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## Stalking Bubbles: Paul Tudor Jones 1987-1990 (/writing/2018/9/4/stalking-bubbles-paul-tudor-jones-1987-1990)

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## Introduction

Many legendary money managers don't like to share their views in public. It's understandable: making a call opens you up to criticism and the potential embarrassment of a mistake. And an isolated comment could easily mislead the audience, since the manager may change his or her view and position at any time. When a manager of David Tepper's acumen appears on CNBC, people tend to listen. But as the months go by, there is no answer to the question: "David was bullish at that price, what about now?" We only see the prediction and the outcome. Unless you receive a fund's letters, or speak to the manager directly, you don't see how they react to new information. This makes it difficult to really understand a manager's process.

I was excited when I learned that Paul Tudor Jones had participated in the Barron's Roundtable for several years. In the wake of the 1987 crash, Jones sat down every January and shared his views on markets and the economy. We can peek over this

legendary trader's shoulder and watch him trade the U.S. and Japanese stock markets. One market was forming a massive bubble, the other merely looked like one.

I don't want to encourage anyone to adopt a global macro strategy, or to look for bubbles to short, or even to actively trade in general. Rather, I think of Jones's extensive comments as a kind of case study. His principles have been studied by generations of traders. How does this episode illustrate his philosophy? What can we learn about his decision-making process? How did he implement his ideas?

## The Crash of 1987

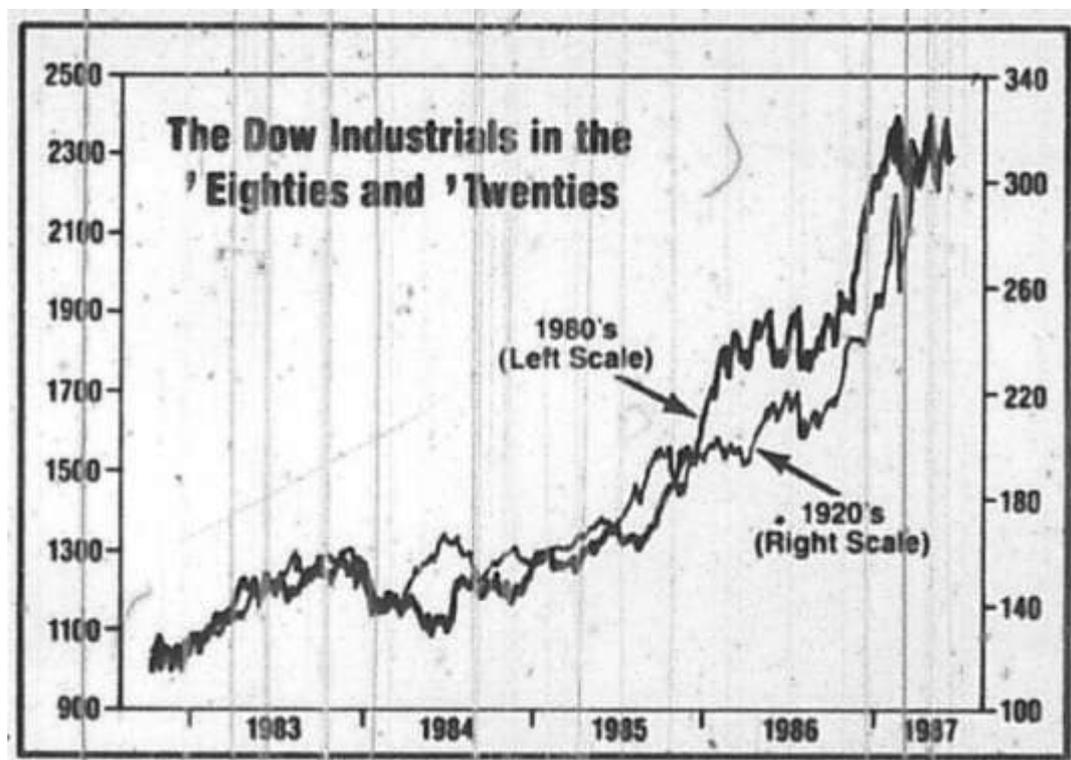
*"The week of the crash was one of the most exciting periods of my life."* Paul Tudor Jones[1]

