Market Crash: Are Bubbles Forming in Areas of the Market?

Description

A market crash is never too far away. Nobody will know what will cause it, when it will happen, and which sectors will be most affected with any degree of precision. But great investors must always be prepared to react accordingly once fear becomes the main emotion on Wall Street once again.

With a slate of great vaccine news in early November, the broader markets, which were led higher by COVID-19 recovery stocks, deserved to surge by double-digit percentage points. And while there is still plenty of value to be had in this market, you should be wary of the white-hot stocks tech stocks that have continued to defy the laws of gravity for most of 2020. I'm talking about the stocks that have more than doubled or tripled within a matter of months. You know, the stocks that you're itching to buy because they made your friend rich, despite having limited knowledge about investments or the art of valuation?

While it's hard to witness your friends making huge profits off major multi-baggers in a matter of months, you must never lose sight of a stock's valuation. Some brilliant people on Wall Street, including the likes of **JP Morgan** CEO Jamie Dimon, know where to walk in today's divided market.

"There may be a bubble in smart parts of the stock market, not all of it," said Dimon recently after expressing his distaste for U.S. government bonds.

Could a bursting of isolated bubbles cause a devastating stock market crash?

In prior pieces, I'd noted the possibility that isolated bubbles or severe pockets of overvaluation may have developed within the hottest areas of the tech sector.

Now, I'm not talking about the bluest of blue-chip tech plays that lead the **S&P 500** (they're probably great buys here); I'm talking about the stocks, many of which have more than tripled in 2020 — the ones that your friend who knows nothing about stocks keeps bragging about; the ones that you, as a Foolish long-term investor, shouldn't touch with a barge pole, given their pie-in-the-sky valuation multiples; the “speculator’s choice” names that have enjoyed a profound, perhaps unreasonable amount of multiple expansion this year.

With names like **Shopify** tripling since those lows in March, investors should resist the urge to ditch the value investor’s mindset in favour of momentum investing.

There’s a major difference between investment and speculation or gambling.

Investors who recognize the boundary between investing and speculating are the ones who can steer clear of potential bubbles, even though they’re not immediately recognizable to the untrained eye. One can avoid feeling the full force of the next market crash by not chasing gains and letting greed and euphoria take control of their investment decisions. The dot-com bust of 2000-01 showed that investors would have been all right had they stayed in their lane and not grown greedy from the stocks that seemed to provide the easiest of riches.

That’s not to say all stocks with nosebleed valuations will end in tears. Investors may wish to speculate on early-stage growth companies if they’re willing to put in the immense amount of homework to evaluate a company. Believe it or not, there are companies, like Shopify, that can be “cheap” at north of 20 times revenues.

As long as you recognize the risks and don’t bet what you’re not willing to lose, you can do quite well with such hard-to-value names. But if you’re like many and feel the slightest hint of FOMO (fear of missing out) on stocks that have already tripled or quadrupled on the year, it’s probably a better idea to bite your lip and take no action, especially if you’re unable to evaluate a stock that’s with speculators. Because once they rush to the exits, you may be the one left holding the bag.

As for a potential market crash, I think a bubble burst in the market’s frothiest areas will be largely isolated. While market valuations are on the higher side compared to historical averages, I believe the stock market, as a whole, isn’t as expensive as it seems, given the weird type of market environment we find ourselves in.

Steer clear of isolated bubbles, buy any coming corrections, are you’ll likely do very well over the long term.

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2. TSX:SHOP (Shopify Inc.)

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joefrenette