Investment Markets: Is there anything to learn from 1929? *Part 1*

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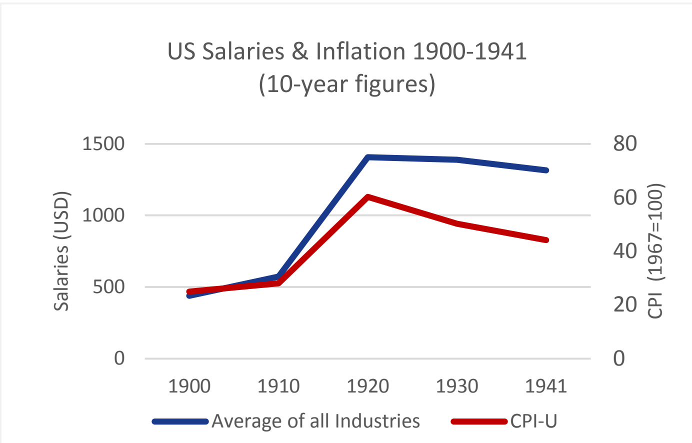
Predicting the future is always a risky business. Accurately forecasting when changes will happen is impossible.

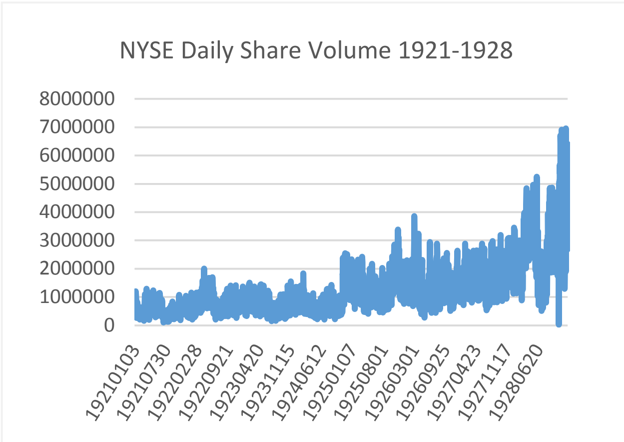
However if, like Kondratieff, we look at the economy as a series of cycles[1], the events around the Wall Street Crash of 1929 and the Great Depression of the 1930s can alert us as to what may happen in the near future.

The Roaring Twenties

Let's take the 1920s as an example. The *Roaring Twenties*: a time when average Americans suddenly had more money in their pockets than ever before; a time of booming consumerism and, towards the end of the decade, investing in the stock market.



Source: St Louis Federal Reserve



Source: NYSE

In fact, the rush to become a consumerist society was merely part of the surge in American urbanization – the urban population rose from 28% in 1880, just under 40% in 1900 to over 51% in 1920[2]. Whilst the cities prospered, this trend also meant that the agricultural sector suffered greatly:[3] a factor which in itself has been cited as a factor leading to the 1929 Crash[4]. Consequently, 1920s USA suffered a significant disparity of wealth, the likes of which we have not seen… until today.