The year 1987 made Paul Tudor Jones famous as the man who had predicted the crash. Jones had started his firm Tudor Investment Corp. three years earlier after years as a commodity pit trader. In the summer of 1987, he was profiled by Barron's and discussed his bearish outlook on the U.S. stock market. Jones thesis rested on two key ideas. First, Jones used an "analog model" that his research director Peter Borish had developed. The model was an overlay chart of the stock markets of the 1920's and the 1980's and showed an "astonishingly robust" correlation. Jones also pointed to a chart showing the Dow Jones Industrial's deviation from its trend. Prior spikes had occurred in 1836, 1929, and 1966 - all followed by bear markets. He observed that there was exuberance in other markets (for example, in fine art), and noted some troubling debt and economic statistics.[2]

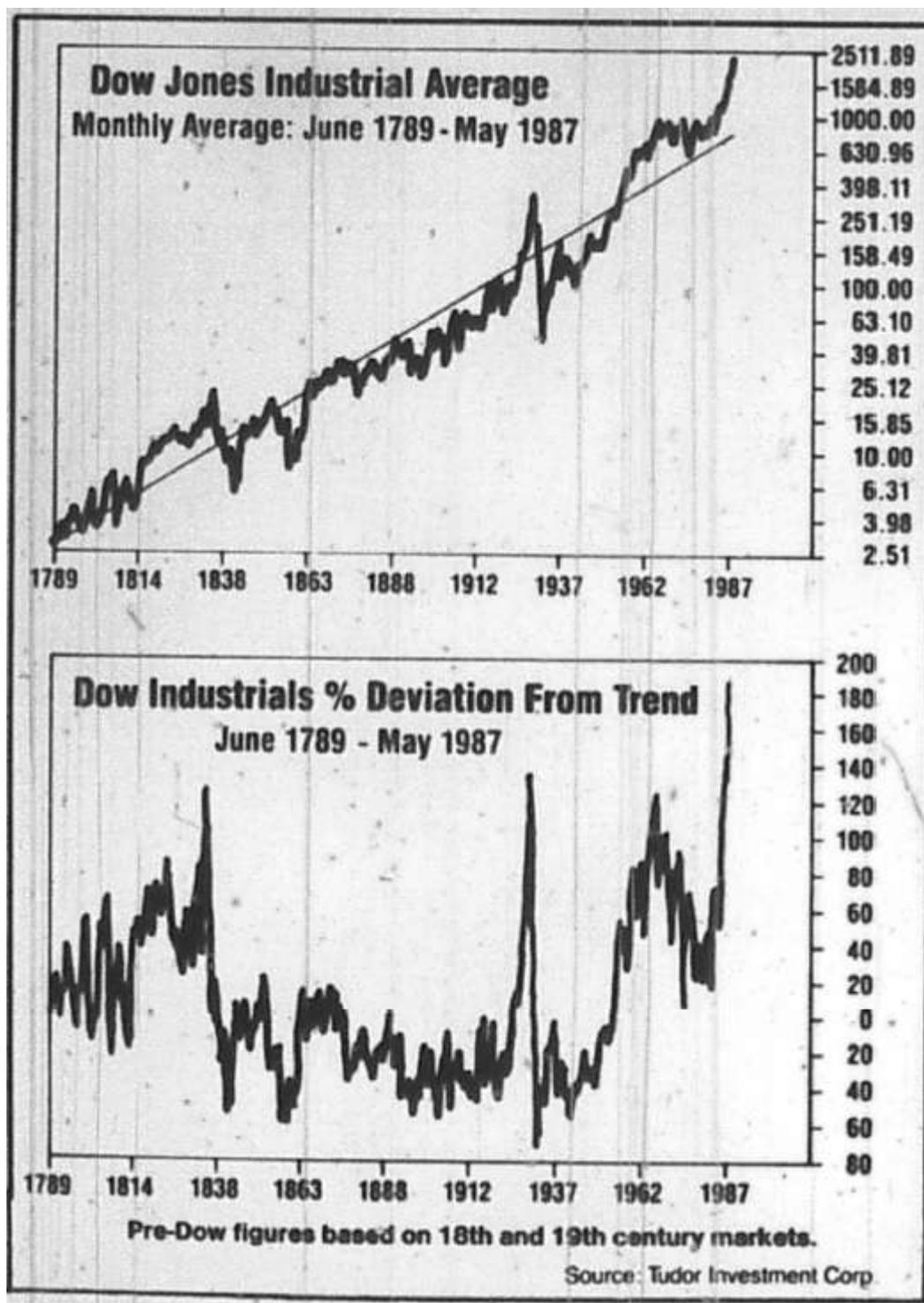
In the article, Peter Borish admitted to "fudging the exercise somewhat by juggling the starting periods". Nevertheless, the bearish outlook paid in spades on October 19. On the day of the crash, Jones covered his short position and went long bonds, expecting the Fed to ease financial conditions. That month he made 62%.[3]

