

The worldwide business and market environments in 2008 were perhaps the worst they have been since the early 1930s. We believe the year was unprecedented, in many ways, particularly in that so much global economic malaise occurred in such a compressed period of time and continues as we proceed into 2009. Some of the more notable events which occurred included the United States takeover of Fannie Mae and Freddie Mac, the collapse of Bear Stearns and Lehman Brothers, the shotgun marriage of Merrill Lynch and Bank of American, the bailouts of American International Group and Citicorp, the collapse of the auto industry with the General Motors/Chrysler bailout, and the world banking system write-offs of nearly \$1 trillion in subprime and alternative A mortgages.

The financial emergency the world is facing, in many cases, has reached crisis proportions – Iceland is a case in point. Its problems are so large that it is for all intents and purposes bankrupt. The resultant meltdown of most of the world's stock markets during 2008 has left many wondering whether we are revisiting the Great Depression. Table 1 below shows U.S. and international investment results for 2008:

Table 1

SELECTED EQUITY RETURNS	2008
<b>US Markets</b>	
S&P 500	-38.5%
S&P Financials	-56.9%
S&P Materials	-47.0%
S&P Information Technology	-43.7%
S&P Industrials	-41.5%
S&P Energy	-35.9%
S&P Consumer Discretionary	-34.7%
S&P Telecoms	-33.6%
S&P Utilities	-31.5%
S&P Health Care	-24.5%
S&P Consumer Staples	-17.7%
<b>Selected Countries: MSCI</b>	
World Index	-42.1%
Russia	-73.8%
India	-64.6%
Brazil	-56.1%
China	-50.8%
United Kingdom	-48.3%
Germany	-45.5%
France	-42.7%
Japan	-29.1%

Sources: Standard & Poors, MSCI Inc

Most of us at Northern Oak have investment careers spanning 25-40 years and we do not recall a period when international market returns have been so highly correlated on the downside.

It is true that the world economy has become much more intertwined in the past 50 years, thus a higher correlation between individual country business cycles should be expected. The universal problem today is credit gridlock, brought about by the actual or perceived prospect of widespread bank failures.

Because many of our clients have been asking whether we think the current economic environment might lead to a repeat of the 1930s and because of the magnitude of our economic problems, we have decided to devote the Northern Oak year-end market commentary to the "Current Recession versus the Great Depression." There is no doubt that there are striking parallels.

While there are still no universally accepted set of causes for the Great Depression, most students of the subject generally agree that the main culprits or catalysts were the bursting of the bubbles in the equity markets and commodity markets in 1929, accompanied by falling house prices. This resulted in a rapid rise in bad loans undermining the ability of banks to lend. Initially, banks with loans to investors in the stock market were immediately at risk (margin requirements in 1929 were 10% ~ all an investor needed to do was put up 10% and borrow the remaining 90%). These factors interacting with other recessionary forces (negative monetary and fiscal policy plus trade protectionism) in a symbiotic way caused worldwide deflation. Many economists believe the collapse of the banking system was the linchpin. In many ways, this period in economic history was the "perfect storm".

Because of the striking similarity to the initial economic events of the Great Depression and the current business environment, we think it will be instructive to review the history of the 1930s. Specifically we will detail what transpired economically, look at the generally agreed upon causes and most importantly compare the then policy responses with our current global policy responses.

The Great Depression is generally considered to have gone through six stages from the initial recession to the final recovery in the early 1940s as follows:

1. 1926-1928: Stock and commodity boom and asset bubble
2. 1929: Recession and stock market crash
3. 1930-1932: Recession turns into depression (deep deflation)
4. 1933-1937: The New Deal and the Recovery
5. 1938: The Relapse
6. 1939-1942: World War II War effort and the end of the Depression.

