Address to the Spring Dinner Meeting of the Committee for Monetary Research and Education (CMRE)

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INSTITUTIONAL ADVISORS

May 14, 2009

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Great Depressions Are So Methodical

One of the features of a great boom is the excitement of shared convictions about eternal prosperity. One of the features of the consequent contraction is bewilderment about how suddenly the bust arrived. Beyond those directly hit, the establishment becomes perplexed by the loss of liquidity and wonders where the money went.

With the 1980s crash in oil and property deals, a hearing run by offended politicians asked a particularly aggressive Oklahoma banker about "just where did the money go?". And as the Wall Street Journal faithfully reported "We spent it on wine, women and song – the rest we just pissed away."

As flippant as this may be, it is accurate and could be suitable in any example in any century. Fortunately, for consistency in any century, there is the classic definition of inflation that it is an "inordinate expansion of credit". In the 1930s, Keynes in a number of letters to the Fed twisted this around to mean that inflation was simply rising prices that had very little to do with central bank manipulations.

Fortunately, Keynes is not around to provide official confusion to the description that deflation is an inordinate contraction in credit. Relentless credit deflation started in 2007, and this implacable force has been part of every long depression.

Clearly, the title of this address puts me firmly in the bear camp. Just as clearly, the possibility of another great depression is highly controversial, particularly when such magnificent efforts are being made to restore the prosperity of a financial mania, which have always been ephemeral.

Perhaps my credentials should be reviewed. Everything I needed to know about the markets I learned on the old and notorious Vancouver Stock Exchange. For example, in a world of extravagant claims from big government, big academe and big Wall Street the old definition of a promotion is useful: *"In the beginning the promoter has the vision and the public has the money. At the end of the promotion the public has the vision and the promoter has the money."*

In 2006 to 2007 the public had the vision that policymakers could depreciate the dollar forever and were positioned accordingly. And for a moment the promoters looked brilliant as everyone thought they were wealthy. Moreover, as with any promotion the bigger it is – the bigger the crash.

There are two failures going on. The most obvious is in the financial markets and the other is in interventionist economics. The latter failure is in theory as well as in practice, and can be described as the greatest intellectual failure since the Vatican insisted that the solar system revolved around the earth, more particularly, Rome. Too many still believe that the financial world revolves around the Federal Open Market Committee.

Last year's disaster fit the pattern of the 1929 fall crash with remarkable fidelity. Such a crash was obvious and as the train wreck in the credit markets continued through the summer of 2008 the Fed continued its recklessness. But with some marketing skills, the objective of "stimulus" changed from keeping the boom going to the absurd notion that bailing out one insolvency, Bear Stearns, would revive the boom. As usual with a bubble, it was not just one bank that had been imprudent – most had been.

The establishment missing this recurring event was bad enough but there is another clanger and that is the hopeless notion of a national economy. Even in ancient times, Cicero knew that the prosperity of Rome was vulnerable to the credit conditions in the Middle East. In this regard, Mother Nature has again been providing some harsh lessons, and history suggests she and Mister Margin will ultimately be successful in teaching markets 101 to many policymakers.

In the meantime, coming out of the classic fall crash orthodox investments such as commodities, stocks and bonds were expected to rebound out until April-May. Until this hooked up, the typical GDP forecast was tentative in looking for the recovery to begin "by mid-2010", but our "model" needed forecasts of the recovery starting much sooner. Then, thanks to the "Green Shoots" that began to appear with the rebound in March, confidence was gradually restored in high places such that the miracle of recovery would happen sooner. The higher the stock market gets the more popular this idea becomes.

And this gets us to another lesson from the old Vancouver Stock Exchange. *"So long as the price is going up – the public can believe the most absurd story."* This has been the best explanation of why Wall Street, the supposed bastion of capitalism, focused on every utterance from central planners in a central bank. Then when the price breaks, the vision disappears along with liquidity.

The next phase of the contraction has been expected to start after mid-year.

For most participants, post-bubble bear markets have been sudden and severe. The 1929 example ran for three years and the post 1873 example lasted for five years. The latter has been the best guide for our recent mania and its bust, but this will be expanded in a few minutes as it is worth reviewing the excuses offered by many in not anticipating that short-dated interest rates as well as gold would plunge in a classic fall crash. This was the pattern with the 1929 and 1873 crashes and knowledge of such a plunge in short rates should have ended conventional wisdom that a Fed rate cut would have prevented crashes from 1929 to 2008.