*"I feel that you have to start getting short now because the panic, when it comes, will be so violent and sudden that the longs won't be able to get out nor the shorts get aboard."* Paul Tudor Jones, June 1987[4]

**The famous overlay chart:**



**The Dow Industrials "Deviation from Trend" with spikes in 1836, 1929, 1966, and 1987:**



## January 1988: “Concerned about the future welfare of the world.”

After the crash, Jones did not shy away from publicity. He participated in the January 1988 Barron’s Roundtable and was also profiled by the Wall Street Journal in May of 1988. The Journal called him the “Quotron Man” who “swaggers through Wall Street with a flair worthy of the movies”. The article described his “rock and roll” trading style, his lifestyle, and his eye-popping returns: “last year he had a 200% return,

mainly because he dumped stock-index futures just before the crash, then bought heavily while other money managers were still reeling." It noted that Jones was focused on the Japanese stock market and thought it might trigger another wave of selling in the U.S.[5]

At the roundtable, Jones discussed his concerns in greater detail:[6]

*"I'm not as concerned about the direction of the market as I am about the future welfare of the world ... will we be able to avoid a worldwide depression like we saw in the early Thirties?"*

*"The only real operative historical parallel to what we have right now is the Twenties. And the similarities are so striking, so rampant and so numerous that one has to use that as a basis."*

*"If you anecdotally go back and read Barron's, it's the exact same newsprint with different names and characters in January of 1930. Everyone was optimistic. **All the earnings that we're talking about can disappear overnight, if the stock market makes new lows. The stock market is a leading indicator, and if it starts back down, you could see commerce literally grind to a halt like in the Thirties.**"*

Jones was worried about the lack of "structural shock absorbers." He pointed to vulnerable corporate balance sheets, the decline in interest rates, the dollar devaluation and "five years of incredible [public] spending orgies." His argument was that these factors had already boosted the market and asked: "tell me, what policy tool is available?" He concluded: *"We're a debtor nation that acts like a creditor nation."*

However, he balanced his negative long-term view with a pragmatic short-term stance. He expected a bounce "back to the 2200-2300 area," similar to the bounce into early 1930. For the second half of the year 1988 he expected new lows and a decline to the "1200 area." His argument was based on market sentiment and positioning:

*"Right now [...] it's sold out." "you've got phenomenal insider buy/sell ratios, mutual-fund cash at [...] extremes; you've got all types of internal indicators that would indicate the market should rally."*

### **Jones's expectation of the Dow Jones in January 1988:**



(charts from [macrotrends.net](http://macrotrends.net))

In 1988, Jones also sat down with Jack Schwager twice for his Market Wizards interview. Schwager noted that by the second interview, Jones had become worried about a potential “governmental witch hunt.” He feared that vocal short sellers would be blamed if the U.S. market declined further. Even in that interview, Jones balanced his long-term bearish view with a short-term neutral stance.[7]

### **Short-term, technical view:**

*“I don’t just use a price stop, I also use a time stop.”*

*“According to the analog model, the market should have gone down – it didn’t. I think the strength of the economy is going to delay the stock market break.”*

### **Long-term, fundamental view:**

*“I think the financial community was dealt a life-threatening blow on October 19, but they are in shock and don’t realize it.”*