Table 2, shown below, shows selected economic data from the periods 1926-1942 which illustrates the six stages:

Table 2

Year	% Change	Money	Unemployment	Inflation
	Real GDP	Supply M2 (\$Bill)	Rate	Rate CPI
1926	6.5%	43.7	3.3%	1.0%
1927	1.0%	44.7	3.3%	-1.9%
1928	1.1%	46.4	3.3%	-1.4%
1929	6.0%	46.6	3.3%	0.0%
1930	-8.6%	45.7	8.9%	-2.5%
1931	-6.4%	42.7	15.9%	-8.8%
1932	-13.0%	36.1	23.6%	-10.3%
1933	-1.3%	32.2	24.9%	-5.1%
1934	10.8%	34.4	21.7%	3.3%
1935	8.9%	39.1	20.1%	2.5%
1936	13.0%	43.5	17.0%	1.0%
1937	5.1%	45.7	14.3%	3.6%
1938	-3.4%	45.5	19.0%	-1.9%
1939	8.1%	49.3	17.2%	-1.4%
1940	8.8%	55.2	14.6%	1.0%
1941	17.1%	62.5	9.9%	14.7%
1942	18.5%	71.2	4.7%	16.3%

**Sources:**

Bureau of Economic Analysis, Historical Statistics of the US, Productivity Trend in the US - Kendrick 1961, US Bureau of Labor Statistics

In 1929, the population of the country was 123 million and the median income was approximately \$1,500 per year. The economy in the 1920s, often referred to as the “Roaring 20’s,” enjoyed prosperous growth with real growth averaging about 4% per year during the decade. Despite the appearance of prosperity, there were signs of weakness in the later part of the decade. In 1924, agricultural prices peaked and began to fall. In 1926, housing prices began to decline. Inflation turned moderately negative in 1927, 1928, and 1929 before becoming full blown deflation in the early 1930s. “Technological unemployment” becomes part of the nation’s vocabulary as many workers were being replaced by automatic or semi-automatic machinery. Construction spending peaked in 1926 and was down \$2 billion by 1929. Automobile sales declined by a third in the first 9 months of 1929. The economy was officially in a recession in August, two months before the stock market crash.

Ignoring all of these warning signs, investors pushed the average price of stocks up 40% between May 1928 and September 1929 with the Dow Jones Industrial Average peaking at 381 that month. The subsequent drop to 42 in July of 1932 was an 89%, peak to trough, decline. It is estimated that at the peak, stocks were trading at 30 times earnings, an extremely high valuation, given economic circumstances. The initial stock market crash, which began on October 24, 1929, wiped 30% off equity values by the end of 1929.

This event and subsequent government policy decisions initiated the ensuing 12 year economic collapse. The Great Depression was a global issue and not isolated to this country. Almost all of the major industrial nations experienced the same economic malaise as the United States, either by contagion or by similar circumstances within their economies, although the depth and duration varied. To illustrate, the unemployment rate in the U.S. peaked at 25% in 1933. By comparison, unemployment in Germany reached 30%, in Canada 19%, in Sweden 23%, in the U.K. 15%, and Japan 7%. The decline in real GDP during the Depression in the U.S., peak to trough, was 30%, 60% in Austria, 25% in Canada, 24% in Germany, and 15% in France.

**Given this background, and the similarities to our current credit crisis, how do the policy decisions of the 1920s and 1930s compare with the current world response?**

**MONETARY POLICY** - A government’s central bank use of changes in interest rates and the money supply to control and guide economic growth.

**MONETARY POLICY THEN**

From 1927 through 1929, the Federal Reserve was in pursuit of a tight monetary policy in an apparent attempt to puncture the speculative boom in the stock market. This occurred despite all of the previously mentioned indications of a weakening economy. In 1927, the New York Fed’s discount rate was in the range of 3.5% to 4.0%, and by 1929, the range shifted upward to 4.5% to 6.0%. By 1930, the Fed’s policy was having its effect with the money supply falling by about 2.5% in 1930. This extremely tight monetary policy put the economy into the beginning of a very severe depression.

It should be noted that data on the money supply before and during the Depression were calculated after the fact by researchers such as Milton Friedman and Anna Schwartz, et.al. At the time, the accepted economic theory did not believe that changes in money supply could cause business cycles, and money supply statistics were not published, although component data was available.

In 1930, it became apparent to the Fed that the tight money policy was a mistake and the discount rate was lowered to the 2.0% to 4.5% range. There is a lag between the time monetary policy changes are made and when the effect takes hold. Despite the initial decrease, the money supply continued to contract and was down nearly 7% in 1931. The Fed learned quickly that once it punctured a balloon, it is difficult to re-inflate it.

