A Depressing Analog

"The fault, dear Brutus, is not in our stars, but in ourselves, that we are underlings." -- Shakespeare's *Julius Caesar*

Well, yes and no. While I have never paid much attention to financial astrologers, who like proponents of Elliott Wave seem congenitally incapable of delivering a simple answer to a simple question, I believe we have far less free will in our lives, in our fortunes and in our collective history than we like to think.

While we are waxing philosophical, I agree with Hegel and Marx' concept of broad historic forces being larger than any one of us, but I also believe individuals can and do make very profound differences in the course of civilization. Disagree? Ask yourself what the course of world history since June 28, 1914 would have been if Gavrilo Princip missed Archduke Franz Ferdinand with his pistol shot? Everything since has been a footnote to the start of World War I.

Think of your own life and how much of where you are today was determined not by direct consequence of your efforts but rather by sheer randomness. Yes, luck is the residue of design, but it is chance combined with your efforts that is a far greater contributor to where you are today than simple effort alone. We do not teach children how much of their future will be determined by randomness; it might be too debilitating to their spirits.

The Great Comparison
All of this is a windup to the question being debated endlessly, both in *RealMoney* and elsewhere, whether the current crisis is going to send us into a repeat of the Great Depression (remember, World War I was called The Great War until events necessitated a name change).

The debate generally proceeds as if it were a boxing match where each punch is tabulated so as to declare a winner by judgment. The side saying not to worry has some impressive arguments on their behalf. These include a relatively early and now unbelievably massive intervention by the Federal Reserve and other monetary authorities, an effort to recapitalize and backstop banks by the Treasury and other finance ministries, no retreat yet into beggar-thy-neighbor protectionism, no misguided efforts to raise taxes and balance the budget and no collapse, yet, of the money supply.

The side fearful of a repeat points to the massive deleveraging of assets, both real and financial, an obvious impairment of the banking system and a pernicious credit crunch that has persisted either despite of or because of the massive efforts to break it, the sudden onset of economic weaknesses as evidenced by declines in industrial commodity prices and a flight away from risky assets in general. Most of our macroeconomic indicators are lagging, especially employment, and have yet to reflect the chill winds surely produced by the market shocks of the past two months.

The Fates Have Spoken
Another approach may be to abandon the point-by-point scoring alluded to above in favor of a theme common in Greek mythology, the inevitability of the fates. We do not like to recognize this possibility any more than we do the role of randomness in our own lives; we prefer to believe we are in control of our own destinies. To that I offer all of the programs created in the last two months to forestall the unfolding crisis and ask, "Did these work as intended, fail or simply produce a combination of successes, failures and unintended consequences?" I will go with the latter; we are thrashing about much as the New Deal really involved far more thrashing about with mixed results than recognized at the time.

If the fates indeed have spoken, we are in for some long-term unpleasantness, discussed below. I began to wonder about this in October 2002, a time when comparisons between the Nikkei 225 and the NASDAQ Composite were all the rage. I noted then we were on an interest rate path similar to that seen in Japan following its twin bust of stock and real estate bubbles in 1990 despite all of the very profound differences between the U.S. and Japan at both the market and macroeconomic levels. Restated, the analogy was holding despite the point-by-point scoring.

I noted six years ago how the Japanese suffered simultaneous wealth shocks from dual bubbles, stocks and real estate, bursting, while we suffered only one, stocks. We now are suffering twin wealth shocks just as Japan did. I will spare everyone a reciting of the horrific statistics for residential real estate other than to note its effect on financial firms' collective balance sheets. Through the end of the third quarter, firms worldwide lost close to $265

billion more than they raised in new capital. Choose your own leverage ratio as to what those net losses meant for new credit; at 10:1, $2.65 trillion in potential credit disappeared. As public and other funds have poured into the financial system to the tune of approximately $235 billion in the fourth quarter to-date, some of the financing hole has disappeared but at the cost of forward public liabilities almost too large to imagine.

Now let's point out just how exposed the U.S. is to equities by taking the simple ratio of stock market capitalization to GDP. Even though this is comparing the future value of American business, a stock concept, to each year's GDP, a flow concept, it does give us an idea of overall exposure to the stock market. This ratio reached 81% in 1929 and did not reach that level again until the third quarter of 1995. It went over 100% for the first time in November 1996 and peaked at 183% in March 2000. It is likely to dip back below 100% by the end of this quarter.

Comparing A Stock To A Flow

As I noted in March, the long upswing in stock market capitalization between 1982 and 2000 allowed Americans to consume more and save less; even after relative stock market capitalization fell after 2000, Americans could still borrow against their houses as mortgage credit was too cheap and too available. The net impact of both asset classes being under such duress today is Americans will have to save more and consume less as "free" savings from asset appreciation no longer are available. That decline in aggregate demand is highly recessionary and highly deflationary unless offset by fiscal spending.