The quickest sign of a gold bug forecast going wrong is "Conspiracy!". With their latest disappointment Wall Street strategists described it as a "Black Swan" event, and therefore unpredictable. That has been a cheap out as each transition from boom to bust has been methodical. Others called it a "Minsky Moment". Minsky accurately described the mechanism of a crash, but being a Keynesian he also wrote that "apt intervention" could keep the economy on a successful path.

Actually, financial conditions reached the perfect "Keynesian Moment". As we all know, Keynes said "If you save five shillings you put a man out of work for a day." As part of the greatest mania in history the savings rate plunged to zero – Keynesian perfection had finally been accomplished. Many in the street, but only a few economists, knew this was dangerous. Econometric modelers, who still believe in the powers of regression equations, have long had their out, which has been "Exogenous", and in one memorable paper of 1983 there was "Super-Exogenity". This arrived in May 2007 when the yield curve reversed from inverted to steepening. Our research expected it to occur around June. By July of that fateful year, there was enough deterioration to conclude that *"This is the biggest train wreck in financial history"*. It is not over.

Although crashes are grisly events, they share a common response from the establishment. No matter how shocking, bloody, expensive, ruinous or just plain shattering a crash is – within a week, there is no one in the street who didn't see it coming. As ironical as this is, there is a critical link from the stock market to the economy.

On the usual business cycle, the peak in stock speculation typically leads the peak in the economy by about a year. On the previous example, stocks set their high in March 2000, and the NBER set the start of that recession in March 2001. Using their determination this has been the case for most cycles back to 1854. But, at the conclusion of each great bubble in financial and tangible assets things change from normal. The failure in the financial markets and the economy beginning in 2007 have been virtually simultaneous.

As we all know, in 1929 the Dow made its high in September and the recession started in August. In 1873 the bear started in September, and the recession in October. This time around, the stock market high was in October 2007 and this recession started in December of 2007. Close enough to fit the post-bubble model, with implications that financial history is now in the early stages of another Great Depression.

This melancholy event is being confirmed by the behaviour of politicians and policymakers. After swanning around claiming credit for the boom politicians panic and then find scapegoats. Remember the "Goldilocks" celebration of perfect management of interest rates, money supply and the economy. Well, all five great bubbles from the first in 1720 to the infamous 1929 have been accompanied by such boasting, followed by what can best be described as frenzies of recriminatory regulation. If the political path continues – protectionism – will follow.

One of the worst such examples was called, in real time, the Tariff of Abominations. But, this is enough of dismal events and it is time to turn to irony for amusement and enlightenment. The clash between the establishment and financial history is rich with irony. Beyond that, financial history, itself, should be considered as an impartial "due diligence" on every grand scheme promoted during a financial mania by the private sector as well as by policymakers. Let's use a good old fashioned term – policymakers have been financial adventurers.

One of the richest ironies occurred with the 1873 mania and its collapse. With typical strains developing in the credit markets during a speculative summer, the leading New York newspaper editorialized:

“but while the Secretary of the Treasury plays the role of banker for the entire United States it is difficult to conceive of any condition of circumstances which he cannot control. Power has been centralized in him to an extent not enjoyed by the Governor of the Bank of England. He can issue the paper representatives of gold, and count it as much as the yellow metal itself. [He has] a greater influence than is possessed by all the banking institutions of New York.”

In so many words, because the treasury secretary was outstanding and had the benefit of unlimited issue of a fiat currency – nothing could go wrong. But it did; the initial bear market lasted for five years and the initial recession ran a year longer. The pattern of severe recessions and poor recoveries continued such that in 1884 leading economists began to call it "The Great Depression", that endured from the 1873 bubble until 1895.

An index of farm land value in England fell almost every year from 1873 to 1895. Of course, academic economists were fascinated and for a couple of decades wondered how such a dislocation could have happened, or even worse, discussed how it could have been prevented. Ironically, this debate continued until as late as 1939 when another Great Depression was belatedly discovered.

Naturally the long depression was blamed upon the old and unstable Treasury System, and at the height of the "Roaring Twenties" John Moody summed it up with:

"The Federal Reserve Law has demonstrated its thorough practicality, and thus secured the general confidence of the business interests. The breeder of financial panics, the National Banking Law, which had been a menace to American progress for two decades, has now been replaced by a modern scientific system which embodies an elastic currency and an orderly control of money markets."

