

C *Economic & Market* Commentary

Déjà vu or something new?

It has been a challenging 18 months for most long-term investors. Whether or not your investments outperformed one or more of the popular indices paled in comparison to the fact that most long-term investors have lost money. The case for long-term investing has taken some heavy damage recently and many are sounding its death knell, but it is not dead by a long shot.

Generally speaking, actions being taken to help “right the ship” are based on policy makers’ collective experience of “what not to do.” Federal Reserve Chairman Ben Bernanke is one of the most knowledgeable scholars on the Great Depression, and most feel that he has used his knowledge to the best of his ability. To better understand why things have not improved yet, let’s take a look at some of the details.

There are regulations that require banks to hold a certain percentage of their deposits in reserve (the reserve requirement), and permit them to lend out the rest. Amounts held in excess of the reserve requirement are called excess reserves. Withdrawals or a decrease in the market value of excess reserves decreases the amount of loans a bank can make, and deposits or an increase in the market value of excess reserves increases the amount. [This is how the banking system creates the liquidity our system needs to survive, and why healthy banks are so important to a growing economy.] At most banks, excess reserves have been falling at an alarming rate due to the combination of an economic downturn and an unintended consequence of “mark-to-market accounting”. Most of the early Troubled Asset Relief Program (TARP) funds were used to replenish depleted reserves as many banks, even after the TARP injection, were not in a position to make new loans. Had the Government not bolstered the reserves in the banking system, things would be much worse.

Before the Federal Open Market Committee (FOMC) was created in 1935, banks were held to a mark-to-market accounting standard. As the economy began rebuilding after the Great Depression, the newly-formed FOMC became concerned that mounting excess reserves in the banking system would usher in a wave of inflation and made a preemptive strike to neuter the potential impact on the economy by doubling the reserve requirement between August 1936 and May 1937. This momentous change stifled banks’ ability to use their reserves to make new loans to support the economic recovery and, when combined with a balanced budget initiative that resulted in a slashing of New Deal spending programs, the economy relapsed into contraction. From the peak in March 1937 to the trough in April 1938, stock prices fell 58 percent, employment rates fell dramatically, and industrial production fell 30 percent. Realizing the impact on the economy, the FOMC reduced bank reserve requirements in April 1938, and at the urging of the Federal Reserve, Franklin Roosevelt suspended mark-to-market accounting in July 1938.

Mark-to-market accounting was reintroduced in November 2007, and had a similar effect on the reserve levels in the commercial banking system as the doubling of the reserve requirement ratio did in the late 30's...with darn near the same impact on the economy. Mark-to-market accounting mandates that financial institutions value their assets at current market prices rather than book value. Conceptually, this makes sense, until you fully consider the difficulty in pricing illiquid loans backed by specific assets at market prices. Essentially, there are no positive impacts, as loans have a specific maturity value. As economic conditions changed, the marked-to-market value of many bank assets fell, and the situation fed on itself leading to a rout in the valuation of many assets held by financial institutions. This reduced excess reserves and in some cases impacted regulatory reserves, which stifled banks' ability to extend new loans and even led to banks calling existing loans. From the peak in October 2007 to the most recent trough in March 2008, stock prices fell 56 percent, employment and industrial production fell...Déjà vu?

Another correlated relationship between the two periods is the "up-tick rule" as it relates to short-selling stock. The rule states that short sales must be executed on an up-tick in the stock's price, which hampers speculators intent on driving a stock price down with the sheer volume of sale orders. The rule was put in place in March 1938 to alleviate speculative selling pressure, but abolished in July 2007. In 1938, after a reduction in the reserve requirement, elimination of the mark-to-market accounting rule, and introduction of the up-tick rule, the stock market posted a 50 percent increase in the six months following the March lows. The following year, gross domestic product (GDP) soared by 10.9 percent and industrial production soared by 23 percent, and the market eventually surpassed its 1937 peak by 1940. Now, in April 2009, we have pending modifications to the mark-to-market accounting rule, and an SEC recommendation to reinstitute the up-tick rule...Déjà vu?

Bloomberg.com recently reported that the U.S. Government and the Federal Reserve have spent, lent, or guaranteed \$12.8 trillion, an amount that is about 90 percent of the nation's 2008 GDP of \$14.2 trillion. That is a staggering figure when you consider that a similar package in 1938, as a percent of GDP, would have approximated \$79 billion, which is far less than the total amount of Federal expenditures from 1938 through 1942. In addition to the current unprecedented stimulus, there is a staggering amount of un-invested cash on the sidelines which is equal to the total capitalization of the S&P 500 stock index.

The policies installed during Franklin Roosevelt's second term ultimately worked and both the markets and the economy turned. However, as a result of the large amounts of new money pumped into the system, consumer prices shot up over 22 percent in the following five years. To date there have been two back-to-back stimulus packages, as well as recommended revisions to mark-to-market rules. When combined, it is pretty powerful stuff, and alone may provide the catalyst needed to jump-start the economy. A re-introduction of the up-tick rule, which served the markets well in 1938, could help to reduce market volatility, further increasing confidence in the market and economy. Calling a bottom in a market and economy like this is a win/lose proposition, and the economy may have more bad news and/or surprises ahead. It may not be déjà vu all over again, but with recent actions, the tide should be close to turning.

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