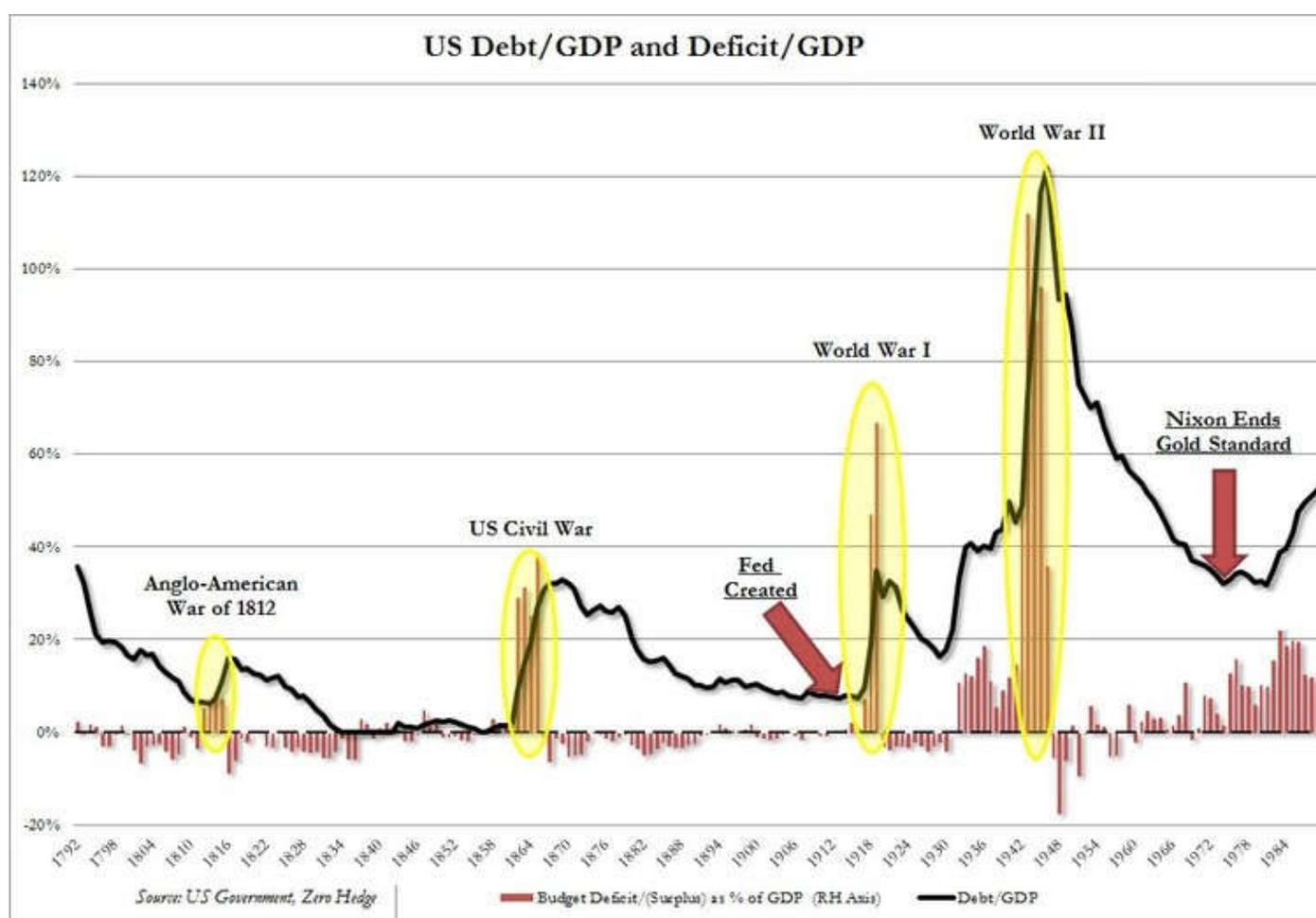
***“I know from history that credit eventually kills all great societies.”***

*“Whether it was the Romans, sixteenth-century Spain, eighteenth-century France, or nineteenth-century Britain. I think we are going to be in for a period of pain.”*

Jones was not alone in his pessimistic outlook. After the crash, Robert Shiller published a working paper called “Investor Behavior in the October 1987 Stock Market Crash.” Based on surveys, he found that the crash of 1929 was an important analogy for investors as they tried to make sense of the 1987 plunge: “comparisons with 1929 were an integral part of the phenomenon. It would be wrong to think that the crash could be understood without reference to the expectation engendered by this historical comparison.”[8]

### U.S. Debt/GDP And Deficit/GDP, 1792-1987:

(chart from ZeroHedge)



### Early 1989: “My job is to get with the flow.”

The U.S. stock market climbed higher throughout 1988. In January 1989, Jones sat down for another Barron’s Roundtable: [9]

*“I think the Fed has done a fantastic job. I really thought last year that there were*

*macroeconomic forces at work that no one would be able to control. And I have learned a lot over the past 12 months, because they have done a good job."*

*"I think that [Greenspan] is going to do everything in his power to try to avoid letting the yield curve invert."*

*"I think the big mistake that I made last year [...] was not recognizing the difference between 1987 and 1929. In 1929, the dollar value of the U.S. stock market was almost 175% of GNP. Today, it is 50%."*

