Bubbles and Busts: Lessons From the Crypto Craze

The dramatic run-up -- and then down -- of Bitcoin and other cryptocurrencies offers an illustration of how dramatically bubbles can inflate -- and then pop. This article considers the cryptocurrency rise and fall, historical market bubbles, and ways to identify a bubble in the making.

2019 has seen a further slide in cryptocurrency prices, with Bitcoin falling over 80% from its late 2017 high.

What do tulips, tech stocks, and Japanese real estate have in common? They have all experienced classic asset bubbles, in which prices rapidly soar only to tumble back to earth, leaving many investors in the red. The latest candidates for bubble status are cryptocurrencies, whose prices skyrocketed, then tumbled to a fraction of their former values.

By price measures alone, Bitcoin, the acknowledged leader in the cryptocurrency world, certainly appears to warrant bubble status. Since its inception in 2009, the price of a Bitcoin rose from pennies to over $19,000 in late 2017. In 2017 alone, the price of a Bitcoin increased by over 1,200%. And a wave of other virtual currencies formed to join the party. Litecoin, Ethereum, Zcash and over a thousand others -- not to mention crypto funds -- emerged, all looking to get a piece of the action.

But, as with other bubbles, the euphoria did not last. Cryptocurrencies have taken a beating over the past year, with the price of a Bitcoin falling to less than 20% of its 2017 peak by January 31, 2019. The Bloomberg Galaxy Crypto Index tumbled over 75% over the same period.[1]

Yet there is more to a bubble than price alone. If a product or technology is truly revolutionary, it may indeed merit an extraordinary run-up in price. In theory, the blockchain technology on which cryptocurrencies are based offers a groundbreaking payment system that can be used anywhere in the world with privacy and security -- one that is not tied to a particular country or economy. In practice (so far at least) cryptocurrencies have been too volatile for mainstream use. At this stage, they appear to be more a speculative vehicle than viable payment system.

Where Bitcoin and other virtual currencies go from here is anyone's guess. But the episode offers a cautionary tale for momentum investors: When is a bubble a bubble?

Most investors now agree that the U.S. stock market boom of the late 1990s -- particularly technology stocks -- represented a classic bubble. That cycle saw the NASDAQ Composite index grow over 200% between February 1997 and February 2000, and then fall by approximately two-thirds of its value by August 2002.[1] But at what stage was it considered a bubble? When, in 1996, Alan Greenspan famously accused investors of "irrational exuberance," markets went on to score strong gains over the next three 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.

Although 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, it should raise a warning. 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 be seen as 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 long periods of time. So if you do spot a bubble in the making, use caution and be sure to work with a professional.

[1]Sources: Yahoo! Finance, Bloomberg.com.