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Investment Markets: Is there anything to learn from 1929? *Part 2*

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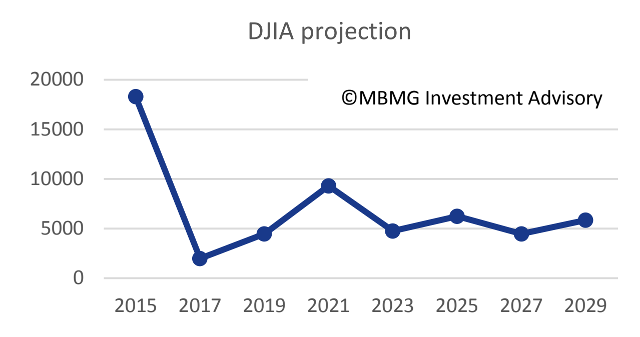
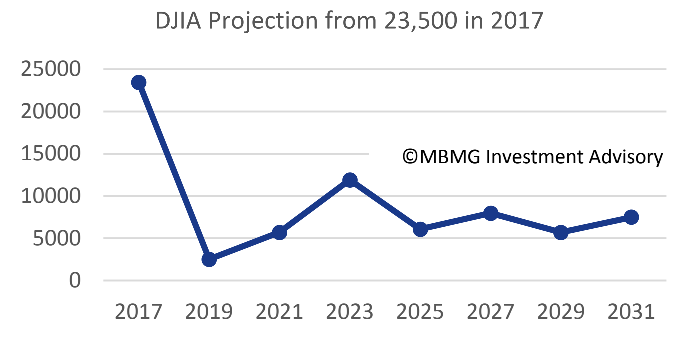
In Part 1, I looked at how the *Roaring Twenties* led to the Wall Street Crash and the Great Depression. In Part 2, we discover how the past can cast shadows on our future.

Taking the post-1929 situation as a benchmark, let's have a look at two possible future scenarios. First of all, imagine the pre-crash peak is 18,289 – the highest price reached in March of this year – this is how the next fourteen years could look if history did indeed repeat itself:



Source: author

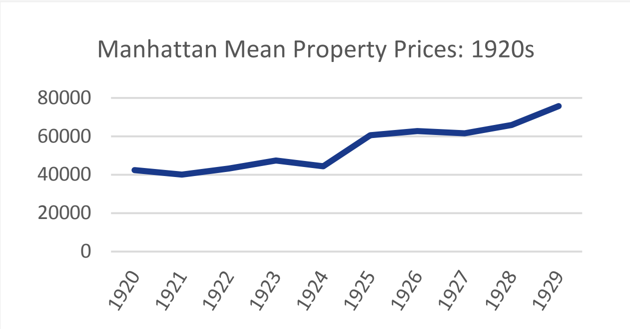
However in a perfect mirror of history, today might equate more closely to 1928 than to 1929 and therefore the DJIA could be expected to rise as high as 23,500 points in a re-run of the precursor to 'The Crash'. In which case a similar pattern over a prolonged period might look something like this:



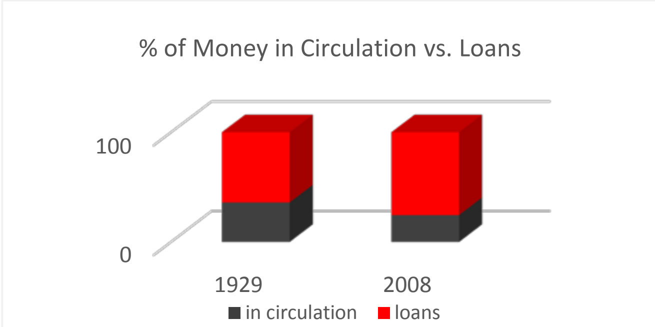
Source: author

An accident waiting to happen

If the timing of the Wall Street Crash was blamed on the Hatry fraud (mentioned in Part 1) or any other trigger, the fact that the market was so fragile came from the speculative boom of the late 1920s. Key indicators, such as property, show significant price rises and the amount of money borrowed was an astounding 1.8 times greater than the real money in circulation.