The probability of a depression has been discussed in the media. It seems that both sides have yet to provide adequate research, with the establishment's response limited to a classic non sequitur. *"This is nothing like the Great Depression, where we had 25%*

unemployment". That was just the most recent example and sound research would compare unemployment numbers from the first year after the crash. In 1930 the number was around 8%, and in noting that there could be some difference in methodology today's number is an 8 percenter.

Will it get to 25 percent? This remains to be seen, but unemployment in the private sector will be the worst since the last great depression.

By way of a wrap we will take it from the top. In late 2007, Gregory Mankiw, boasted that the US had a "dream team" of economists as advisors, and as with all claims at the top of six previous bubbles "Nothing could go wrong". And even if things went only a little wrong there were the "safety nets" that Krugman claimed would prevent serious deterioration. Our view on Keynesian safety nets has always been that in a bust they would be about as useless as a hardhat in a crowbar storm.

In the post-1929 bust policymakers were realistic enough to know that the boom caused the bust. The SEC was established to prevent another hazardous 1929 mania. Also, one of the promoters of the SEC boasted that the SEC would put a *"Cop at the corner of Wall and Broad Streets"*. Without much doubt the SEC has failed to live up to its billing. The discovery of malfeasance always accompanies the discovery of malinvestment.

Of course, the other act passed to prevent another 1929 mania was Glass-Steagal, which separated commercial banking from the evils of Wall Street. This was taken off the books in 1999 as too many banks were participating in the high-tech frenzy.

Has this happened before? I'm glad I asked the question. With the financial violence of the South Sea Company in 1720, the House of Commons passed the "Anti-Bubble" Act, which was taken off the books in 1771 – just in time for the full expression of the 1772 bubble. As with the climax of the 1720 bubble the Great Depression ran for some twenty years. This was also the case for the bubbles that blew out in 1825, 1873, and 1929.

This ominous sequence of financial excess and consequent disaster brings us to 2007, which will soon have the connotation of "1929", as the world experiences the sixth Great Depression. Quite likely, the only offsetting event could be the collapse of interventionist policymaking, that would eventually be seen as a blessing.

The title of this address, "Great Depressions Are So Methodical" is intended to be ironical, but some may be startled by the audacity of the statement. Actually it is the conclusion that anyone would make after a thorough review of market history. The real audacity is in the claims of charismatic economists that their personal revelations can provide one continuous throb of happy motoring. As Hayek said – Keynes, as a young scholar, was absolutely ignorant of financial or economic history. Only someone who was ineffably ignorant of financial history would claim that it can arbitrarily be altered.

The next Oscar in audacity goes to Paul Samuelson, who, in the 1960s, boasted that the business recession had been eliminated. Right!

Another such example was recently provided by Gregory Mankiw when he condemned the “old” Fed with "When you look at the mistakes of the 1920s and 1930s, they were clearly amateurish." Any impartial review of market history would conclude that the "Roaring Twenties" and the contraction was the way financial history works, after all it was the fifth such example. It is worth recalling that at the height of the 1929 mania John Moody had condemned the old Treasury System while reciting that the new Fed was the perfect instrument of policy.

Mankiw then bragged *"It is hard to imagine that happening again – we understand the business cycle better".*

The Harvard professor topped this late in 2007 with: *"The truth is that Fed governors, together with their crack staff of Ph.D economists, are as close to an economic dream team as we are ever likely to see."*

Now it is time to get into the way Great Depressions have worked. All six have started with soaring prices for tangible and financial assets that, typically, run against an inverted yield curve for some 12 to 16 months.

Then when the curve reverses to steepening it is the most critical indicator that the credit contraction is starting. This time around, the sixteen-month count ran to June 2007 and the curve reversed by the end of May. Our presentations in that fateful month stated that the greatest train wreck in the history of credit had begun. Deterioration through July prompted the advice that most bank stocks were a nice "widows and orphans" short.

Beyond the raw power of speculation, one of the key features is each mania has been accompanied by a remarkable decline in real long interest rates, sometimes to zero, and sometimes to minus. In our case the decline was to around minus 1.5% in January and the increase so far has been 5 percentage points. In five previous examples, the typical increase has been twelve percentage points, which has been Mother Nature's way of correcting untempered expansion of credit. And - in our times, untempered policymaking.

Lower-grade corporate bonds, have already suffered an increase of some 25 percentage points, which suggests that the 12 point potential for treasuries is possible.

