The Great Recession

As jobless rates skyrocket, numerous pundits have raised the spectre of the Great Depression, capturing headlines and garnering lucrative speaking venues as they prophesize inevitable devastation. Already overwhelmed by painful losses, many investors capitulate, preferring the refuge of cash to the prospect of utter ruin.

Fortunately, the analogy between today's economic woes and those of the early 1930's has been overplayed by many self-interested scaremongers. There is one fundamental similarity – in both cases, extremely severe economic contractions were triggered by credit crises when excessive asset prices, inflated by too much leverage, poor underwriting practices and speculation, collapsed. Stocks and margin accounts were the culprits in 1929, housing and mortgage-backed securities in 2007. Both then and now, the credit crunch and contagion of fear spread to other sectors of the global economy and sent it into a tailspin.

The differences between these crises, however, are telling. Today's economy is much more resilient than that of the 1930's. Indeed, automatic stabilizers did not exist then as there were no Social Security or unemployment benefits and few private or public pensions. Other stabilizers that exist today - more dual income households, a high proportion of public sector and health care workers, and a more diversified, service-oriented economy - should mitigate the current downturn relative to the 1930's.

Today's greater resilience has already manifested itself. Based on U.S. statistics, this downturn is 15 months old. By October, 1930, fifteen months into the onset of the Great Depression, "production had fallen by 26 percent, prices, 14 percent, and personal income, 16 percent"*. The U.S. economy is nowhere near experiencing that broad level of decline. In 2008, the first full calendar of this contraction, real U.S GDP declined by less than 1 percent versus the prior year; in 1930, real GDP declined by almost 9 percent.

A second pivotal difference is the failure rate of banks. With no federally guaranteed deposit insurance, fearful depositors in 1930 triggered a widespread run on U.S. banks that resulted in 1,352 bank failures. At its height, 256 banks failed in November followed by 352 failures in December. By the time President Roosevelt signed the *Emergency Banking Act* in March 1933, over 9000 banks had ceased operation, nearly one in five banks. In comparison, since December 2007, 42 banks have closed in the

U.S., many of which were acquired by other institutions. At the end of 2008, the Federal Deposit Insurance Corporation (FDIC) identified 252 banks in trouble, just over 3 percent of the 8305 banks and saving institutions in the U.S.

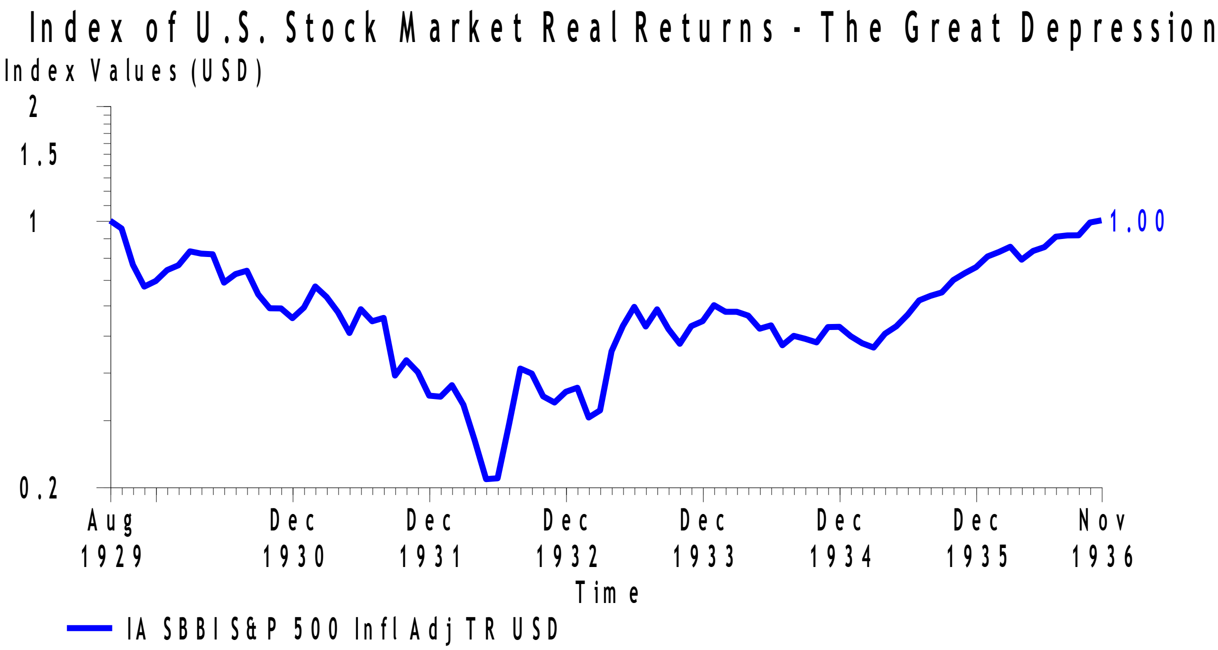
In the first three years of the Great Depression, depositors and creditors suffered billions in losses as banks closed their doors. Depositors today who have account balances guaranteed by the FDIC suffer no losses when a bank closes. In fact, the FDIC was created in 1933 to stabilize the banking sector and prevent panic-induced bank runs.