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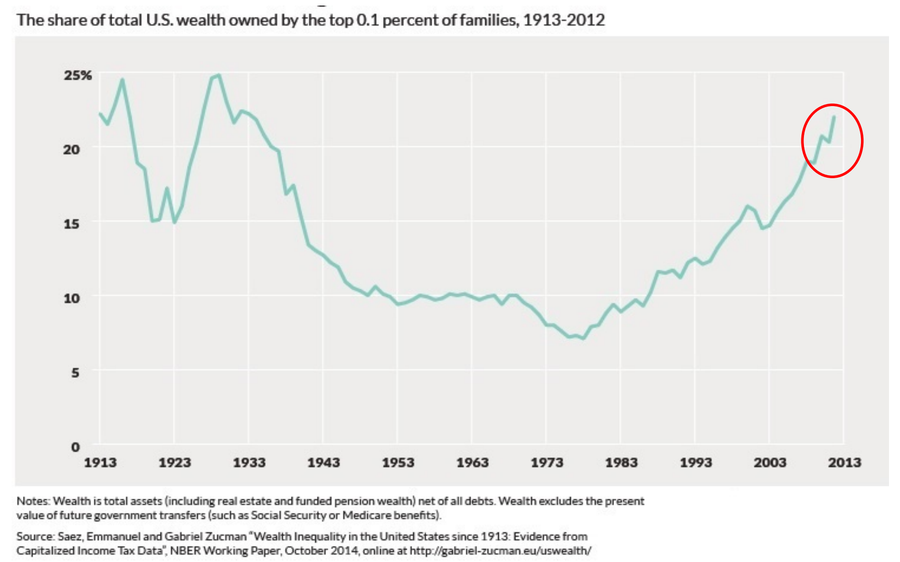
[1] http://www.investopedia.com/terms/k/kondratieff-wave.asp
[2] US Census Bureau
[3] Dan Bryan (2012). *The Great (Farm) Depression of the 1920s*, American History USA http://www.americanhistoryusa.com/great-farm-depression-1920s/
[4] http://eh.net/encyclopedia/the-1929-stock-market-crash/



Source: Washington Center for Equitable Growth

Another similarity between the 1920s and the 2000s is the level of confidence in the strength of the markets and the overall economy. Key players shared an unswayable belief that the economy could take a downturn as it had in the past.

> Stock prices have reached what looks like a permanently high plateau.
>
> - Irving Fisher (economist), 15th October 1929 (9 days before Black Thursday)

> At this juncture […] the impact on the broader economy and financial markets of the problems in the sub-prime markets seems likely to be contained.
>
> - Ben Bernanke, (chairman of the Federal Reserve), 28th March, 2007 (by 3rd April, over 50 mortgage companies had declared bankruptcy in 2007, including highly-respected New Century).[5]

> This is far and away the strongest global economy I've seen in my business lifetime.[6]
>
> - Henry Paulson, (US secretary of the Treasury), 12th July 2007 (1 month before BNP Paribas froze 3 funds, acknowledging risk of exposure to sub-prime mortgage markets

There had already been a drop in prices in March 1929, which had caused panic before Charles E. Mitchell's National City Bank provided USD 25 million of credit to prevent the market from dropping further.[7] However

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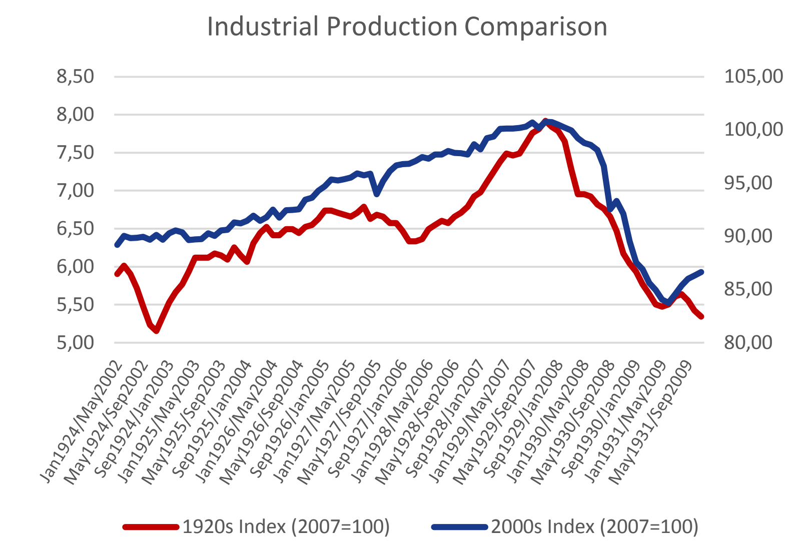
[5] http://www.washingtonpost.com/wp-dyn/content/article/2007/04/02/AR2007040200591.html

[6] http://archive.fortune.com/magazines/fortune/fortune_archive/2007/07/23/100134937/index.htm