There is another important distinction. At the peak of a great bubble, the stock market peaks virtually with the business cycle. In 1873, the stock market blew out in September and the recession started in that October. As noted above, a fiat currency with the potential of unlimited issue was not proof against yet another Great Depression. In 1929 stocks peaked in September and the economy peaked in August. This time around stocks set their high in October, 2007 and according to the NBER, the recession started in that December.

Since 1937 the average length of recession has been ten months, with six in the order of 8 months. This one has run for 17 months, which breaks a long-standing pattern. Following

1873, the initial recession lasted 65 months, and following 1929, it ran for 43 months. NBER data starts in 1854 and these were the longest recessions, with no others in this league. This one has the potential of being a long one.

This is a lot of history, but what is happening in the markets right now? Well, then the Green Shoots have finally encompassed chairman Bernanke. On May 5, Bernanke observed that the *"broad rally in equity prices"* is indicating that *"economic activity will pick up later in the year."*

At the height of a similar rebound to April-May of 1930, Barron's wrote:

> *"It is thus apparent that the public preference for stock is not only as marked as ever, but also the will to speculate is still a speculative factor not to be overlooked. The prompt return of huge speculation and the liberal manner in which current earnings are again being discounted indicate that it will be difficult to quench the fires of stock-market enthusiasm for long."*

Prompted by an animated stock rally, the Harvard Economic Society, but with more gravitas, concluded that it "augured" a recovery by late in the year. As we all know this did not last and what we should understand is that it is the dynamics of a crash that sets up the exciting rebound. Not policymakers.

Let's look at a classic fall crash, which we expected. The pattern is interesting. The 1929 crash amounted to 48%. The decline to the low in November 2008 was 47%, and within this the hit to October 27 amounted to 42%. In 1929 the initial plunge amounted to 40% to October 29.

The rebound was to November 4, in both examples, with 2008 gaining 17% and 1929 gaining 12%. The final slump into each November was 22% and 23%. Is it important to identify it as 1929 or 2008?

Our "historical" model expected the crash and the rebound, as well as the nature of the establishment's utterances. Another usual event is a frenzy of recriminatory regulation – all supposedly new, but delivered without knowing that their counterparts over the centuries have made the same futile gestures.

Ironically, today's excitement in the markets and convictions in policymaking circles are important steps on the path to a great depression. As disconcerting as this may be, it is worth reviewing another cliché of policymaking, which is the notion that lowering administered rates will restore the momentum of a boom. Massive declines in short rates, such as Treasury Bills have only occurred in a post-bubble crash. In 1873 the senior bank rate plunged from 9% to 2.5%, as the stock market crashed. In the 1929 example the fed discount rate plunged from 6% to 1.5%, as the stock market crashed.

This is getting a little heavy. Not so long ago, but in another world, financially speaking, when an economist would change a forecast on GDP from 3 % to 3.25% it was only done to display a sense of humor. Now policy wonks seriously debate whether the Fed target rate should be zero or a quarter of one percent (that's 0% to 0.25%). It is patently absurd to debate what the rate should be or whether it would have any effect on financial history.

It won't, because we are in a world of financial violence that is not random, and not due to the Fed not making the perfectly-timed rate cut. Instead it is due to a natural accumulation of private speculation, as well as a chronic experiment in policy by financial adventurers – to accurately use a Victorian term.

There are some early terms to describe the sudden loss of liquidity that marks the end of a bubble. In the 1561 crash Gresham wrote the *"Credit cannot be obtained – even on double collateral."*.

Another term goes back to the 1600s when Amsterdam was the commercial and financial center of the world. The Dutch described the good times as associated with "easy" credit and the consequence as "diseased" credit. I'm sure that all in this room would agree with the accuracy of the latter description. Diseased credit.

What can be done about it? Nothing – since the 1500s the literature is complete with many comments that someone, or some agency can set interest rates – either high or low depending upon the personal concerns of the writer.

Misselden in the 1618 to 1622 crash earnestly believed that throwing credit at a credit contraction would make it go away. Despite all this history, Keynes and his disciples cannot be accused of plagiarism.

What's next?

Virtually, all of the "good stuff" likely to be revived into May is being accomplished. This includes investments such as commodities, junk-bonds and stocks, as well as positive statements from the establishment. Both technical and sentiment measures on the stock market are at "tilt" levels.

Because it is up at the right time, the conclusion is that the down will come in on time as well. This would be the next step on the path towards another Great Depression.

Of course, there is no guarantee that events will continue on the path. But, then there is no guarantee that it won't. Best to consider the odds.

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