Bank closures contributed to the rapid decline in the stock of money which fell by over one-third from August 1929 to the trough of the Great Depression in March 1933. This contracting money supply reinforced deflationary trends which in turn thwarted economic recovery by inhibiting consumption and driving up real interest rates. Learning from this experience and no longer hampered by the gold standard of the early 1930's, the Federal Reserve has engineered a 14 percent increase in the money supply since December 2007. They have also reduced interest rates and have ensured that liquidity is flowing to financial institutions as well as key credit markets.

Finally, the U.S. government has responded to today's economic crisis with speed. The Treasury announced the $700 billion Troubled Asset Relief Program (TARP) 10 months into this downturn. In contrast, Andrew Mellon, who was the Secretary of the Treasury from 1921 to 1932, advocated spending cuts to balance the budget and opposed support for the banking sector. He is infamous for his advice to President Hoover to "liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate." It wasn't until Hoover belatedly acted in 1932 followed by Roosevelt's many initiatives when he took office in March of 1933 that the government dealt forcefully with the collapse of the banking sector and economy.

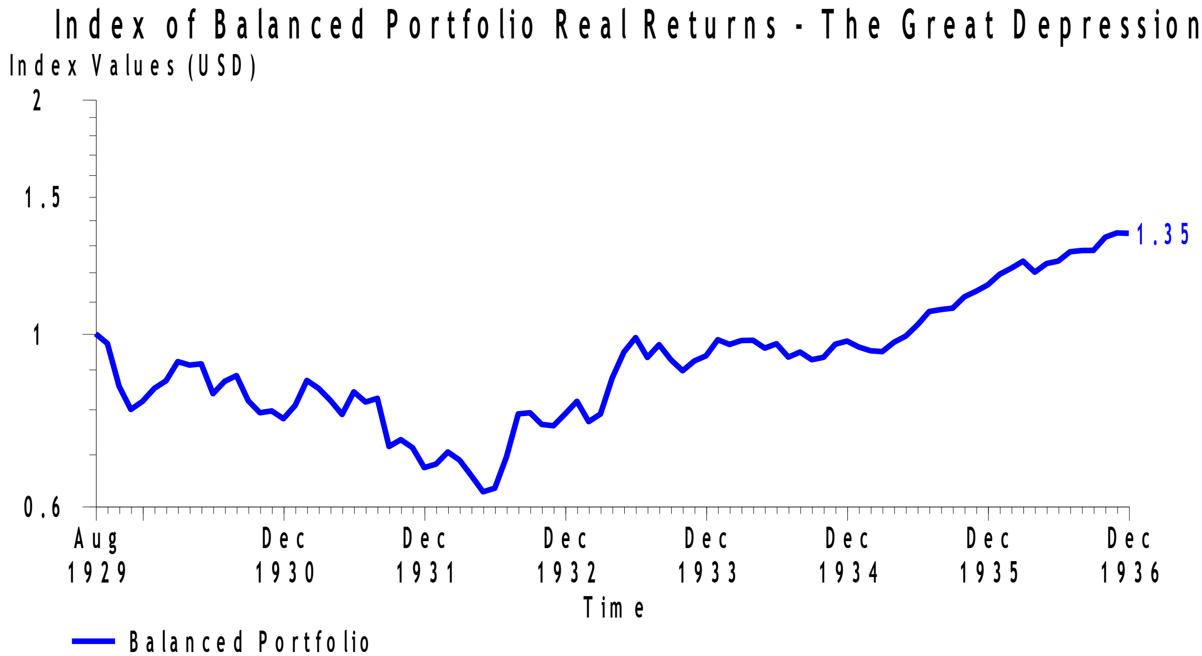
The Great Depression alarmists also stress the shattering 86 percent decline in stock prices that occurred between September 7, 1929 to June 1, 1932. While they are right to point out the massive damage to equity investments, they fail to tell the whole story. First, dividends should be included to provide a picture of total return. Second, returns should be stated in real not nominal dollars. Wealth is about purchasing power and in a period of falling prices, it is real wealth that matters (see our February commentary – The Money Illusion). Finally, they leave out any discussion of the ensuing recovery.

Incorporating these three elements – dividend returns, real prices and the recovery – a more accurate picture emerges. The following graph tracks the cumulative real return of U.S. stocks during the Great Depression starting at the market peak in 1929 with an index at 1.00.**



