

Lowly Analyst Newsletter

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The Economy and the Markets

The market is still in the last phase of a rally. Foreign markets are doing better than US markets. The dollar fell 18% in the last 12 months. Market price-based consumer prices increased at a 4.6% rate.

The market labors against four thunderstorms on the horizon: slowing economic activity, a credit market crisis, a decline in housing prices, and less construction.

Defaults in subprime and jumbo mortgages have occurred. Unscrupulous brokers sold variable rate mortgages at teaser rates, -no down payment to borrowers who could not afford them. As teaser rates ended and the payments on adjustable rate mortgages rose, default rates also rose.

The variable rate mortgages were packaged as asset-based securities and sold to investors, including banks and hedge funds that were leveraged 200% or more. Banks needed to sell assets and borrow. Despite the Fed making money available, investors panicked in Europe. European banks had invested in US mortgage backed securities. The big insecurity stemmed from the lack of knowledge about which firms were solvent and which were not.

Sector ETFs: For the last 6 months, Steel (SLX) up 75%, Oil Service (OIH) 32%, Material (MXI) 28%, Internet Architecture (IAH) 28%, Oil Equipment & Srv. (IEZ) 27%, Aerospace (ITA) 23%, Natural Resources (IGE) 23%, Clean Energy (PBW) 21%.

Country ETFs: For the past 6 months, China (FXI) up 76%, BRIC [Brazil, Russia, India, China] (EEB) 54%, Brazil (EWZ) 49%, Emerging Markets (ADRE) 36%, Latin America (ILF) 35%, Hong Kong (EWH) 35%, South Korea (EWY) 35%, Pacific-Japan, (EPP) 24%, Australia (EWA) 23%, Singapore (EWS) 20%, US (WFIVX) 7%.

Selected Stocks: For the past 12 months, Baidu.com, China (BIDU) up 267%, China Life Insurance (LFC) 229%, Vale do Rio Doce, Brazil Metals and Mining (RIO) 215%, New Oriental Ed, China (EDU) 171%, China Mobile (CHL) 145%, Vimpel-Communications, Russia (VIP) 141%, China Petroleum 109%, Focus Media, China, (FMCN) 100%, China Medical (CMED) 78%.

Market Bubbles II

1. Introduction

This discussion is a continuation of the May newsletter. In the last century we had 7 bubbles:

- Panic of 1907
- 1929 Crash
- 1972 Oil Embargo
- 1987 Savings and Loan Crisis
- 1989 Japan Bubble
- 1998 Russian Crisis
- 2000 Tech Wreck

They all followed the same paradigm:

A belief that "this time it will be different", decrease in government control, rampant leverage, low interest rate, expansion of credit, speculation achieving respectability and spreading, media primarily reporting price increases rather than valuation measures, consumer panic, restriction on credits, crash. The smart investors got out early; the public was left holding the bag. Some of the worst offenders closed shop. The current bubble follows the same pattern. It is not yet known when it will crash. The consequences of Federal Reserve interest rate hikes, on the other hand, are varied.

In this newsletter we will be looking at the first two bubbles in more detail.

2. The Panic of 1907

Railroads and cars were developed. Alaskan gold increased the money supply. Low interest rates and little government control led to rampant speculation. Trusts, huge combinations of investments in natural resources enabled by bank credit on easy terms, often succeeded in establishing monopolies.

The president of Knickerbocker Trust, one of the largest US banks, tried unsuccessfully to corner the copper market and drive up prices. When the corner failed, it defaulted on loans leaving Knickerbocker in a precarious condition. As a consequence, on Oct. 21 the National Bank of Commerce stopped accepting Knickerbocker checks. That led to a run on Knickerbocker and resulted in the Panic of 1907. The stock market declined by 48% from Jan 06 to Nov 07. The decline stopped when the Fed made a large amount of federal money available. By Feb 1908 confidence in the US economy was restored.