Despite his praise for the Fed, Jones was hesitant to abandon his bearish view:

***"Unfortunately, I still believe in the charts first."***

*"There are too many instances of 35-40% breaks, followed by 12-16-18 month rallies, where a market did subsequently go back and either double-bottomed or make new lows. **Until I see a Dow close significantly above 2240 on a weekly basis – which may be this week – until I see advance/declines turn, I am not going to be invested.**"*

### **Dow Industrial in early 1989:**



Both the economy and the market had defied Jones's pessimistic expectations. Jones

recognized this, but he was still skeptical:[10]

*"If it goes above 2250, then I would certainly think about buying the market much more."*

*"This thing keeps acting like a bear market, in the sense that the price action is not strong." **"Maybe we're in the nascent stages of a bull market. It is either that, or we are at the top of a bear market."***

**"My job is to get with the flow. I will make a forecast, but my job is simply to trade the range."**

## January 1990: "Everything comes back to the Japanese quotient."

Jones was wrong again in 1989 as the market made new highs. By January 1990, Jones was very bearish on Japan and feared spillover effects from its bursting bubble. He also described the U.S. economy as being "late in the business cycle" and noted an acceleration of inflation. He observed that short sellers were doing well in an advancing U.S. market. His interpretation was that the market internals were weaker than the index level suggested.[11]

*"This time last year, there were many reasons not to be negative on the stock market. Now, I can see an external event that can be very negative. I see internally a number of events that can be very negative."*

***"Everything that is being sold on Wall Street today, whether it's a company, a fund, everything ultimately comes back to the Japanese quotient. I refuse to believe they are not at the base of probably all the asset inflation we have seen."***

*"There are a million reasons to be negative on our stock market, but Japan is the biggest factor."*

*"If the Dow takes out the December low - you cannot find an instance since 1960 where you have taken out the December low in the month of January and the stock market has not subsequently declined."*

*"I can have money with four different managers playing the market from the short side - amid a tremendous explosion in the stock market- and they all make money. So, something tells me, intuitively, that something is not right in the landscape."*

At the same time, he described the U.S. market as "seemingly bulletproof" and noted "a tremendous amount of pessimism," as indicated by measures like mutual fund cash levels and put-call ratios. Again, he was willing to let market the market

overrule his bearish fundamental bias: ***"I would have to see the market take out 2800 and exhibit amazing upside volume before I get too excited about U.S. stocks."***

## S&P 500, 1977 – 1992:



## January 1988: “In particular, I want to be short Japan.”

Japan fit perfectly into Jones’s 1929 analogue. At the 1988 Roundtable he explained:[12]

*"In particular, I want to be short Japan. Everyone is so worn out from trying to sell Japan, and yet, the reality of the situation is that – and I hate to use the word – on a 'fundamental' basis, it has the greatest downside."*