In addition to an excessively tight monetary policy in the late 1920s and early 1930s, the Fed made a second major mistake. The most important role in the Federal Reserve's charter is to be the lender of last resort. This means that when a bank is in trouble and cannot meet its depositor's demands for cash, the Fed must provide the liquidity. Otherwise, panic from the inability to withdraw funds can spread throughout the banking system, forcing even solvent and profitable banks to disrupt business and shrink the money supply by calling loans and reducing deposits. While the tight monetary policy of the late 1920s initiated the decline in the money supply, the rash of bank failures accelerated the decline dramatically.

The first banking crisis began in the autumn of 1930 when the Federal Reserve stood aside and permitted banks to fail in the South and Midwest. The result was to undermine confidence in the banking system. The Federal Deposit Insurance Corporation (FDIC) did not exist at this time. As a result, runs on banks spread as depositors rushed to convert their deposits into currency. This was the first of three runs during the early 1930s on bank deposits. Of the more than 25,000 banks in business in 1929 only 15,000 survived to 1933. The result of tight money policy and the inability (or unwillingness) of banks to lend caused the money supply to drop nearly 31% from its peak in 1929 to its trough in 1932 (see Table 2 on page 2). This was an unprecedented decline in our economic history.

### **MONETARY POLICY TODAY**

It has been said that "a country that doesn't understand its own history is not well equipped to deal with its future." The Federal Reserve in the United States is the most powerful institution charged with guiding and safeguarding our economy as well as that of the world, given our present dominance.

The Federal Reserve in this country, today, as well as central banks around the world, have acted in a definitive and coordinated fashion lowering official policy interest rates, in most cases dramatically. The first signs of economic distress from sub-prime mortgages began to surface in the summer of 2007, when the U.S Federal Funds rate was 6.25%. On August 16, 2007, the rate was cut 50 basis points to 5.75%. There were eleven subsequent declines with the last on December 16, 2008, bringing the new level down to a range of 0.00% - 0.25%. Table 3, below, shows official policy rates for selected countries as of August 31, 2007 and December 31, 2008.

Table 3

Country	Official Policy Rate		
	08/31/07	12/31/08	% Decline
United States	5.75%	0.25%	95.65%
European Central Bank	4.00%	2.50%	37.50%
Japan	0.50%	0.10%	80.00%
Australia	6.50%	4.25%	34.62%
United Kingdom	5.75%	2.00%	65.22%
Saudi Arabia	5.50%	2.50%	54.55%
China	7.00%	5.00%	28.57%
Hong Kong	6.75%	0.50%	92.59%
Switzerland	2.50%	0.50%	80.00%

In addition to the interest rate cuts, the FDIC has enacted an increase in deposit coverage from \$100,000 to \$250,000 per account for one year in an effort to mitigate any loss of bank deposits. Also, money market fund accounts are now federally insured for one year with participating mutual fund sponsors, another means of insuring liquidity. It is highly likely that the new FDIC coverage and money market guarantees will become permanent as they are being funded by participating banks and mutual fund sponsors. Similar moves have been initiated by most countries. To date, only a few domestic commercial banks have been allowed to fail and the deposits have been covered by the FDIC.

Finally, all three measures of the money supply (M1, M2, and M3) have shown substantial increases this year in the range of plus 10 to 20%, unlike the declines which took place in the 1929-1932 period. The long and short of this is that monetary policy, in our present environment, has been as accommodative as has been possible, both here and abroad.

**FISCAL POLICY** - A government's attempts to influence the direction of the economy through changes in taxation or through spending allowances.

### **FISCAL POLICY THEN**

Fiscal policy during the depression was also restrictive. As the economy shrank, government receipts also fell. In 1932, the Federal government collected only \$1.9 billion, compared to \$6.6 billion in 1920. Budget deficits reached \$2.7 billion in 1931. Congress, believing deficits were more economically harmful than tax increases, passed the Tax Act of 1932 which dramatically increased tax rates. The lowest individual tax rate in 1929 was 0.375% on income between \$0 and \$4,000. Prior to the 1932 act, the lowest rate was tripled to 1.125% in 1930. The Tax Act of 1932 then increased the lowest rate to 4%. In other words, taxes between 1929 and 1932 for most Americans increased more than ten times. The top bracket under this act saw an increase from 25% on income over \$100,000 to 63% on incomes greater than \$1,000,000.

