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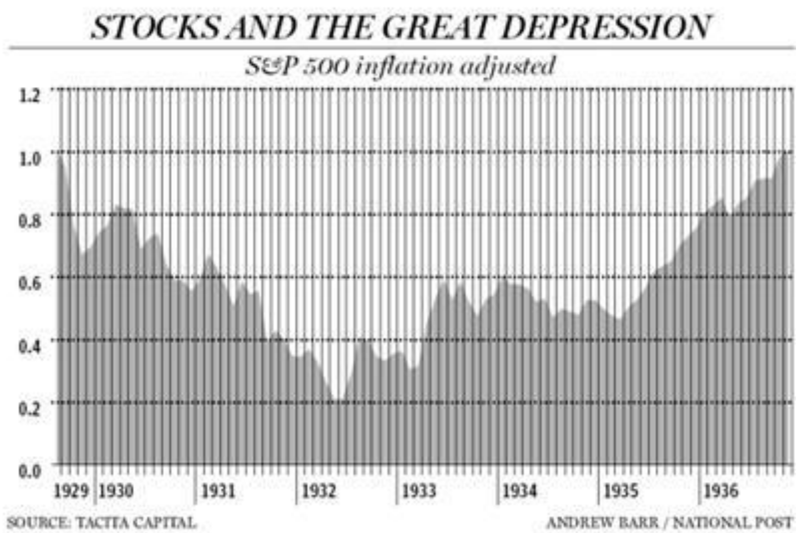
It's a recession, not a depression

The analogy between today's economic woes and those of the early 1930s is being overplayed



Stocks And The Great Depression Tacita Capital, Andrew Barr, National Post.

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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 1930s is overplayed by many self-interested scaremongers. There is one fundamental similarity -- in both cases, very 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 1930s. 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 this downturn relative to the 1930s.

Today's greater resilience already manifests itself. Based on U. S. statistics, this downturn is just over 15 months old. By October, 1930, 15 months into the onset of the Great Depression, production had fallen by 26%, prices by 14%, and personal income by 16%. 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 in the fourth quarter declined by less than 1% versus the prior year's fourth quarter; in 1930, real GDP declined by almost 9%.

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 9,000 banks had ceased operation -- nearly one in five banks. In comparison, since December, 2007, 42 banks have closed in the U. S., many of those acquired by other institutions. At the end of 2008, the Federal Deposit Insurance Corporation (FDIC) identified 252 banks in trouble, just over 3% of the 8,305 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 1930s, the Federal Reserve has engineered a 14% increase in the money supply since December, 2007. It has also reduced interest rates and ensured 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, 1933, that the government dealt forcefully with the collapse of the banking sector and the economy.

The Great Depression alarmists also stress the shattering 86% decline in stock prices that occurred from Sept. 7, 1929 to June 1, 1932. They are right to point out the massive damage to equity investments but fail to tell the whole story. First, dividends have to be included to provide a picture of total return. Second, the returns have to 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. 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. Despite the colossal market plunge, patient investors saw the purchasing power of their equity capital fully restored by November, 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 the 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 in 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 accompanying graph tracks the cumulative real return of a portfolio invested 20% in government bonds, 15% in corporate bonds and 65% 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 the portfolio asset mix is not rebalanced.

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

What if an investor had the fortitude to rebalance his 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 above graph tracks the cumulative real return of a the balanced portfolio with the same initial asset mix of 20% in government bonds, 15% in corporate bonds and 65% 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% from the initial target of 65% of the portfolio.

The rebalanced portfolio suffers deeper declines than the previous non-rebalanced portfolio, losing nearly 50% of its value by 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% 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 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 catastrophe like that of the early-1930s will be averted. This is the Great Recession, not a replay of the Great Depression. - Michael Nairne is president of Toronto-based Tacita Capital.