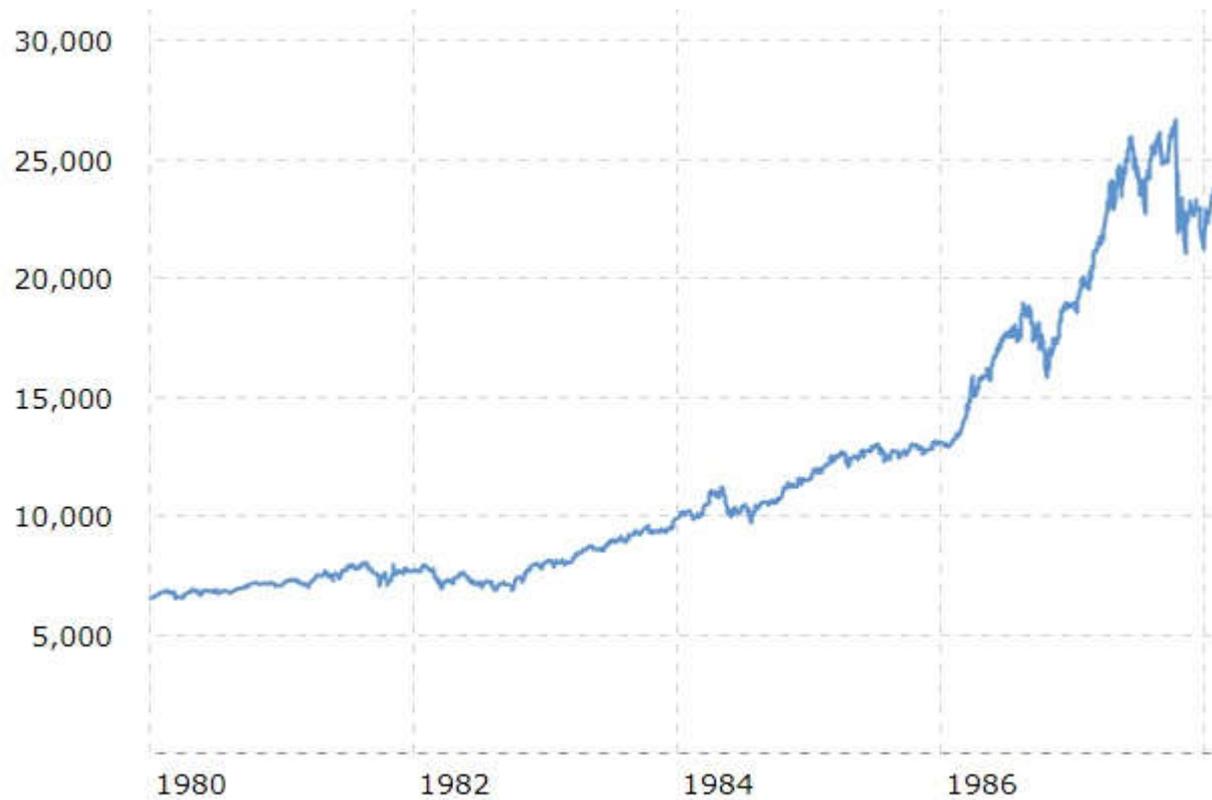
***"Today, the U.S. is analogous to what Great Britain was back in '29, and Japan is analogous to where the U.S. was. The U.S. market still finished 1929 on a positive note. The biggest correction in 1930, in the world, was in the U.S. stock market."***

Japan in the 1980's and the US in the 1920's: two prosperous creditor nations, two stock market bubbles. However, as Barron's pointed out: the bears had been wrong

for some time. For example, George Soros had been short Japan and even penned an op-ed in the Financial Times, days before the 1987 crash. He was badly bruised as the U.S. markets cracked first.[13]

There was another catch: the Tokyo market did not have its own futures contract at the time. Said Jones: *"If they ever start a stock futures market in Tokyo, they're talking about the sale of all sales."*[14]

### **Nikkei in January 1988:**



### **Dow Industrial in January 1930:**



## January 1989: “Every time that market breaks, I am going to sell it.”

The Nikkei roared higher in 1988. But Jones was not about to give up:[15]

*"Japan was, obviously, the best stock market in 1988. I was 100% wrong."*

*"Being short in Japan in 1988 probably cost my fund about 4%."*

*"The Japanese market right now is 127% of GNP. And if there is going to be a problem – if there is going to be an external shock that creates a problem here – it is going to come from Japan."*

***"I have not been short since it came out of that consolidation range last November. But every time it breaks 5%, I will sell it. I will probably try to market-time it, and risk 2-3% of my portfolio."***

*"And it will probably cost me another 4-6%. But it is going to break. I will catch it, and I will get paid 25% or 30% or 35%. That is my function, to try to get with it."*

### Nikkei in January 1989:



**Jones:** When I think that Japan is selling at 4.8 times book and we are selling at 1.5 times book, and the rest of the world's stock markets are selling between 1.2 and 1.8 times book—to me, there are just gross overvaluations over there. I want to take every opportunity to believe that any break that I see will be the beginning of a 30% or 40% break and maybe something more significant than that. And if I miss another 20%-30% on the upside, that is fine with me, because I am going to catch the break. And there will be a very severe break there at some point.

We can observe how Jones implemented his bearish view of this runaway bull market. He would short the market on every break of 5%. That break represented a possibility of the top and he wanted to catch the first big decline. However, if the market recovered, he would cover his short. The market had consolidated in mid-1988, then shot up into January of 1989. Therefore, at the time of his comments, he was bearish but not short.

The risk-reward expectation seems to have been: a loss of 4-5% on every false breakdown and a 25-35% gain when the market broke. Jones was willing to endure repeated small losses while waiting for the big payoff.

