An Old Fashioned Depression? Maybe, But Not Likely

How could this be happening?
In the modern era, the most extreme terminology permitted in polite society for describing an economic downturn is "recession". Although there was a 10-year period, well-known as the Great Depression, the word Depression has been banished by financial industry word-police for many years.

Apparently, the 1930s were, until now, considered an anomaly which could not re-occur, because now we have modern hedging technology, incomparable market liquidity and much improved government supervision, among many other reasons. So, what went wrong this time? How could the damage be so colossal? After all, until very recently, business was still doing well; jobs and unemployment figures were not dramatic.

Here is the basic, 5-chapter, 8-year story:

Greenspan's easy money: Beginning in early 2000, in order to confront the looming possibility of a deflationary economy, the Greenspan-led Federal Reserve aggressively reduced US borrowing costs. The Fed Funds rate began this period at 6% and reached a 40-year low of only 1% in mid-2003....an 83% stimulus! It worked, sort of. Consumer spending not only didn't decline, it increased. But, businesses stubbornly continued not spending on big-ticket capital purchases. So, the Fed persisted at 1% for 12 months. One result: adjustable-rate home mortgages and home equity lines became plentiful at give-away "teaser rates" around 3%.

Low interest rates were problematic for lenders: Big investment banks, knowing that the low rates were surely temporary, pushed hard to deploy their money in adjustable rate mortgages. Investor demand for this type of mortgage investment paper outran the supply; consequently, lending standards were relaxed, indeed they were eliminated, which attracted hoards of previously unqualified borrowers* to buy no-money-down homes, or refinance the ones they owned and take down "equity cash" for buying big SUVs, trucks and boats...further stimulating the economy. Home builders struggled to meet demand; prices soared...and soared, reaching classic bubble stage by 2006 (See our White Paper, January 2006).

Excess investor demand was (always will be) met: Gigantic mortgage paper buyers, Fannie Mae and Freddie Mac were delighted at the juiced-up home lending, for two reasons: (1) societal benefit: more Americans were getting first access to home ownership and (2) greed: Fannie and Freddie managements were "earning" fat bonuses on the additional loan volume. But even Fannie and Freddie's white-hot loan volume wasn't sufficient for the level of investor demand. Enter Wall Street investment banks.

Wall Street genius failed: A combination of Wall Street genius for creating investment vehicles to meet strong demand, plus credit rating agency greed for the high volume of fees produced tons of complex, pre-packaged "mortgage cafeteria" paper that, although supported by undocumented borrowers, was gobbled up by yield-seeking banks worldwide. The expected level of homeowner defaults had already been estimated and neatly taken into account in the pricing of the investment packages. But then, as we now know, those default estimates turned disastrously inadequate.

Trust relationship network failed: Despite its sophistication, the core of global investment markets is a daisy chain of trust (i.e., credit) relationships. A dominant portion of worldwide market financiers consumed enormous portions of the same weak mortgage debt investments that turned progressively rancid in their bellies. This created a domino-chain failure of the trust network, the result being a virtually total freeze in credit availability and lending transactions.

Where do we fit now, in market history?
As we write, shortly before 3PM on October 6, the S&P 500 Index has declined almost *22% in only 26 trading days*. The current swoon began on October 11, 2007 and has now chalked up a whopping ***-36%***.