3. The crash of 1929

WW1 led to improvements in US manufacturing. Research labs were established leading to an increase in US productivity. The Federal Reserve System was established in 1913. The federal government had budget surpluses. Top income tax was reduced from 65% to 20% and corporate income taxes decreased to 12%. In 1924 the great bull market began with manipulation of stocks by banks and capitalists aided by the absence of regulations and expansion of the money supply. Bankers established huge trusts, accumulating large pools of labor and capital. Leaders proclaimed a permanent new era without business cycles. The absence of business cycles justified a permanent higher valuations of stocks.

The rich became richer. Profits rose, but workers experienced decline in real wages. Installment debt rose to \$6 billion; margin loans to \$16 billion. The Fed lowered the discount rate in 1925 and 1927 to a record low of 3.5% thus stimulating the economy. Speculators and firms borrowed, using huge leverage. Firms issued stock thus borrowing at the cost of dividends, about 4% and then lent the money from stock sales as margin loans at up to 15%. Individuals and firms purchased businesses, factories, homes, automobiles and stocks all on credit.

Rampant speculation prevailed. Banks, businesses, businessmen who made a fortune in the automobile industry and immigrants who were willing to take greater risks to establish themselves speculated. Detroit tycoons led. Individuals who wanted to get rich quick like the tycoons followed. Then the crowd participated. The more people speculated, the more they stimulated one another.

When the economy overheated, the Fed raised the rate to 6% in August 1929. The Great Depression began Oct. 29, 1929, with the stock market crash. As interest rates increased, individuals cut spending to keep up with debt payments. Debtors defaulted causing lenders to fail. Massive layoffs resulted in 25% unemployment. The failing of 9000 banks caused additional defaults. With demand for goods shrinking prices and incomes fell 20-50%. The Fed could not increase the money supply since the amount of credit available to the Fed was limited by law. The money supply shrank by 1/3 from 1930-1931. An increase in tariffs is often falsely blamed for the depression. Foreign commerce is only a small percentage of US GDP.

Stocks did not return to the 1929 level until 1935, adjusted for inflation and dividends. Individuals lost their savings, but the fortunes of the Carnegies, Fords, Mellons, Morgans, and Rockefellers survived.

4. Takeaways

We study market bubbles to learn from the past.

Basic economic laws are as solid as the laws of physics. One cannot defy gravity; one can not violate basic laws of economics.

- a. The most expensive sentence in the English language is "This time it will be different."
- b. There have been changes since those 2 bubbles we discussed. The Fed now has the funds available to act as lender of last resort. This capability should make recessions shorter.
- c. We are now a global economy. It is the worldwide money supply that matters. No single country's central bank, such as the Fed, can control the money supply and interest rates. Today available credit is shrinking.
- d. Changes in technology fuel the booms that lead to bubbles. Today's technology change is the internet. It is very difficult for ordinary investors to get abnormal returns from technology. It is too difficult to predict which technology and firms will win. There is only one Microsoft, one Google. Only monopolies can make abnormal profits from technology privilege.
- e. Increases in money supply stimulate the economy and generally lead to excessive borrowing.
- f. Leverage is risky whether it is individual, corporate, or government debt. Floating rate loans are particularly risky.
- g. Speculation is risky.
- h. During the boom phase of the bubble, interest rates are usually low. They are still low today. During a depression incomes fall and interest rates generally rise, leading to defaults.
- i. There are crowd effects. If your friend made money borrowing on his house to invest in Google, the tendency is to follow his lead. People talk about their successes. If one bank stops funding commercial paper, the others follow
- j. Low tax rates for the affluent make more money available for investments, stimulating the economy and also speculation that causes bubbles. The eventual higher interest rates could start the bust.
- k. Today there is unprecedented world-wide growth. Interest rates are low, facilitating high consumer debt and speculation in derivatives, hedge funds and leveraged buyouts. The government lost its discipline. Even though some Chinese stocks, like Baidu.com, increased 267% in the last 12 months, the stock market is not yet bubbling. No one knows if a bubble will occur, nor if the downturn will last 6 months as in 1906, or 6 years as in 1929.