Also, stock index futures began trading in Japan in September of 1988. Jones visited the country two weeks later and observed trading live at one of the brokerage houses. He remarked that dollar volumes had already eclipsed U.S. pre-crash volumes.[16]

***"From an intellectual standpoint, during '88, watching that market [Japan] defy conventional logic was a lesson in humility for me. The great thing about markets is that you learn something new every day."***[17]

## January 1990: "I am extremely negative right

now.”

Jones was wrong again in 1989. The Nikkei advanced all year and only declined into January of 1990.

### Nikkei in January 1990:



At the Barron's Roundtable, Jones turned into a raging bear.

The Japanese market advance had become increasingly narrow: [18]

Jim Rogers: "When you look at the advance/decline there, the market has gone up 4,000 or 5,000 on very few stocks. They drove up a few very big stocks."

Felix Zulauf: "That advance/decline line goes down for 10 years."

Jones: "When you see that kind of chart patter – I don't care what it is – it is a signal to watch out for the terminal point in that particular market."

**"[Japan] went parabolic. Its rate of acceleration was as great as any other period in the history of the stock market."** [19]

*"I first started getting bearish on it when it was around 24,000, and now it now is 37,500. So even if it declined 40%, I would still be completely wrong as far as that forecast went."*

**"The sustainability of the bubble, though, is directly dependent on a continual progression in prices."**

*"The fact that it has actually doubled without anything even approaching a 6% decline makes it all that much more of a candidate to ultimately burst."*

**"You have the potential for that market to decline 20% or 30% in a rapidly accelerating fashion."**

## Playing the Player

At this point, Jones turned his attention to the institutional players in the Japanese market. He analyzed market sentiment, positioning, and institutional incentives. This allowed him to form a thesis of how the key players were likely to react if the market weakness continued.[20]

*"There was a euphoria building up in that market because of the perceived January effect ... And you have now started out in the beginning of January with a 3.7% decline, which is the worst two-week performance in Japan since the 1947 era."*

*"Look at the breakdown of assets held by Tokkin funds and/or insurance companies and/or investment trust. In the past seven years, their holdings of stocks have almost tripled, going from 14% to over 52%."*

*"Their bogey is 8%. They have to 8% in some fashion."*

*"Now, you are looking at a situation where they are down 4% in the first two weeks of the year. And, they have an alternative that they haven't seen since the early 1980s. That is, 7.25% short-term rates."*

*"So here you have a very compelling reason for the Japanese stock market to decline – much in the same way that portfolio insurance down the market in the U.S. in 1987. **Every day the market does not advance, and particularly, every day that it declines, it becomes that much more compelling for a manager to shift his assets from stocks.**"*

*"So here we are, at the beginning of the year, and I posit that, from a fundamental standpoint, **there's probably the greatest opportunity for a reversal of that flow that has ever existed.**"*

## The Japanese Stock Market Bubble, 1977 – 1992 (Nikkei)



### May 1990: “Past the Peak”

In May 1990, Jones met with Barron’s for a follow-up interview. He was up 30% for the year. When Barron’s called his prediction on Japan a home run, he humbly noted that he had made the same prediction in both 1988 and 1989. Jones described the Japanese top as a peak like “1929 or 1966” that would not be exceeded for another 25 years. In his view, the market had “a long way to go on the downside” and little “real liquidation” had taken place yet.[21]

Despite this long-term bearish view, he was long Japan at the time of the interview. He was acting in a tactical manner because of “too many U.S. buyers of puts anticipating an easy money play for the market to accommodate them.”

He described his strategy:

*“My investment strategy springs from developing a fundamental view of a particular market.”*

*“Under- or overvaluation is only part of the battle. The key thing is to be able to time one’s entry into a position at the precise moment when the market is about to move*

*in your favor.”*

***“If you put a gun to my head and ask me to choose between fundamental and technical analysis, I would take the technical every time.”***

## **Takeaways: “Don’t be a hero. Don’t have an ego.”**

Long-term stock charts tempt us to look at history in a simplistic way. The crash of 1987 is followed by a steady recovery and, eventually, the roaring dot-com bull market. The 1990 bear market appears as barely a blip. Investing looks easy and straightforward in retrospect. We know it is important to think of the future in a probabilistic way, as a range of possible outcomes. But the same is true for the past. The path we see in a stock chart represents just one of multiple possible scenarios. Was another depression in the cards after the crash of 1987?

When analyzing a decision-making process, I find it helpful to look at the historical context and try to empathize with the actors. What were the conditions of their situation? What information did they have to form their view? How did they weigh contradictory information?

