Doug's Blog

Economic and Market Outlook – Oct 31, 2008

Recession, Depression, Inflation, or Stagflation – Part II
What is different now compared to 1929?

Three months ago I wrote an article in which I suggested harder economic times were ahead. I expected that in a stagflationary environment, expectations would fluctuate between concerns about inflation and recession, and that there might be "a temptation, when "depression" fears predominate, to go all to cash."

We are in such a period now. When the real estate/banking crunch suddenly turned into a crisis, the US government had to convince the world that in this "worst financial crisis since 1929," a horrible recession was unavoidable unless they were allowed to act. Act they did, but in the process they managed to enough psychological damage to make the recession a reality, and bring about a crash in global stock markets.

With media noise about this "crisis" excruciatingly loud, a market crash behind us, and a recession hard upon us, it is only natural that many fear another Great Depression is ahead of us. Why wouldn't we sell all our investments, and go to cash or GIC's?

Well for one thing, a lot of very significant things have changed since 1929. So perhaps it is not really logical to expect events to follow the same path they did back then. Here are six significant differences that contrast today's economy and markets from those that existed 75-80 years ago.

1. Social Safety Net

In 1929 there was no employment insurance. There was no welfare. No Old Age Security (OAS) or Guaranteed Income Supplement (GIS) or Canada Pension Plan (CPP.) No universal health insurance. If you lost your source of income, you were out of luck. Even if unemployment rises, (and remember the percentage of Canadians who are actually employed is at an all-time high) people will still have income.

2. Multiple sources of Family Income
In 1929, most families had one source of income. Mostly it was Dad, going to work at the factory, mine, or office, or running the family farm or business. Today most working age families have two incomes. Retired people have multiple sources of income – OAS, CPP, Pensions, possibly some part-time employment, as well as income from their own savings and RRSP's.

3. Government Involvement in the Economy

In 1929 there was relatively little government employment. It was only in the 30's that the government got involved in creating jobs. Roosevelt pulled the American economy out of a depression by building infrastructure. Hitler pulled the German economy out of a depression by building a war machine. Keynes' theories that the government could moderate swings in the economy by spending into deficit when the economy was slow, were published in his "General Theory of Employment, Interest, and Money," in 1936.

Today publicly funded institutions in health care, education, basic infrastructure and public administration are major industries unto themselves. These industries will continue to employ people, pay wages and salaries, and spend money even as the private sector goes into a recession. In Canada, we have a long history of redistributing wealth by building infrastructure where we need the jobs, whether we need the infrastructure or not. Now the infrastructure is needed and government funds have already been set aside to build it.

4. Global Economy

In 1929, we were between the first and second world wars. At that time nationalism was a major force and markets were regional or national in nature. Furthermore, after the "Crash of '29", countries reverted to greater degrees of protectionism, slowing the flow of international trade. These are factors that economic historians believe helped make the depression worse than it otherwise would have been.

In contrast, we have a truly global economy today. Countries around the world realize their economic interdependence. In the last few months we have seen that nations are willing to work together to meet economic threats. It may be true

that the banks, real estate markets, consumers and governments in the United States and Europe are overly indebted and appear to be in the middle of a painful deleveraging process (AKA Recession.) But circumstances are different in other parts of the world. Growth is far more robust in producing countries in Asia, such as China, India, Singapore and Thailand. Since the “Asian Flu Crisis” of 1998, these countries have built up massive foreign reserves and stores of wealth known as “Sovereign Wealth Funds”. China has been actively using fiscal and monetary policy to try to “slow” its growth. While China is expected to slow in 2009, this massive economy is still expected to grow at 7%, a growth rate the West rarely sees in boom times. And with interest rates at 6.7%, the Chinese government has plenty of ammunition to stimulate its economy back to its target growth rate of 10%.

Resource exporting countries such as Canada, Norway, Australia, New Zealand, Brazil and the OPEC countries, have boomed significantly over the last decade, and have used this boom to improve their national balance sheets, build economic infrastructure, and in some cases, also build up sovereign wealth funds. These sovereign wealth funds are now becoming a source of capital for cash starved western banks and other corporations.

5. Monetary System

All of the factors we are discussing are significant, but I believe that this is the most significant!

Economic growth and decline is defined by the flow of money. If the flow of money declines, we define that as a recession. When it speeds up again, we call that a recovery, and when it reaches new heights, we define that as growth.

In 1930, the western world was on the gold standard, which meant there was a fixed amount of money. Central banks could not create more money, so when the people that had it “hoarded” it instead of spending or investing it, “cash was king”. The way to protect yourself was to hang on to your cash.

We have not been on the gold standard since 1971. We now have what is called “Fiat Currency”. Simply put, this means that in fact our currency is not backed by anything – except confidence. The central banks can create as much money as they want. And they are. You are hearing about it in the news all the time. Phrases like “injecting liquidity into the banking system.” In fact, statistics kept by the Federal Reserve Bank of St. Louis show that over the last two months there has been a virtual explosion in the monetary base in the U.S. This didn’t happen in 1929.

6. Technology

Modern technology has dramatically changed the investment process. In the 1930’s, information was transmitted by the written word, by radio, by telephone or by telegraph. Almost all trading was in individual stocks and bonds, settled by paper certificates exchanged for cash, with a weeklong settlement process.

On the one hand, the slow flow of information provided a trading edge to those who found out first. On the other hand, transactions were costly and inconvenient, discouraging frequent trading.

Today information is available to most active market participants instantly. Computerized trading is instantaneous, with minimal transaction costs. This promotes the idea that gains can be maximized and losses minimized by active trading. Computers have allowed the growth of mutual funds, hedge funds, ETF’s and derivative instruments such as futures, which allow trading in volumes and speeds previously unheard of. The market reacts instantly, (and often overreacts,) to any new information.

Conclusion: If one definition of insanity is doing the same things over and over again and expecting a different result, perhaps another definition is doing things differently and expecting the same result.

Today, many fear that since we are experiencing a financial crisis that some say is unrivalled since the crash of 1929, then what comes next has to look like 1930. We must be heading for another Great Depression, and the way to protect yourself financially today is the way that would have worked best back in ‘29.

I think we have to be careful how we connect the dots. When so many things are different – in particular the monetary system itself – is it logical to expect the same result? We really don’t know how the economy, or the markets are going to react.

Perhaps the social safety nets, government intervention, and growth outside of Europe and North America will mitigate the current slowdown, and the slowdown will be short-lived. Perhaps we will look back at this moment in history as more of a transfer of economic power from the US and Western Europe to certain other parts of the world, than a global

recession. Perhaps, with the speed and volume of trading, the market has already reacted and over-reacted to the coming slowdown. Perhaps the massive creation of new money will create a situation where we are more worried about inflation in six months or a year, than we are about recession. Gold, oil, and other “inflation hedges” may once again be the rage, as they were just six months ago.

If we accept these possibilities, as opposed to the certainty of a depression, perhaps converting all our holdings to cash, GIC’s, and Government Bonds, which would have been the way to protect yourself in 1929, and which would have been a good strategy for the last six months, may not be the best way to protect yourself going forward.

The alternative is to invest in a balanced, diversified portfolio, with adequate liquidity. Using a form of Dynamic Asset Allocation, disciplined investors can keep all the bases covered. And they can still take some advantage of the market’s manic-depressive behaviour by selling some of what spikes up and buying some of what spikes down. They might just come out ahead.