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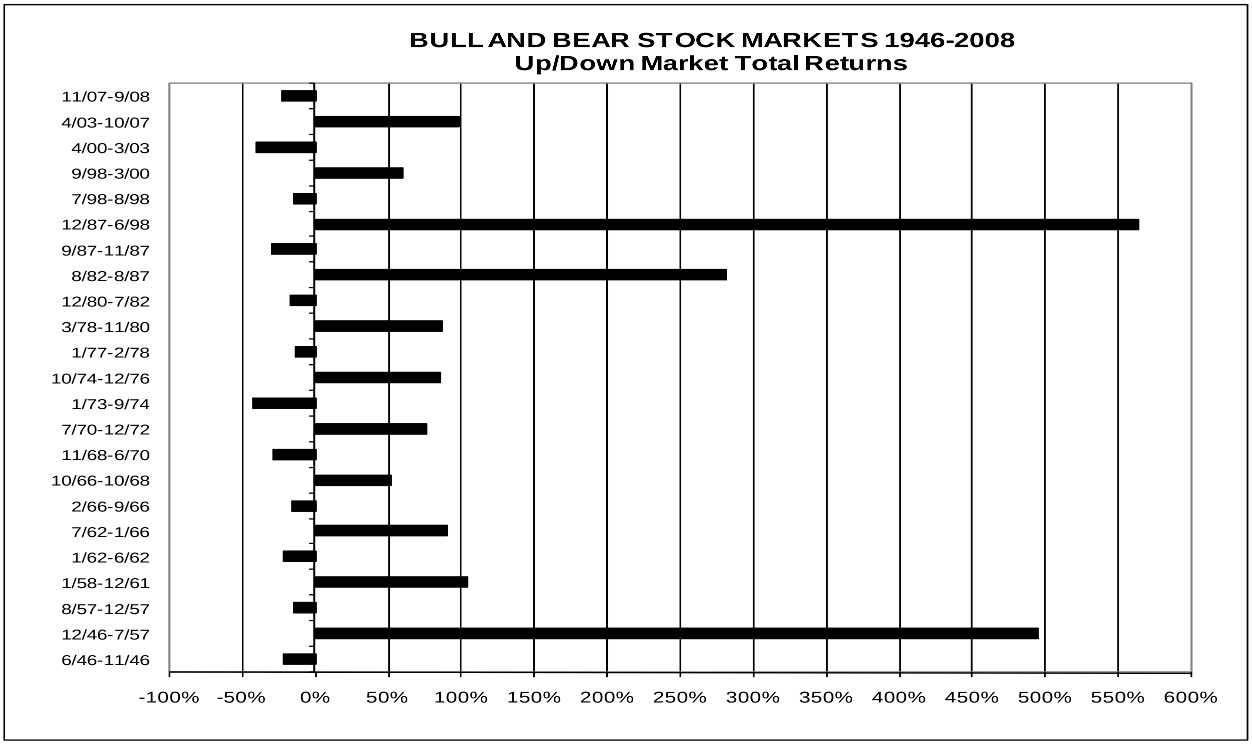
*At this same time, creditworthy home buyers were gleefully taking advantage of near-record low rates on 15- and 30-year fixed rate mortgages...but, such long term, low-fixed-rate loans were unattractive investments for Wall Street lenders.

So, how do these numbers compare to the worst dips during the Great Depression? There were 5 of them:
September - November 1929: -33%
June – December 1930: -35%
March – May 1931: -26%
September – December 1931: -40%
March – May 1932: -45%
Overall: September 1929 – February 1933: **-78%**
Soon afterward, the return for April 1933 was +42% (but that was 42% of the puny $22 that survived from every $100 of pre-9/1929 capital).

The current bear run is the 12th to occur during the 62 years since World War II. The average of the other 11 bear cycles was -23%. The current36% decline ranks 3rd behind -43% (1/73-9/74) and -41% (4/00-3/03). Perhaps it is also worth noting that the average duration of the 11 bear phases has been 12 months, compared to bull markets that have averaged just over 4 years in length.



The late, renowned economist, Milton Friedman opined that the Great Depression mostly happened (and sustained itself) because the Federal Reserve Bank failed to do its job. What did he mean by that? Following a blowout stock market run-up in the 1920s, various international trade restrictions and other factors caused the US credit markets to seize-up, while the Fed stood by instead of injecting liquidity ....cash.....until the system normalized.

The 1930s credit conditions sound annoyingly familiar today, but this time they're global. The Fed's activity level is now remarkably dissimilar to the Depression era. This time around, the US Treasury is taking a hyper-active leading role. Its actions have produced loud voices of protest from the public and a significant portion of the Congress, mostly based on the notion that a surviving America with government-owned banking, securities and insurance industries and maybe more is not the America they want to live in, or hand over to the next generation.