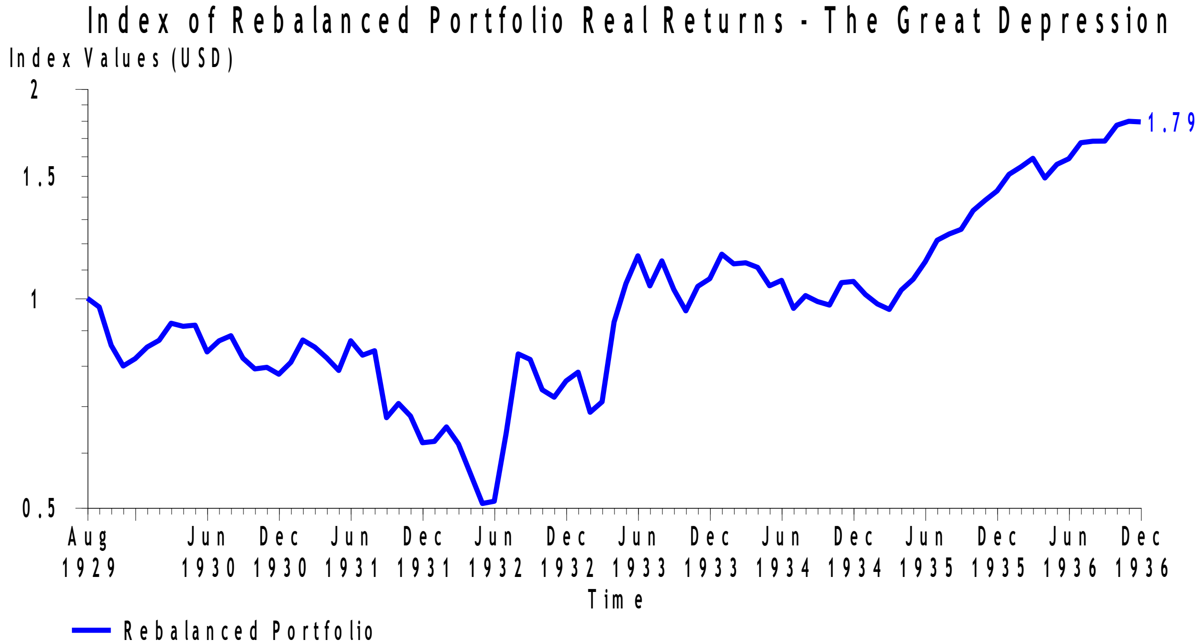
Despite the colossal market plunge, patient investors saw the purchasing power of their equity capital fully restored by 1936, the year when real GDP had finally recovered to its 1929 level. In fact, the market began to recover in the summer of 1932 with a stunning rally that saw stock prices nearly double in three months. The catalyst was the first large open market bond purchases by the Federal Reserve and the initiation of a lending program to banks by the newly created Reconstruction Finance Corporation. This script is being followed today by the Fed and Treasury, but they are acting in the first year of the downturn, not the third.

However, very few investors are invested solely in equities. A more illustrative portrayal of the Great Depression investment experience is that of a balanced investor. The following graph tracks the cumulative real return of a portfolio invested 20 percent in government bonds, 15 percent in corporate bonds and 65 percent in stocks during the Great Depression starting with an index of 1.00 at the market peak in 1929. In this example, we have assumed that the asset mix is not rebalanced.



A more positive picture emerges. At its worst moment in May of 1932 just before the market rallied, the real value of the balanced portfolio was down 37 percent; an incredibly challenging investment experience, but far from total desolation. A balanced investor would have spent only 16 months where the real value of his or her portfolio had declines greater than 20 percent, would have broke-even in June 1935, and would have gone on to enjoy a cumulative 35 percent real wealth gain by the end of 1936.

What if an investor had the fortitude to rebalance his or her portfolio back to the initial asset mix by selling bonds and buying stocks whenever the allocation to stocks fell too far and alternatively, selling stocks and buying bonds whenever the stock allocation rose too high? The following graph tracks the cumulative real return of a the balanced portfolio with the same initial asset mix of 20 percent in government bonds, 15 percent in corporate bonds and 65 percent in stocks starting with an index of 1.00 at the market peak in 1929. In this example, we assume the portfolio is rebalanced whenever the stock allocation varies more than 20 percent from the initial target of 65 percent of the portfolio.



The rebalanced portfolio suffers deeper declines than the previous non-rebalanced portfolio, losing nearly 50 percent of its value at the market's nadir. This is caused by a rebalancing in 1931 when bonds were sold to buy stocks. The benefit is that as the market rallies, the higher equity exposure rebuilds value more quickly. An investor with this rebalanced portfolio would have broken-even in May 1933 and would have gone on to enjoy a cumulative 79 percent real wealth gain by the end of 1936.

Balanced investors were badly mauled in the Great Depression but those with the fortitude and patience to stay with their long-term plans emerged with their real wealth not only intact but enhanced. Investors today with sound, diversified investment strategies should take note and heart.

There is no question that we are enduring a very severe recession. Although the fourth quarter 2008 real GDP decline in the U.S. was smaller than the drops in both 1980 and 1982, the prognosis is that further contractions this year will make this the worst downturn since 1946. Yet, a more resilient economy, early and extensive support to the banking sector by the Treasury and dramatic action by the Federal Reserve strongly suggest a that catastrophe like that of the early 1930's will be averted. This is the Great Recession, not a replay of the Great Depression.

March 24, 2009

*_A Monetary History of the United States 1867 – 1960,_ Milton Friedman & Anna Jacobson Schwartz.

**Ibbotson Associates SBBI data series is the source for the index return analysis.

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