TrendMacro

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A Funny Thing Happened on the Way to the Depression

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No depression, and no "double dip." Still it's hard to recover from a great bear market.

Update to strategic view

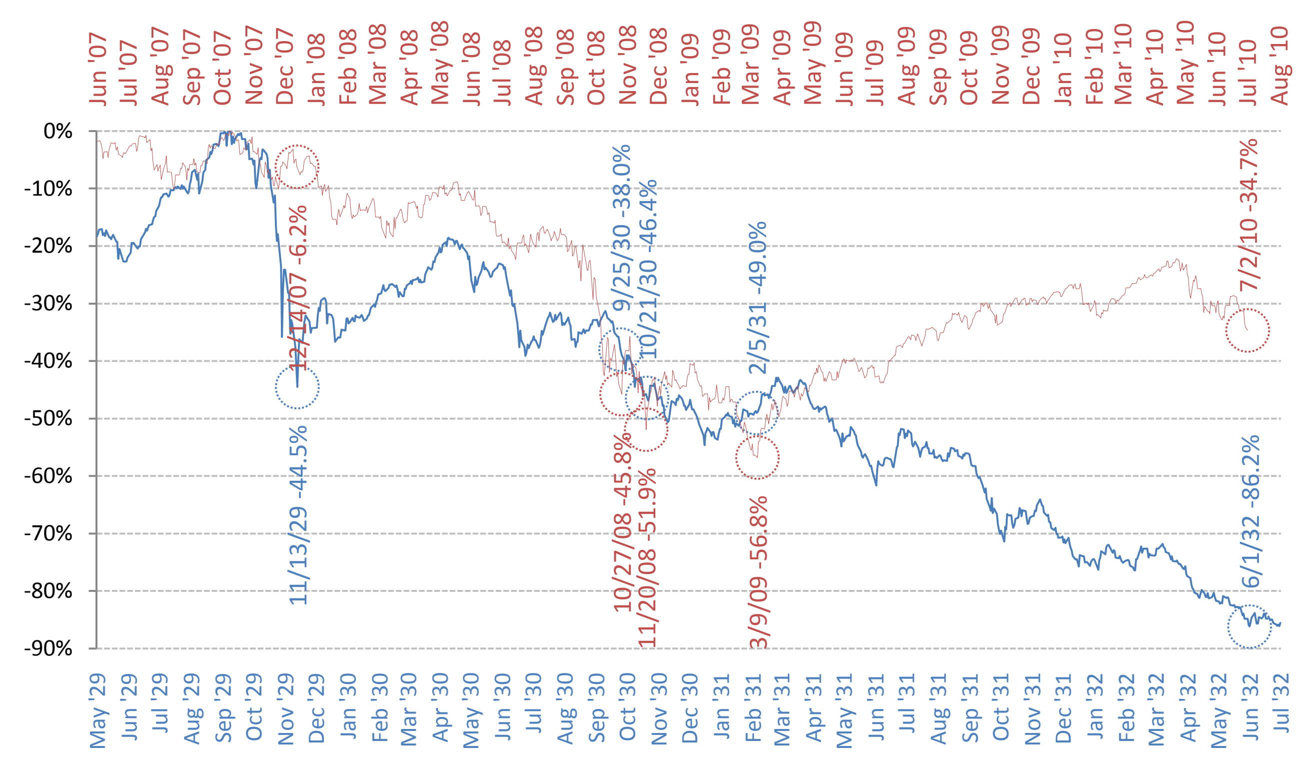
US STOCKS, US MACRO: On the analogical anniversary of the 1932 bottom, stocks are telling us that we …

[continued next page]

An important anniversary passed last Friday without comment. July 2, 2010 was the 997th day after the October 9 2007 all-time high for the S&P 500. That makes Friday the anniversary of June 1, 1932, the 997th day after the then all-time high in stocks on September 6, 1929. That was the bottom for US stocks in the Depression, with the S&P 500 having lost 86.2% of market capitalization.

Below is an anniversary update of our familiar chart showing the parallel progress of stocks then and now (first shown in "Obama: '…today does mark the beginning of the end.'" February 20, 2009). In the initial phase,

S&P 500 today **S&P 500 in Great Depression** Aligned to respective cycle peak, price change only



Source: Standard and Poor's, TrendMacro calculations stocks performed far worse at the onset of the Great Depression. After the crash of 1929, stocks were down 44.5%, while at the comparable number of days from the 2007 peak they were only down 6.2%. In the middle phase, cumulative performance was broadly similar then and now -- at this point it was touch-and-go whether the economy would indeed lapse into a New Great Depression. In fact there were three periods -- October 2008, November 2008 and March 2009 -- in which stocks in the recent bear market performed worse than in the Depression. Now, in the final phase, stocks today have cumulatively performed far better than at the comparable point in the Depression, even though they are still off 34.7% from the cycle peak. From here, stocks would have to lose 806 S&P 500 points, or 78.8% of market cap, to match Depression performance.