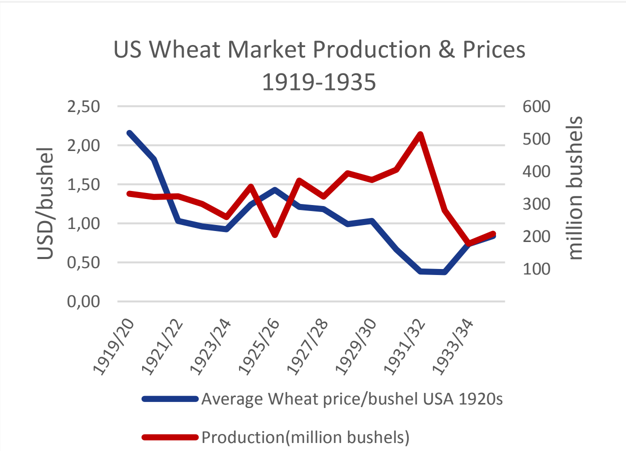


Source: Harvard Business School

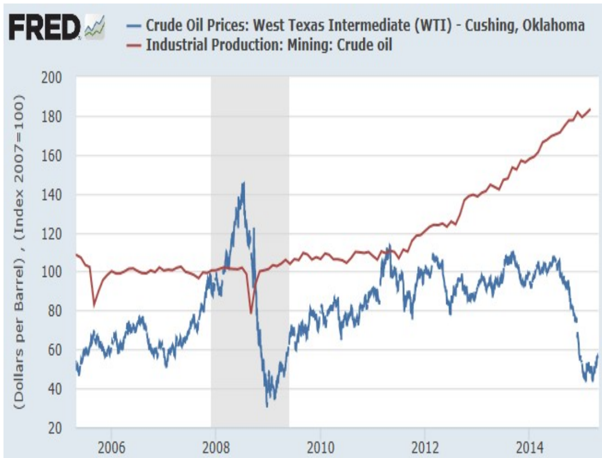


Sources: Federal Reserve, San José State University, Financial Times

One product where the prices did go down in the 1920s was wheat. However this was due to oversupply, meaning that farmers were becoming considerably poorer. Similarly, oil prices have taken a nosedive over the past year: on 20th June 2014, WTI prices hit USD 107.95 a barrel; eleven months later they were at USD 56.25 and have hovered between USD 55 and USD 60 ever since, going into mid-May 2015. This dramatic drop and subsequent low level has far-reaching repercussions; not least for the shale gas market.[1]



Source: USDA



Source: St Louis Federal Reserve

Two dramatic days on Wall Street in October 1929 saw the Dow Jones Industrial Average drop by 12.82% on *Black Monday* and a further 11.73% on *Black Tuesday*. Whilst the Wall Street Crash may be seen as lighting the blue touch paper to the Great Depression, we mustn't forget that, back in the late 1920s, only around 16% of

[1] http://business.financialpost.com/news/energy/how-falling-oil-prices-will-bring-u-s-shale-output-back-to-earth-this-year?__lsa=591c-cb8e

American households owned stocks and shares.[2] Nowadays, that figure is around 48%,[3] meaning that a future crash could have far wider consequences than that of 1929.

After the 1929 crash, measures were taken by governments and stock market authorities[4] to protect markets against such collapses thereafter – including halting trading during particularly turbulent times and regulating the activities of banks (separating commercial and investment banking).[5]

Over time the regulatory landscape based on the Glass-Steagall Act of 1933 eroded, as financial products evolved to circumvent the Act which wasn't updated or revised accordingly [6] meaning that by 1999, when Glass-Steagall was finally repealed, it had become largely marginalized and toothless; plus, the Bank Holding Company Act was amended. This change came after Citigroup and Travelers merged[7] and it allowed affiliations between financial services companies; such as banks, securities firms and insurance companies. The new regulations therefore removed the very barriers that Glass-Steagall had erected.[8]

In the aftermath of the 2008 Global Financial Crisis, the US government implemented the Dodd-Frank Act, giving itself more powers against banks in areas such as mortgage-lending and derivatives trading.[9] Part of this Act was the Volcker Rule, which banned proprietary trading and was designed to curb risky trading activities by banks.[10]

Consequently there has been a move towards restricting certain aspects of financial activity. However, that doesn't mean that bubbles will no longer occur. The crash of October 1987, for example, saw a 34% drop in the DJIA in just 2 weeks,[11] yet Glass-Steagall was still 12 years away from being fully repealed.

Not only that: in its QE and its near-zero-interest-rate programmes,[12] one of the Fed's stated objectives is to encourage the public to borrow more money.[13] That seems a strange move, given that household debt was at its

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[2] Russell Napier, *Anatomy of the Bear: Lessons from Wall Street's four great bottoms*, CLSA Books, 2005

[3] http://www.bankrate.com/finance/consumer-index/money-pulse-0415.aspx

[4] For example: by the NYSE in line with the US Securities and Exchange Act 1934

[5] Banking Act 1933, often referred to as the Glass-Steagall Act

[6] Barry Ritholtz, A Brief History Lesson: How we ended Glass-Steagall http://www.ritholtz.com/blog/2012/05/how-we-ended-glass-steagall/

[7] *idem*

[8] http://topics.nytimes.com/top/reference/timestopics/subjects/g/glass_steagall_act_1933/index.html

[9] http://www.investopedia.com/terms/d/dodd-frank-financial-regulatory-reform-bill.asp

