

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

Distributed to our clients and friends weekly

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Perspective

In uncertain times we look for some bedrock to anchor into. While history cannot predict the future, it can provide a useful frame of reference. Some say we are in completely uncharted waters. Others argue there are eerie similarities to the Great Depression, and still others argue that this will be no more than a deep recession not unlike those of the 1970's.

While the uncharted waters argument has merit, given the long string of broken economic records during its 14-month life so far, our purpose today is to build an historical framework that might offer some clues for relief from our current situation.

In conversations about our difficulties, the question often comes up; could this recession spin into another Great Depression? Some perspective would be helpful before providing an opinion.

Many of our readers lived through the Great Depression as children. But the stories I've heard from my parents and my grandparents of those difficult times resonate with a passion and clarity that time strangely neither exaggerates nor diminishes. It was a time that deeply affected everyone who lived close to it.

The Great Depression was a global downturn that started in the United States with the stock market crash on October 29, 1929, known as Black Tuesday. From its peak of 381 on September 3, 1929 to its trough November 13, 1929 the Dow fell 48%.

Optimism was not crushed immediately by the stock market collapse. John D. Rockefeller said that "These are days when many are discouraged. In the 93 years of my life, depressions have come and gone. Prosperity has always returned and will again." Government and business together actually spent more in the first half of 1930 than in the corresponding period of the previous year. But consumers, having lost much in the crash cut spending by 10%. To make matters worse, a severe drought ravaged the agricultural heartland of the US beginning in the summer of 1930.



Dorothea Lange's Migrant Mother depicts destitute pea pickers in California, centering on Florence Owens Thompson, a mother of seven children, age 32, in Nipomo, California, March 1936.

The depression impacted virtually every country in the world. According to Wikipedia, international trade plunged by half to two-thirds, as did personal income, tax revenue, prices and profits. Cities all around the world were hit hard, especially those dependent on heavy industry. Construction was virtually halted. Farming and rural areas suffered as crop prices fell by roughly 60%. The majority of countries set up relief programs, and most underwent some sort of political upheaval, pushing them to the left or right. In some states, desperate citizens turned toward nationalist demagogues, the most infamous being Adolf Hitler which set the stage for World War II in 1939 and ended the Depression in the US.

Irving Fisher, an early American neoclassical economist made some observations of the Depression that resonate with some circumstances today. Fisher argued that the predominant factor leading to the Great Depression was over-indebtedness and deflation (we do not suffer deflation, but it cannot

be ruled out). Fisher tied loose credit to over-indebtedness, which fueled speculation and asset bubbles (tech bubble, real estate bubble, asset backed mortgage bubble). He then outlined 9 factors interacting with one another under conditions of debt and deflation to create the mechanics of boom to bust. The chain of events proceeded as follows:

1. Debt liquidation and distress selling
2. Contraction of the money supply as bank loans are paid off
3. A fall in the level of asset prices
4. A still greater fall in the net worths of business, precipitating bankruptcies
5. A fall in profits
6. A reduction in output, in trade and in employment.
7. Pessimism and loss of confidence
8. Hoarding of money
9. A fall in nominal interest rates and a rise in deflation adjusted interest rates.

The Case Against Depression

There was no FDIC in the decade of the 1920's or 30's. In the 20's, an average of 70 banks failed each year. But during the Depression a staggering total of 9,000 banks failed.

Since November of last year, 21 banks have failed.

From 1931 to 1941 unemployment never fell below 14.3%.

1929 – 3%

1930 – 9%

1931 – 16%

1932 – 24%

1933 – 25%

1934 to 36 – 20%

Since 1941 unemployment has never risen above 10%. It now stands at 7.6%. Economists on average see the unemployment rate hitting 8.8% by December.

The Smoot Hawley Act of 1930 imposed excessively high tariffs on imports to protect domestic farmers. The Act caused retaliation by the rest of the world of the crippling trade.

Japanese Finance Minister Shoichi Nakagawa said yesterday he wanted “frank” discussions with U.S. Treasury Secretary Timothy Geithner on the “buy American” provision in a stimulus package that’s moving through Congress. It would require steel and other goods used in infrastructure projects to be made in the U.S. The Senate voted on Feb. 5 to say that the clause must be consistent with international trade agreements. We hope the Administration and Congress learned from history.

The global economy declined 12.67% in the early 30's.

The IMF predicts advanced economies will shrink 2% in 2009. The expansion of developing nations will keep the global economy growing at a 0.5% pace, it estimated last month.

Government mentality was different in the 30's. There was a balanced budget discipline. Taxes were increased in 1932 and 1937 to keep it balanced. Government borrowing was frowned upon as it would crowd out private investment. It was believed that government was not a good allocator of resources; that was better left to the private sector. Finally, it was believed that government should not be a relief agency.

Things have changed, have they not?

Numerous other indicators argue against the worst. The most important, of course is the government's eagerness to do all it can to avoid further destruction. Trillions have been poured into the US and global economy by the Fed and other central banks as well as from fiscal stimulus plans of countries around the globe.

Early results from the world's third-biggest economy China are quite encouraging. That country's economy may expand 6.6% in the second quarter after slowing to 6.3% in the first, economists project. China is trying to reverse an economic slide that has already cost 20 million jobs, raising the risk of social unrest as exports plunge and the property market sags, according to Bloomberg. Spending on roads railways and housing has increased prices for iron ore, put a floor under industrial output and helped to drive a record \$237 billion of new loans in January.

Here in the US signs of that credit thawing came this week as high-yield, high-risk bond sales almost tripled to \$2.38 billion, the most in seven months. Bloomberg reports that speculative-grade bond yields are at their lowest levels since October relative to US Treasuries, a sign that the credit markets are beginning to work. Companies are turning to capital markets to free up bank credit lines and reduce debt amid a deepening global recession.

Higher quality investment-grade bond issuers have raised \$38.4 billion this month, compared with \$32.5 billion in the year-ago period. Yields over benchmark rates on investment-grade bonds narrowed six basis points in the week to 5.19% as of yesterday, the lowest since Oct. 7, according to Merrill's US Corporate Master index. A narrowing indicates that investors are warming to corporate bonds as yields on US Treasuries have plummeted by comparison.

In mid-December we added investment grade bonds to our portfolios because of their remarkable value and yields. You might recall it was the time that the Fed said they were lowering rates to essentially zero to get the economy going. Government bond yields plummeted to near zero. All other bonds, including high grade corporates were priced as though defaults would greatly exceed those of the Great Depression. In essence, corporate bonds were priced to discount a 27% default rate. That exceeded by a wide margin the peak default rate of 4% seen for investment grade companies in the 1930s. It is also higher than the peak default rate of 21% for all companies - speculative, as well as investment, grade - seen at that time. We believe these investments will provide attractive long-term yields with any downside risk more than adequately priced in.

Yes, it is hardly possible to overstate the severity of this economic crisis. Hyperbole is nearly impossible, but it doesn't seem to stop the media or our politicians from trying. Our economy is hurt, but it is not dead. 92.4% of the US workforce is still employed providing services and products. Business still goes on at all levels. Parking lots at malls and popular restaurants remain congested. Economists are moving out their recovery estimates from mid-year to end-of-the-year, but they still predict recovery. Confidence and patience will be rewarded.

Have a good weekend.