

Are We in a Stock Market Bubble?

Many people worry about the possibility of a stock market bubble. A bubble happens when the price of something, like stocks, houses, or even tulips, gets so high that it doesn't make sense anymore. Eventually, prices crash, leaving investors with huge losses. If you've heard stories about big financial crises, like the dot-com bust in the late 1990s, you know how damaging bubbles can be.

A bubble isn't just about prices being high; it's about irrational thinking. Imagine you hear about a group of stocks everyone is excited about. People believe these companies are so amazing that they're willing to pay any price to own a piece of them. They fear missing out, and the frenzy pushes prices higher and higher. This emotional behaviour, not grounded in facts, is what creates a bubble.

One key sign of a bubble is when people say things like, "This time is different," meaning they believe the rules of investing no longer apply. This phrase has popped up in every bubble in history, from the Dutch tulip mania in the 1600s to the internet stock craze of the 1990s.

Today, a small group of companies, nicknamed the "Magnificent 7," has dominated the US stock market. These are big technology companies, like those working on artificial intelligence (AI). They've been responsible for most of the stock market's gains in recent years.

Some people wonder if these companies' stock prices are in a bubble. To understand, let's look at how bubbles form and what signs to watch for.

Bubbles often involve something new and exciting, something people don't fully understand.

When tulips were introduced to Holland, they were considered exotic and beautiful. People paid outrageous prices for them, believing they were priceless. Eventually, the bubble burst, and tulip prices crashed.

The internet was revolutionary, and investors believed it would change the world (which it did). But during the dot-com boom, people invested in internet companies without understanding whether these businesses would succeed. Many internet companies eventually failed, and their stocks became worthless.

New innovations create excitement, but they also make it hard to know what a fair price should be. If something has never existed before, how do you decide what it's worth? This uncertainty can lead to overly optimistic pricing.

To understand if stock prices are too high, let's start with the basics. When you buy a stock, you're buying a tiny piece of a company. In return, you're entitled to a share of that company's profits, now and in the future.

Stock prices are often measured using something called the price-to-earnings (P/E) ratio. This tells you how much you're paying for each dollar of the company's profit. For example, if a company has a P/E ratio of 20, you're paying \$20 for every \$1 of its earnings.



If the P/E ratio is much higher than usual, it might mean investors expect the company to grow rapidly. But if the price is too high, it can lead to disappointment if the company doesn't grow as expected.

During bubbles, investors often assume new companies will keep growing forever. They don't consider the risks, like competition or new technologies that could disrupt the market.

For instance, in the 1990s, investors believed e-commerce (online shopping) would change the world. It did, but most internet companies from that time failed. Only a few, like Amazon, survived and thrived.

Today's leading technology companies have incredible advantages, like cutting-edge technology and global scale. But history shows that even the biggest companies can face challenges. In the fast-moving tech world, being disrupted by newer technologies is always a risk.

The US stock market has done incredibly well recently. In 2023, the S&P 500 (an index of the 500 biggest companies) went up by 24.2%, and in 2024, it rose another 23.3%. That's unusual, such big gains two years in a row are rare.

Now, people are asking: What's next? Are stock prices too high?

The current P/E ratio for the S&P 500 is 23.6. This is higher than average, but not ridiculously high. It suggests that stocks are expensive, but not in full-blown bubble territory.

During past bubbles, people said things like, "There's no price too high for these stocks." That level of enthusiasm isn't as widespread today, which means we're not in a bubble. Valuations are high, which means investors should be discerning about where to allocate capital, but we are some way off being in bubble territory.

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