What can we learn from this comparison at this point? First, we think it helps us understand the current fear in the air about a "double dip" recession as stocks endure a long-overdue correction. We think such fear is unwarranted by any evidence (see "Betting Against a 'Double Dip'" June 30, 2010), and that it's mostly the residual of the fear felt a year ago -- when we couldn't look at the chart on the previous page and see confidently that we weren't headed for a New Great Depression. We think the chart tells us that the economy definitively deflected that fate in March 2009 -- thanks to the government-backstopped stress-testing of US banks which enabled the recapitalization of the credit system (see "Geithner Gets a Do-Over" March 24, 2009), and the Fed's aggressive asset purchases which headed off monetary deflation (see "Ben Boldly Goes" March 19, 2009).

Second, when we expand the Depression-comparison chart forward in time, and include the history of other economic and market cycles, we can gain insight into the dashed hopes for a "V-shaped" recovery that reached their zenith just at the top in late April (see "So Much For The 'V'" May 21, 2010). Fear of a "double-dip," which is tantamount in this context to slipping back toward the risk of Depression, is colored by the dashing of these hopes. But we think history shows that they were based on myth to begin with. It turns out not to be true that the worse and more protracted the bear market, the stronger and more rapid the next bull market.

The chart on the following page adds three years to the chart, extending the timeline in the Great Depression to June 1935. It also adds the history of the stock market during the banking crisis of 1907, spanning September 1905 to October 1911. We include that era because it and the Great Depression are the two major US systemic banking crises that offer precedent for the convulsion of 2007-2009. A glance at the chart shows that the current cycle is much more similar to the 1907 crisis than to the Depression -- in depth of the decline, duration from top to bottom, and degree of comparable recovery.

For the near term, this comparison is encouraging. In both precedent cases, there were significant gains off the bottom in the first couple years, suggesting that stocks today have further to run in the coming year. In fact, in the 1907 epoch, stocks nearly recovered to the previous highs in late 1909, for a gain of 89.9% from the bottom in about two years. This

[continued from previous page]

…successfully avoided a New Great Depression. The residual emotions from the near-miss leave markets vulnerable to fears of a "double dip" based on no evidence. For the near-term we repeat that this is only a correction in stocks, and a buyable dip. However, long-term prospects for reclaiming the 2007 highs remain quite remote.

[Strategy Dashboard home]

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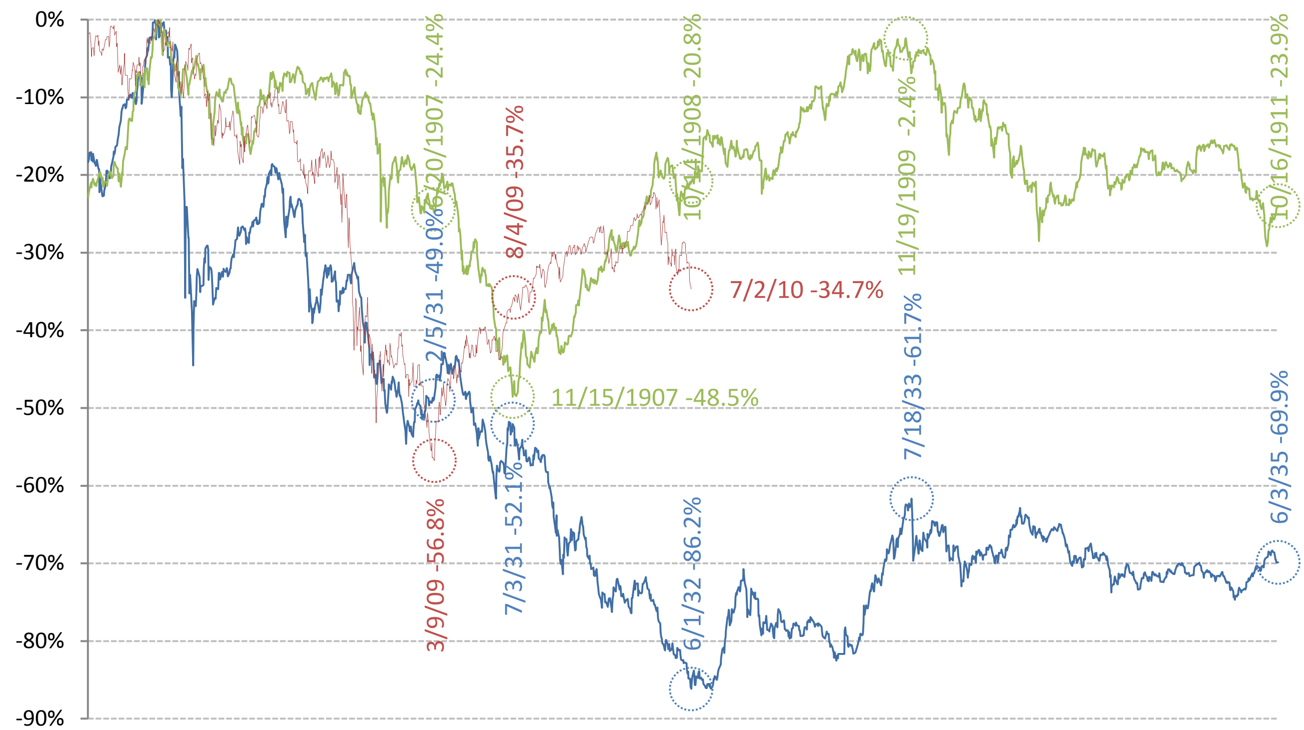
corresponds nearly to the day, given the way the chart is set up, to the maximum recovery from the Depression lows, which occurred in July 1933 -- a gain of 177.3% in about 14 months. If past is prologue, then this is consistent with our near-term view that we are currently only in a correction -- not a new bear market -- and that investors should be looking for entry points to buy the dip (see, again, ["Betting Against a 'Double Dip'"]()).