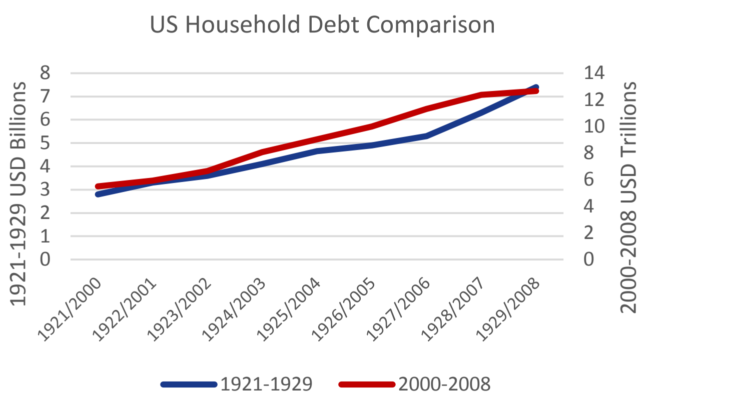
[7] Jerry W. Markham, A Financial History of the United States: From Christopher Columbus to the Robber Barons (1492-1900), M.E. Sharpe 2002

the rise was temporary and the overall US economy was flagging, with industrial production symptomatic of the slump. If we compare industrial production figures of the early twentieth century with those of today, the similarities are uncanny.



Source: St. Louis Federal Reserve

Furthermore, consumer debt tripled in the 1920s reaching around USD 7 billion in 1929. This was because, for the first time, middle-class Americans were able to buy on credit through *buy now, pay later* practices. Generous lines of credit were offered by department stores for families who were not able to pay upfront but who could demonstrate their ability to pay in the future. Instalment plans were also offered to buyers and more than half of the automobiles in the nation were sold on credit by the end of the 1920s.[8] In the eight years before the Wall Street Crash, household debt levels in America more than doubled – a pattern that was replicated in the build-up to the GFC in 2008.

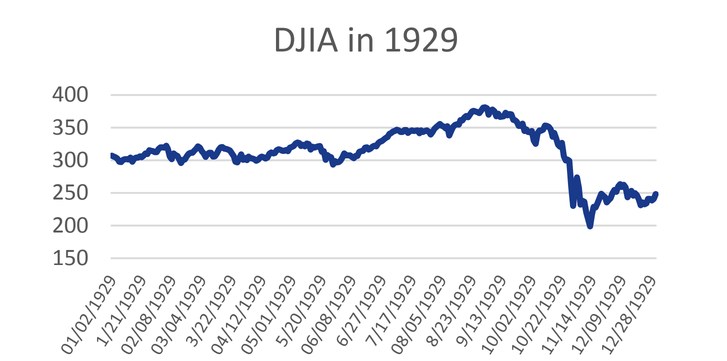


Sources: Historical Statistics of the United States & Federal Reserve Bank of New York

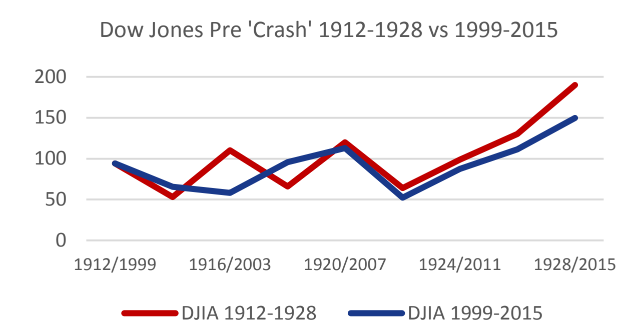
[8] http://www.thebubblebubble.com/roaring-twenties-bubble/

Despite all the warning signs, including stock market prices dropping in March and May 1929, the Dow Jones Industrial Average gained around 28% between June and September 1929.