In dollars, the income taxes payable on \$4,000 of income increased from \$15 to \$160 between 1929 and 1932, a 10.7 - fold increase. In today's dollars, that would represent an increase of about \$2,000 on an income of \$50,000 (using the BLS inflation calculator) - not insignificant.

In 1935, the Social Security Act was passed and was financed by a 2% tax, one half collected from employees and one half from employers. The tax was levied on the first \$3,000 of the employee's salary or wage.

Another tax increase was passed in 1936, raising the top income tax bracket from 63% to 79%. All in all, fiscal policy was not conducive to economic recovery and actually exacerbated the downturn.

### FISCAL POLICY NOW

In recognition of a slowing economy, Congress passed the Economic Stimulus Act of 2008. The law provided for one-time tax rebates to low and middle income taxpayers and tax incentives to stimulate business investment. The cost of this act was \$152 billion, and checks were mailed during the second quarter of 2008. Real GDP growth in the second quarter jumped 2.6% versus a 0.9% gain in the first quarter. It was not sustainable.

As financial conditions continued to deteriorate in 2008, the Emergency Stabilization Act of 2008 was passed in October. Commonly referred to as a bailout of the U.S. financial system, the law authorizes the U.S. Secretary of the Treasury to spend up to \$700 billion to purchase distressed assets, especially mortgage-backed securities and make capital injections to banks. This act has become known as the Troubled Asset Relief Program (TARP) and in theory should be highly stimulative in the long run.

President Barack Obama promised during his presidential campaign that he would repeal the 2003 tax cuts rather than just let them expire in 2011. Now he has decided to break his campaign promise, given the severity of the economic decline, and not attempt to repeal them; so taxes will stay low on incomes, dividends and capital gains.

Finally, President Obama's \$825 billion stimulus package is in the process of being finalized. The package consists of a combination of two-year tax cuts or rebates and new spending programs to create employment. Although the final form is still being debated, it should also prove to be highly stimulative.

### TRADE PROTECTIONISM THEN

In 1930, Congress was concerned that it needed to protect American jobs and tax revenue given the economic slowdown.

To accomplish that end, the Smoot-Hawley Tariff Act was enacted. This Act raised U.S. tariffs on over 20,000 imported goods to record levels. Many countries retaliated with their own increased tariffs on U.S. goods. The net result was that foreign trade dropped by more than 50% and it took more than 50 years for the percentage of world GDP contributed by global trade to recover to 1929 levels. Many economists believe this Act was responsible for pushing much of Europe into economic discord as it was trying to recover from the effects, monetary and otherwise, from World War I.

### TRADE PROTECTIONISM NOW

In November 2008, the G-20 Group (the largest 20 industrial economies in the world) met in Washington D.C. to discuss the global recession. The members pledged not to use protectionism as a tool for creating local recovery at the expense of the global economy, recognizing this as a lose-lose proposition. Inhibiting the efficiencies of cross-border trading hurts everyone, everywhere.

### CONCLUSIONS

The Current Recession officially began in December of 2007 according to the National Bureau of Economic Research. While it is likely to be deeper and more prolonged than previous recessions, it is highly unlikely to degenerate into an economic environment like the 1930s for the following reasons:

1. Global policy response has been immediate, and highly stimulative - both monetary and fiscal policy.
2. Trade protectionism has not and is not likely to occur.
3. The worldwide banking system is being supported.
4. Two income families have somewhat softened the impact of rising unemployment.
5. Social Security and Medicare in the U.S. help offset the threat of widespread financial destitution among the elderly that accompanied the Great Depression.
6. Economic data is more accurate and timely, allowing central banks to better manage economies.
7. Better inventory controls by manufacturers and retailers have helped minimize the big inventory buildups that exacerbated past recessions.

While the financial crisis has caused deep, emotional concern across the globe, the stock markets of the world have gone a long way in discounting our problems. We believe the healing process is taking place and the combined global policy actions taken will succeed in economic recovery.

David J. Szatkowski, CFA  
Vice President