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Do the Stock Prices Bubble?

Recently, the stock market prices have raised sharply all over the world. The boom has mainly been due to the enormously high growth expectations in information technology businesses. By all means, it is possible that these expectations can be fulfilled in future. However, more and more people are worried about the existence of a possible bubble in stock prices. A bubble that might burst throwing the economies into a depression. Stories have been heard about collapsed asset price bubbles, beginning from the tulip bubble of 1600s until the stock market crashes of the 20th Century. More and more people argue that the next stock market crash is just ahead of us.

The modern financial theory knows the bubbles in stock prices. The Euler equation determining the theoretical stock price accepts the existence of a possible bubble component. Having once been developed, in a way or another, the bubble may exists in prices as long as one expects it to stay there over her own investment period. What then causes the bubbles to be born? During certain periods, new irrationally behaving noise traders are continually entering the market making the prices to diverge from fundamental value. If their power is strong enough, the rational traders the smart money have to take their actions into account in their own pricing policy. This makes irrational prices rational from the point of view of an informed investor. The power of noise traders comes from their herding behavior. Many well-known trading rules that are typically followed by noise traders are basically Ôfollow the trend' type of trading rules. Such being the case, instead of being independent of each other, the actions of uninformed noise trades are highly tied together. This makes their relative power strong enough to determine the market prices. The different technical analysis tools and positive feedback strategies are typical examples of these pricing elements.

We might have had elements in our domestic market that have been favorable for the prices to diverge from fundamental values. For instance, in the initial public offerings of information technology firms, there has been much more demand than there have been shares to sell. The prices have hardly been determined by the equilibrium in demand and supply of these stocks. Also, there has been a continuous flow of new uninformed investors into our market. We cannot be sure that there is a bubble in our stock market. However, we should notice the presence of all the elements that are required for the existence of a price bubble.