S&P 500 today — S&P 500 in Great Depression — Dow Jones Industrial Average in 1907 crisis
Aligned to respective cycle peak, price change only



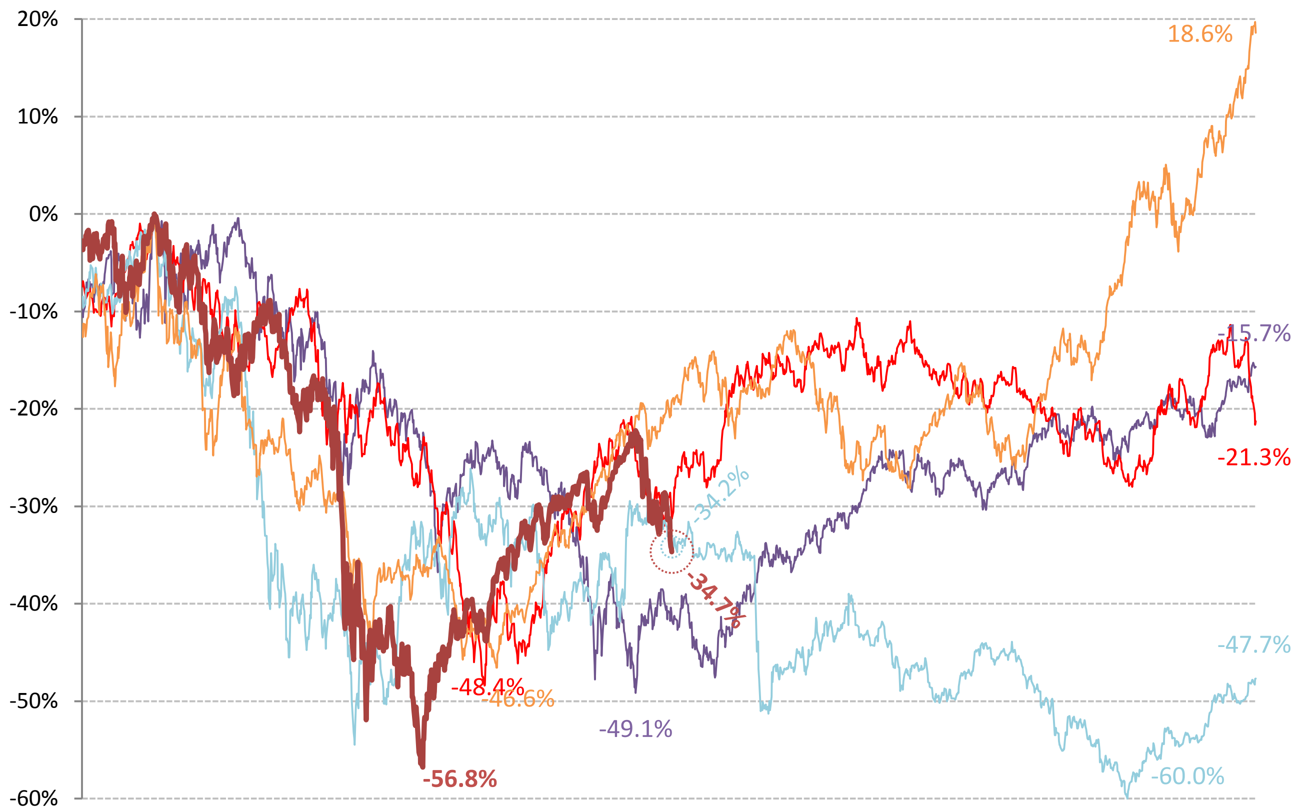
Source: Dow Jones, Standard and Poor's, TrendMacro calculations