I hope I was able to shed some light on these questions and show how Paul Tudor Jones made decisions under uncertain and volatile conditions. His comments and behavior illustrate several trading principles and touch on interesting dichotomies.

### **The big idea (top-down) vs. pragmatism (bottom-up)**

*“If you put a gun to my head and ask me to choose between fundamental and technical analysis, I would take the technical every time.”[22]*

Jones developed a fundamental thesis and tested it. The crash of 1987 looked like the confirmation he had been waiting for. It makes sense to me that he retained a fundamentally bearish outlook after his narrative seemed to unfold perfectly at first. But he didn’t let that big idea keep him from entering short-term bullish positions when technical factors suggested it.

## Risk management and sizing

*"The most important rule of trading is to play great defense."*

*"First of all, never play macho man with the market. Second, never overtrade."*

*"Risk control is the most important thing in trading."*

*"If I have positions going against me, I get right out."*[23]

When Jones's fundamental view aligned with the technical picture, he was willing to bet big. However, when the U.S. market was oversold, or when sentiment was overly negative, he was tactically neutral or bullish. While the Japanese bull market was roaring, he patiently watched and waited for a break to enter. When the market rallied again, he would cover instead of letting the losses compound. Jones was a bear on Japan for years before the market crashed. Arguably, his risk management discipline was more important than his analysis of the bubble.

The following is a quote from a 1994 memo about risk control that Jones sent to his traders:

*"The key to putting together a good year of trading is to never fall behind early in the year. I can only remember one instance when a trader has been down at mid-year and recovered to have a really good year. At best, people claw their way back even which in itself is only a mental victory. It is so critical to be disciplined, patient, and precise in the early going."*

## No ego

*"Don't be a hero. Don't have an ego."*

*"Who cares where I am long from. That has no relevance to whether the market environment is bullish or bearish right now, or to the risk/reward balance of a long position at that moment."*[24]

Jones had a fundamental view, but he did not proclaim to know better than the market. He was open to new information. He didn't complain about how irrational the market was. He just observed and waited for opportunity. If the U.S. market made new highs on strong volume, that meant that a new bull market was beginning. His job was to "go with the flow." In the words of Jesse Livermore: "the only thing to do when a man is wrong is to be right by ceasing to be wrong." It's ok to be wrong, but not to stay wrong.

## **The historical analog vs. the specifics of the current situation**

John Templeton said the four most expensive words in the English language were "this time it's different." But I think this episode illustrates how deceptive it can be to rely on a simple historical analogy. Some key factors will align and tell a compelling narrative of how everything will unfold. But confirmation bias will discount other, conflicting facts.

## **Playing the cards (fundamental information) vs. playing the player (market participants' behavior)**

I think it's notable that Jones visited Japanese trading floors a couple of weeks after index futures started trading. He wanted to know the players. He wanted to have an intimate understanding of this marketplace. He watched the New Year's ceremony at the Tokyo stock exchange and analyzed the portfolios and incentives of the major institutional players. All of this was part of a mosaic: he wanted to understand positioning, sentiment, and behavioral biases.

*"I avoid letting my trading opinions be influenced by comments I may have made on the record about a market."*[25]

I do wonder to what extent Jones's public commentary affected his market views. It seems that he was aware of this potential pitfall. But being a vocal bear, or bull, year after year carries a danger that one wants to eventually be proven right.

In a 1997 article, a market observer noted: "Time and again I've heard traders say, 'You can always see Jones coming, but you can never see him going.'" That's something to keep in mind when hearing Jones's public opinion, such as his bearish call on bonds in early 2018. He may be a bear today, but he might already be going

with the flow tomorrow.

*"You guys [Barron's] talk about buying stocks and holding them for the long run. I'm flipping \$300 million every four or five days in the futures markets, because I'm a product of the day. I'm a consumer at heart, because that's the way I was raised."*[26]

## Sources

[1] Market Wizards, Jack Schwager

[2] "Trader With a Hot Hand," Barron's, June 1987

[3] Market Wizards, Jack Schwager

[4] "Trader With a Hot Hand," Barron's, June 1987

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[6] Barron's Roundtable, January 1988

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[11] Barron's Roundtable, January 1990

[12] Barron's Roundtable, January 1988

[13] "This Time the Turning Point Has Been Reached," George Soros, Financial Times, October 14, 1987

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[17] Barron's Roundtable, January 1989

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[22] Ibid.

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