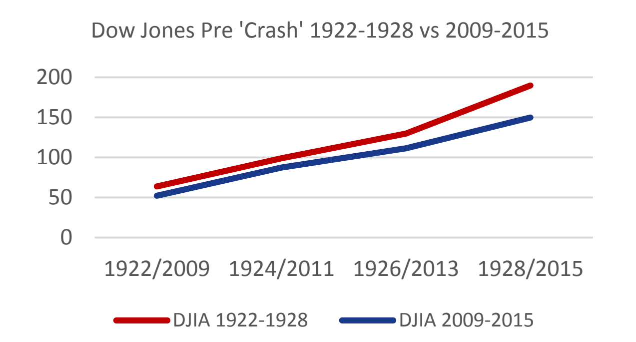
In fact by September 1929, there had been a near 200% rise in stock market prices in 7 years. Whilst this was not something which happened prior to the GFC, it is in fact a trend that is happening today – evolution between prices in 1922-1928 and 2009-2015 is eerily similar:



Source: NYSE



Data: St Louis Federal Reserve; Chart: author



Data: St Louis Federal Reserve; Chart: author

Any remote event can be the trigger

The 1922-1929 rise may have given the likes of Irving Fisher the impression that it was permanent but things began to unravel in the autumn of 1929. In September, American optimism in overseas markets took a blow thanks to a case involving Clarence Hatry, described by John Kenneth Galbraith as "one of those curiously un-English figures with whom the English periodically find themselves unable to cope".[9] Hatry had built up a business around vending machines but was discovered by the London Stock Exchange Committee to have expanded his empire through issuing unauthorized stock.[10] The fraud was for a significant amount of money, but it was nevertheless committed in England – a world away from the big banks of Wall Street.

This event may not have been solely responsible for a sudden lack in confidence; however it did nothing to ease public concern just seven years after Charles Ponzi was jailed.[11]

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[9] John Kenneth Galbraith, *The Great Crash 1929* (1955) Mariner Books; Reprint edition (2009)

[10] *ibid*

[11] Barry Eichengreen & Kris Mitchener (2003), BIS Working Papers, No 137, The Great Depression as a credit boom gone wrong).

We would do well to take heed from the Hatry example. When markets become vulnerable, any remote incident can burst it. For example, the first quarter of 2015 was marked by a sharp drop in oil prices. As some commentators lauded this as positive news for the consumer, it is worth noting North American oil companies have since reduced plans for 2015 capital expenditure by 41%. One way of reducing spending so rapidly is to make redundancies – it has been estimated that by March this year, 75,000 global oil industry workers had already been laid off.

Lower oil prices puts pressure on shale gas producers, whose exploration funding has largely been financed by junk bonds.[12] Once enough investors get twitchy about shale gas companies' ability to repay, it could trigger a financial crisis.[13]

Once the scene had been set in 1929, governments' reactions globally were to adopt *beggar-thy-neighbour* policies to advantage their economy of competing countries'. The US government passed the Smoot-Hawley Tariff Act[14] which raised import tariffs to record levels. Since the 2008 GFC, this mentally has returned, particularly in the form of competitive devaluations, sanctions and through easing interest rates.[15] The US, the UK, Japan and the Eurozone have embarked on unprecedented policy experiments.

Despite a one-day respite the day after Black Thursday, the Dow continued to fall until mid-November. Recoveries and putative bounces followed – including a long slide from April 1931 to July 1932 when it hit the lowest point in the whole twentieth century). Consistent upturn did not come about until after the US had entered World War II and it only came back to pre-crash levels in 1954.

Source: Stockcharts.com

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 Fundamenta Investment Analyst and an Investment Planner.

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[12] http://www.nytimes.com/aponline/2014/12/19/business/ap-us-junk-bond-slump.html?_r=0

[13] See MBMG IA Update *Oil Price drop could fuel crisis*, December 2014 http://www.mbmg-investment.com/in-the-media/inthemedia/34

[14] 19 U.S. C ch. 4

[15] http://www.zerohedge.com/news/2013-11-11/beggar-thy-neighbor-back-goldmans-five-things-watch-currency-wars-return

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