But the historical record is also consistent with our darker long-term view: that it will take many years to break through the 2007 highs in an economy weighed down by the after-effects of a world-historical credit crisis, and in the face of so many policy barriers to growth. After the initial recovery highs in the 1907 and Depression epochs, stocks endured very long corrections and consolidations. After the 1907 banking crisis, it took stocks 10-1/2 years to reclaim the previous highs in market cap. After the Great Depression, it took 25 years.

Let's bring in other historical experiences. In the chart on the following page, we've replaced the bear markets from the Great Depression and the 1907 crisis with the four other most severe and long-lasting ones (these not associated with systemic banking crises). In every case, it's a long drawn-out process for stocks to recover, regardless of the anecdotal specifics of the economic backdrop. In only one case -- the recovery from the great post-WW1 deflation -- did stocks reclaim their previous peak within the timeframe we've been using. Even then, the recovery took longer than the decline that preceded it.

The eye is drawn to the coincidence on the chart that the S&P 500 closed Friday 34.7% below its 2007 peak, while the same number of days after the March 1937 top it was down a nearly identical 34.2%. That decline --

S&P 500 today **1921 deflation** **1937 relapse** **1974 crisis** **2001 bust**
Aligned to respective cycle peak, price change only



Source: Standard and Poor's, TrendMacro calculations

which occurred against the backdrop of 1937 and 1938's so-called "recession within the Depression" -- was the longest lasting and second worst bear market in history, ending with a loss of 60.0% over 1875 days. While the very similar losses to date then and now are indeed just a coincidence, there is some unsettling salience to the analog. After four years of robust expansion from the depths of the Great Depression in 1933, a deep recession was caused by a confluence of serious policy errors. Taxes were raised, the Fed tightened, public spending was reduced, and the Roosevelt administration embarked on an aggressive campaign of anti-business regulation and rhetoric (all of this is vividly documented in *The Forgotten Man* by Amity Shlaes -- clients who would like a copy should click here to have one sent from TrendMacro).

We are at risk now from some similar errors. On the negative side of the ledger, taxes seem sure to rise with the sunsetting at year-end of the 2003 tax cuts, and the anti-business climate is toxic. On the positive side, we are by no means convinced that more public spending would help the economy (or that less would hurt it) -- but either way, the fact is that more than half the funds from the 2009 "stimulus" remain to be spent. And we are firmly convinced that the Fed will not tighten, and in fact expect it to find a way to ease further (see "How to Ease, Not When to Tighten" June 23, 2010).

The analog we like best is the 1974 crisis. It occurred midway in the long period from 1966 to 1982 in which stocks were locked in a trading range defined by about Dow 1000 on the upside and Dow 500 on the downside (see "Wolf in the Fold" May 18, 2009). Those 16 years coincided with a great increase in government spending as a fraction of GDP (which we have already seen over the previous decade), and with a great inflation (which we expect to see in the coming decade). They were great years for investors in some ways -- that was the heyday of value investing, in which Warren Buffett and Peter Lynch made their reputations; it was the golden age of the "small stock effect;" it was a playground for market timers; it included the "go-go years," the "conglomerate boom" and the "nifty fifty." But it was a disaster for long-term buy-and-hold investing, and especially so in inflation-adjusted terms. With stocks having gone nowhere now for a decade, we've probably been in such a period for quite a while without realizing it. We expect it will last for at least several more years.

We don't mean to take chart parallels too literally, but if 1974 is indeed the best analog, then stocks today have an upside well worth pursuing once the present correction plays out. But don't have any illusions about the long-term. It could be many years until we see the 2007 highs again.

Bottom line

On the analogical anniversary of the 1932 bottom, stocks are telling us that we successfully avoided a New Great Depression. The residual emotions from the near-miss leave markets vulnerable to fears of a "double dip" based on no evidence. For the near-term we repeat that this is only a correction in stocks, and a buyable dip. However, long-term prospects for reclaiming the 2007 highs remain quite remote.