Yes, the government is spending like a drunken sailor, not on make-work projects as in the 1930s or on public works boondoggles as in Japan in the 1990s, but rather on financial system recapitalization. The hope is recapitalized banks and unclogged short-term credit markets will offset the pernicious effects of asset deflation. This is a relatively new experiment in public policy and makes the current crisis unique.

I will say this: If banks are going to take their TARP funds and buy other banks, as PNC did with National City, nothing will be achieved on a macro level.

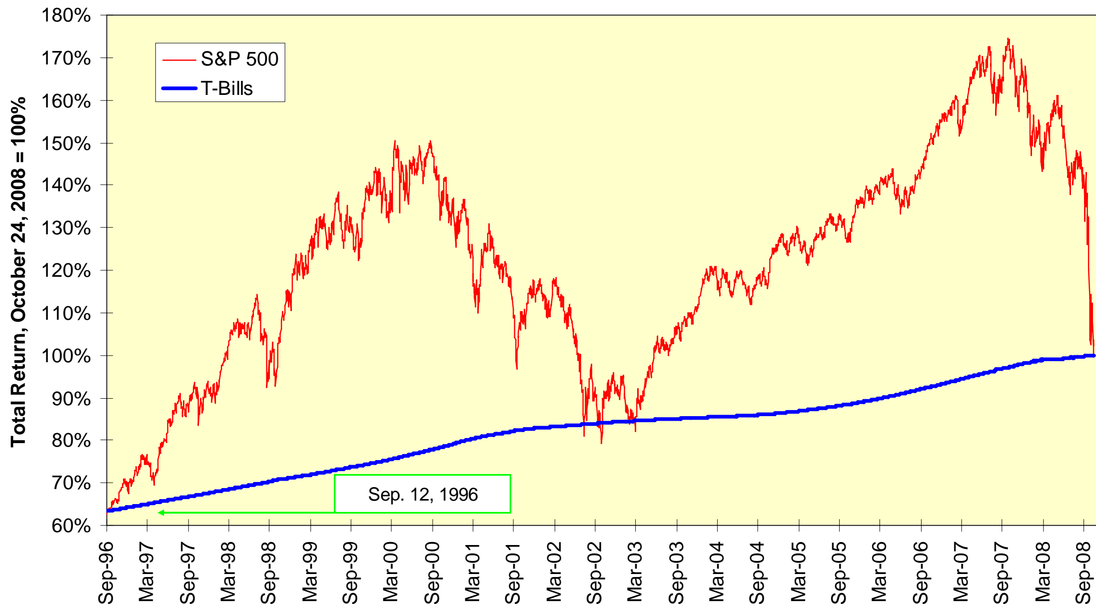
Culture Shock

A final set of points must be made. National calamities force people to question their core values and beliefs. The loss of a generation in The Great War forever broke the bond between the British upper and lower classes. The Great Depression forever altered the role of government within society.

Investors' core beliefs have been shaken. People were told to buy and hold, to diversify and that if they were to make any returns they would have to assume more risk. And they bought the argument; investing became a national pastime and indeed a source of entertainment.

But this advice failed. Let's compare the total return paths of the S&P 500 and of an index of three-month Treasury bills, indexed to October 24, 2008. If we go backwards in time, we see how the SPX underperformed the T-bills in the 2002-2003 bear market after giving up all of its gains. If we keep going back in time to find the date before which you would have had to have bought and held a SPX index instrument to have outperformed risk-free T-bills, it would be September 12, 1996. That is correct: All you achieved by taking on stock market risk over the past twelve years was a roller-coaster ride; gains came and went, but at the end of the game the tortoise was doing a touchdown dance in the hare's end zone.

The Tortoise And The Hare



How will investors en masse react to this realization? If the experience of the Great Depression and modern Japan are any indications, they will retreat from risk and focus more on the return of the principal than the return on the principal.

This collective risk-aversion will intersect with the retirement of the Baby Boom generation, the huge unfunded liabilities of Social Security and Medicare and the massive indebtedness of the U.S. If you pile such a burden on a risk-averse populace, the best you can hope for is years of slow growth, low returns and a cultural shift away from risk-taking and consumption.

So let's stop worrying whether this is 1929, 1987 or 1990 in Japan and accept the reality this is 2008 around the world. No one knew once The Great War began how it would change everything for all time. We are in such a revolutionary moment today. My own feeling is we will avoid a complete implosion by refusing to allow a complete implosion, but the cost of such avoidance will be a very long era of global torpor, a new Dark Ages following the end of empires. The best investment stance here is to maintain capital preservation and current income and play the occasional short and violent trading rallies when they come.