[10] http://topics.nytimes.com/top/reference/timestopics/subjects/g/glass_steagall_act_1933/index.html

[11] See http://www.thebubblebubble.com/1987-crash/ for the story of the 1987 Crash

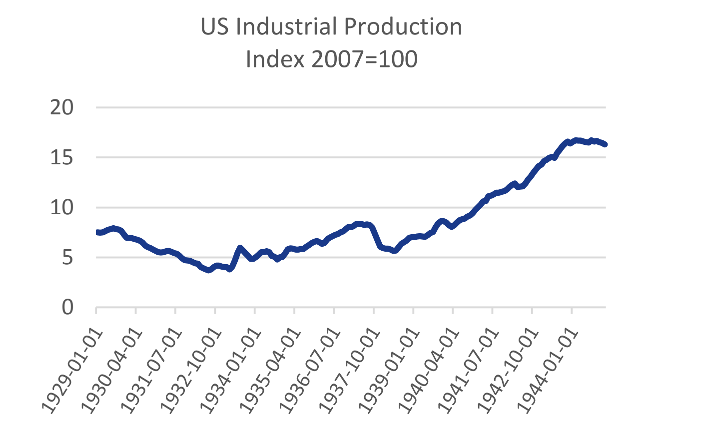
[12] http://www.bloombergview.com/quicktake/federal-reserve-quantitative-easing-tape

[13] https://research.stlouisfed.org/publications/review/13/01/Fawley.pdf

peak of 135% of disposable income[14] when the GFC began in 2007. It also raises the question as to whether this is purely a coincidence.

Benchmark for recovery?

Once the Great Depression took hold in the 1930s, FD Roosevelt famously promised a "New Deal for the American people."[15] Attempts to regulate the financial system and increase economic activity were hampered by unemployment, which was still close to 15% in 1940.[16] As for industrial production: it took America's entry into World War II for US figures to improve with any significance.



Source: St Louis Federal Reserve

Thus we currently have no practical benchmark for emerging from any downturn as prolonged as the Great Depression, without resorting to destruction of the planet.

The debate rolls on

86 years on, there is still widespread disagreement among academics as to what caused the 1929 Wall Street Crash and the Great Depression of the 1930s. One Princeton professor wrote a book in 2004 analyzing the causes of the Great Depression, in which he suggested, amongst other things, that flooding the system with money would help avoid a depression [17]. That professor was one Ben Bernanke – Fed chairman during the GFC. Along with Larry Summers, Ken Rogoff, Paul Krugman and the IMF's Olivier Blanchard – his former colleagues in Stanley Fischer's MIT class – he shows tendencies towards Milton Friedman's thinking that the economy is linear and the objective is a return to normal.

Others question the actual existence of normal. Economists such as Nikolai Kondratieff, Charles E. Mitchell and Joseph Schumpeter claimed that the Wall Street Crash was part of an economic wave and its impact was merely to speed up the arrival of a depression that was coming anyway.[18] Some economists, including Steve Keen (my colleague at economics think-tank *IDEA Economics*), believe that this is analogous to the situation we're in today. Steve, unlike Bernanke and friends, was one of only 13 economists who predicted the GFC.[19] He has spent many

[14] http://www.wsj.com/articles/americans-wealth-dips-amid-stock-volatility-1418317233

[15] The Roosevelt Week, *Time*, 11 July 1932

[16] Gene Smiley, "Recent Unemployment Rate Estimates for the 1920s and 1930s", *Journal of Economic History* (1983) 43#2 pp. 487–93

[17] Ben Bernanke, *Essays on the Great Depression*, Princeton University Press, 2004

[18] http://blogs.wsj.com/marketbeat/2008/05/30/springtime-for-kondratieff/

[19] http://barnabyisright.com/2013/05/30/an-historical-warning-for-proponents-of-a-modern-debt-jubilee/

years developing an economic model that is actually able to replicate upturns and downturns, rather than merely being able to be manipulated to produce never-ending expansion.

It's quite possible then that the cycle theory is the correct one and that the market manipulation being attempted today will merely create stability. Hyman Minsky argued that stability was the exception rather than the norm, leading us to revise our expectations upwards, thus causing speculative bubbles.[20] Persisting in following this upward path could well mean that collectively, we have learned nothing whatsoever about 1929 and its consequences.

For further information, please contact us by e-mail on info@mbmg-investment.com or call +66 2 665 2536.

Paul Gambles has completed CFA level 1 and is licensed by the SEC as both a Securities Fundamental Investment Analyst and an Investment Planner.

[20] Hyman P. Minsky (1982). Can "it" happen again? : Essays on instability and finance. Armonk, N.Y., M.E. Sharpe. p. 24, extracted from http://www.debtdeflation.com/blogs/2012/04/16/inet-presentation-minskian-perspective-on-instability-in-financial-markets/