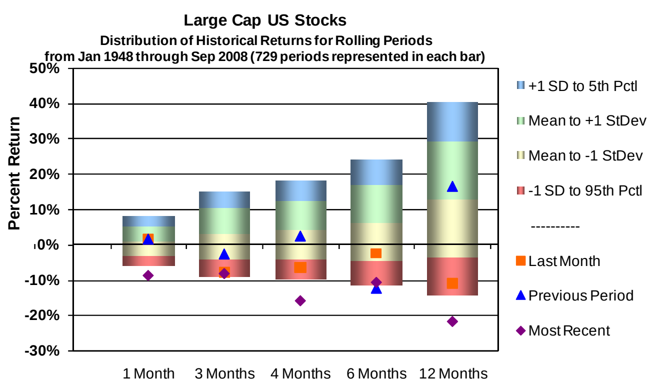
"This time it's different" (as usual)
One important market similarity existed between (a) the period before 1938 and (b) July 2007 to now: In both periods, there was no "uptick rule" for short sellers of stocks (traders who make money on a stock's price decline). So, for 70 years (1938 to July 2007), the SEC enforced that rule which required short sales of stocks to be at a price at least one "tick" higher than its previous trade, the rule's intention being to prevent short sellers from "piling on" to a stock that is already declining in price.

But, in July 2007, after a long campaign waged by hedge fund operators whose techniques typically include heavy use of short selling, the

SEC suspended the uptick rule. It did so, based on its pilot study in 2004-05 which concluded that removal of the rule would not encourage stock price manipulation. Big deficiency of the study: the post-2004/pre-2007 stock market conditions were generally rising prices and abnormally low volatility. So, the study formed an erroneous cover for granting the, by now, gigantic hedge fund industry's wishes. In the days and weeks after July 6, 2007, newly unrestricted short selling and double-digit *daily* percentage declines in the prices of financial industry stocks began to occur.

Market cycle position: worst case?

Below is a chart created from FiduciaryVest's research showing the broad US stock market's current position versus its range over more than 700 rolling periods of various lengths since World War II.



What if the Paulson bailout/rescue plan fails to work? Is a depression the next step? What could the US Fed do?

First, an assumption: that the Federal Reserve Board, just now, has put aside its traditional vigilance for indicators of inflation lurking behind every bend in the road ahead. If that's the case, then we foresee a scenario -

- The Fed Bank's Ultimate Weapon will be its authority to literally order the $$ printing presses to run on a 24/7 production schedule.
- The resulting avalanche of newly printed currency would then go into the Fed's nationwide bank deposits, earning a very low interest yield (i.e., low cost to depository banks).
- Those "cheap" deposits would likely be made on 2 conditions: the Fed promises not to withdraw them, provided the banks promise to lend the money out...quickly, on favorable terms.

Such a rapid expansion of the US currency supply would normally be quite inflationary and would cause dollar-devaluation, but those consequences are prices the Fed is surely poised to pay. (Moreover, it now appears that the Fed's counterparts in Europe and Asia may very well be forced to do the same thing, soon, thus neutralizing significant cross-currency devaluations.)

Lots of scared money, hiding under a rock

There is a modern record proportion of the investment market now being held on the sidelines. A sudden spike in money funds has more than doubled their normal share. This phenomenon is particularly noteworthy, because money market interest rates are only slightly higher than the return from deposits made in a mattress. In addition, unprecedented demand for US Treasury bills has caused their annual rate of interest yield to fall near zero. This huge "cash-overhang" will predictably not remain so inefficiently invested for a significant period.

A modest proposal

Given: From at least 800 years of history, we know that fear and greed drive prices in investment markets.
Recommendation: In this time when global markets are generating a rare, Biblical level of fear, consider preparing for the next greed-phase, so that when (not if) it develops, you will, (a) recognize it and (b) deal with it sensibly. But how?

- Recognition: One of the most apparent characteristics of a bubbling equities market is the high level of confidence and abundant forecasts for asset values to continue on a steep upward climb. Telltale signs (reference the apexes in 1999 and 2006): Confidence-providers in a running bull market (who, up to now, were Wall Street bankers) become convinced, publicly so, that they actually possess gifted investing insights, have earned their way to titan status, and hence deserve a well-publicized, piggish amount of compensation. So, we propose to create a contrarian-indicator to be called the *Smugness Index* (details to be provided in a later paper).
- Reaction: When the *Smugness Index* reaches its pre-determined alarm point, re-balance equity portfolios to a more conservative allocation level, in proportion to the strength of the Index's signal. Subsequently, continue to rebalance, so long as the Index rises further and without hesitation.