slow increase in price followed by a much steeper rise ending in a nearly parabolic curve approaching a near infinite slope at the price peak followed by a sharp reversal sometimes followed by a bull trap and then a resumption of a rapid down trend in price to a point where the price is back to near pre-bubble values. The whole process of bubble formation and the following collapse typically takes about four years. Near the peak of such bubbles one sees such ridiculous things as one tulip bulb equal to one oxen, or the price of a tech stock gaining ten times its value in one year during the Dot.Com era without showing any signs of earnings. Most investors who are caught in such bubbles do just the wrong thing. They buy very close to the price maximum and then sell in disgust after the price is back down near the pre-bubble price values. To buy high followed by selling low is a sure way to loose in any market. This is what apparently happened to the famous scientist Issaic Newton. He lost at the age of 77 the equivalence of 3 million dollars in the South Sea Bubble. His comment concerning the loss was "I can calculate the motion of heavenly bodies but not the madness of people".

There is a sure-fire way to avoid being caught in a financial bubble. It makes use of our recently discovered Christmas Tree scan, be it a present bubble or one which has occurred in the past. For a first specific example, we take a CT scan of the Dow Jones Industrials over the twenty year period from 1920 through 1940. Here is the scan-



You see that this bubble peaks in 1929 , is known as the Crash of 1929, and was preceded by the Roaring Twenties and followed by the Great Depression. One sees from the graph that one should have been long from 1923 through the middle of 1929.This was followed by a short from the end of 1929 through the summer of 1932 and followed by a long position from the summer of 1932 through 1937. The short term up-movement in price at the beginning of early 1930 is known as a bull trap and one which can be avoided by use of a short term lag curve. Following these indicators means one would have reaped excellent returns over the entire twenty year period.

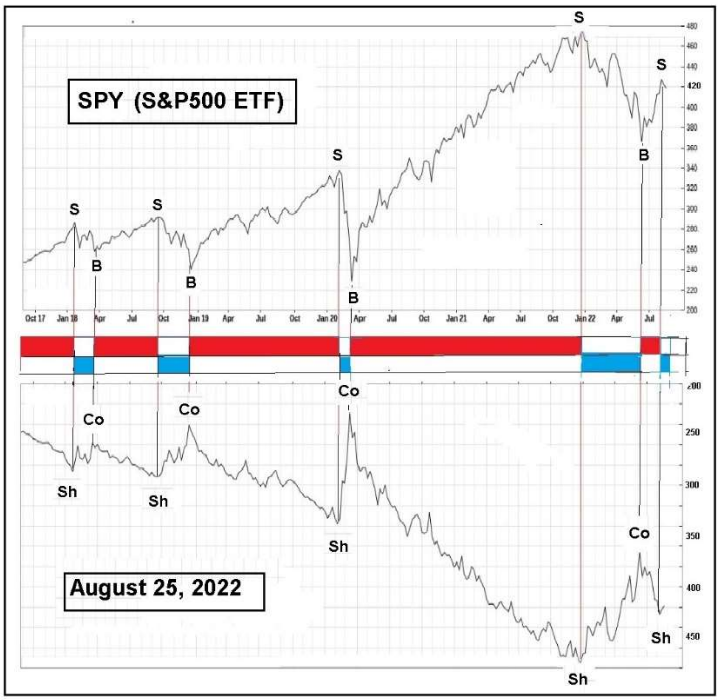
As a second scan consider the financial bubble of Raytheon stock from 1956 through1963. As the following graph shows, its price pattern indeed had all the characteristics of a financial bubble-



Its price went from a low of 15 to a maximum of 74 in just two years. I being a young and inexperienced investor at that time noticed this rise and the subsequent downturn in 1959 until the price hit 55. Thinking that RTX was a good stock with promising increase in earnings, I decided to buy a few hundred shares thinking for sure things would turn around and rise to its old 74 price level. How wrong I was. It took until 1967 before I broke even.

Knowing today that we were dealing with a financial bubble, I should never have bought the stock until 1961 when a buy signal was finally given according to the scan pattern.

As a final CT scan consider the financial bubbles associated with the ETF SPY over the past five years. Here is its CT graph -



SPY represents a measure of the S&P500 index and hence is a good indicator of market conditions. The pattern shows several price bubbles peaking at the locations marked by S. I have made excellent returns on my investments by holding SPY long in the time frames marked by red. Since I don't believe in shorting, I have stayed out of this ETF during the times marked in blue. This means that I have been out of the market since late last fall since the sharp uptrend from a few weeks ago was likely to have been a bull trap. I will step in and buy SPY again as soon as a legitimate B signal is given. There is really no good way to make a prediction concerning when a trend will change other than a new B or S signal. The Federal Reserve is trying to do two contradictory things by keeping interest rates low while at the same time trying to reduce the excessive inflation rate we are currently experiencing due to past excessive monetary easing . We will hear tomorrow from Jerome Powell concerning the future intention by the Fed on interest rates. My guess is that our rather meek Fed Chairman will suggest a slowing down of interest rate rises making the control of the present intolerable inflation questionable.

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August 25, 2022
Gainesville, Florida