

## Bubbles always burst; double bubbles make bigger bursts

Published: January 13, 2026, 12:10 am

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The FT has, whether inadvertently or not, added to the ongoing debate on where the next downturn is coming from with two articles on exchange traded funds in the last day. The first was on the use of these funds in the USA, [and noted that](#):

*Record-breaking inflows into exchange traded funds this year are fuelling fears that the tide of money surging into passive investment is helping to inflate a bubble in the US stock market.*

*Demand for ETFs has accelerated sharply this year, as a growing number of investors move into low-cost funds that track an index, and out of traditional actively managed funds in protest at inconsistent performance and high fees.*

A particular quirk on the use of these funds in Japan [was also noted](#):

*Last week ... the BoJ unleashed a test launch of ... a record-breaking grab of more than \$2bn of Japanese equity ETFs in 52 hours. That adds to a BoJ share portfolio whose book value passed \$127bn at the end of June and is on track to envelop 3.2 per cent of the Tokyo Stock Exchange's market cap, according to forecasts for June 2018.*

*Instinct suggests that being the only developed market central bank to buy equities at this astronomical volume will have consequences; evidence suggests that is already happening. Apart from damping the downside when an apocalyptic soundtrack is playing, the BoJ's \$30bn ETF spree in 2015 made that the first year since 1989 that the N225 posted a net gain for the year despite foreign investors being net sellers.*

First, a quick note on what ETF's are: as [Investopedia says](#) of these funds:

*An ETF, or exchange-traded fund, is a [marketable security](#) that tracks an index, a [commodity](#), [bonds](#), or a basket of assets like an [index fund](#). Unlike [mutual funds](#), an ETF trades like a [common stock](#) on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold. ETFs typically have higher daily [liquidity](#) and lower fees than mutual fund shares, making them an attractive alternative for individual investors.*

In other words, ETFs are quoted funds that are in effect tracker funds of other quoted investments. So what's the issue? There are two.

The first is the folly of the Bank of Japan: QE may have a role buying government bonds (although even that can be questioned unless the funds are used to create new asset investment) but it definitely has none in my view in buying corporate bonds, let alone shares. This is just market game playing and I cannot see any role for a central bank in doing that. The BoJ position is artificial and distortionary as a result and I can see no benefit from that.

The second is broader, and is a liquidity issue. If there is a run on these funds in the event of a stock market downturn I can see them adding to liquidity pressure as they effectively leverage the underlying assets by double quoting them. This could ratchet a downturn in market sentiment and add to instability, effectively reflecting the burst of a double bubble. Anything that can do that is dangerous. The fact that ETFs have had a good track record simply says they have reflected the market recovery (as opposed to the real market recovery) from 2008. Nothing suggests that they add real value, and I strongly suspect that in a period of instability they would do the exact opposite.

I share the FT's concerns.