Value Investing and the Pre-Depression Circumstances At the Present Time

By Paul Sandison*

Investment Postcards of the 17th December 2011 directs the reader to this week's WealthTrack programme, in which Consuelo Mack interviews two value investors, Chris Davis of the Davis Funds, and David Winters of the Wintergreen Fund.

I give the pair 5 stars ***** for their account of value investing, which in normal times is a valid and beproven way to go if one is not a day trader.

However I give 3 stars *** only for the response to the questions of what to do in a depression and how to protect against high frequency trading. In this article I will only deal with the circumstances around the vexing question of how to protect one's investments in a depression.

In the last depression the Dow Jones index sank to 8% of its 1929 highs. It took 26 years from 1929 to 1955 for the Dow to reach the same level as the peak of 1929. Which small private investor, especially a person investing for retirement, has that time horizon? Private people invest not only for dividends but also for growth. Which firms maintain high dividends during a depression? Also, many firms collapse in a depression which often means the shareholders lose everything. Lastly, in this present pre-depression time, should a responsible investor not keep a considerable amount of cash for investing at the bottom of the crash?

Of course some may counter with the argument things are different now - that 50 years ago 90% of the stock market shareholders were private citizens whereas today 90% of the shareholders are institutions. There may well be differences between the behaviour of individuals versus institutions during a burgeoning depression but it would be interesting to know what those differences might be. Even if an institutional investor does not have any skin in the game he or she is bound to be gripped by amazement and shock when the market drops vertically and not too seldom "adjust the portfolio" and sell. For why else do we have the spectacular falls of 2001, 2008 and even the lesser drop of the fall of 2011? I submit that fear takes over. For all the Fibonacci tools at his disposal, would an institutional pension funds manager really think 'Oh, this is such a huge drop, this cannot carry on, the market must bounce right back up'?

Consuelo Mack put very cogent questions to the pair without receiving, in my opinion, adequate answers. Her questions are at once both current and valid. At this fraught time they should be one of a number of relevant intensive and sustained topics among economists and investors. The result of her interview, while quick and interesting, is therefore only a starting shot. Far more needs to be discussed and explicated.

When I first started writing in Investment Postcards about 3 years ago, the danger then was a US banking sector teetering on the brink of collapse, and a deflationary spiral in the US including some Central and Eastern European countries. The interventions by the US Federal Reserve, including two massive bouts of Quantitive Easing (in essence, money printing) has changed the economic and stock market landscape not only in the US but around the world. By propping up the US banks the US deflationary cycle has been delayed, but at a huge cost to the taxpayers and without addressing the underlying lack of production and employment in the economy.

However in the mean time the shock wave of the noxious mortgage backed securities which were based on fraudulent selling to the sub-prime segment of the US housing market and then sold on to unsuspecting banks in Europe has weakened the European banking system.

These weaknesses have in turn exposed faults not only in various Southern European countries' sovereign debt but also the whole contradictory and dysfunctional edifice of the European Union. At some stage these weaknesses may have been exposed anyway, but this is not the scenario here. The grave threat on hand is that this mortal blow to the European Union is now rebounding to come back to punish the United States with a vengeance, quite apart from negatively affecting many other innocent countries as well.

The unfortunate fact right now is that the European Union (EU) is in deep financial, fiscal and political trouble, as well as increasing internal ideological and political conflict. The EU very much looks as if it is going to be the spiralling centre of the vortex that has a huge international reach and sucks everything else down in about 6-10 months time, the usual time-lag for incorrect monetary and fiscal policies.

The elected representatives of the various EU countries and the unelected officials of the EU bureaucracy have proved incapable of dynamically changing the modus operandi of the EU, much less initiating the acutely necessary far-reaching change which should require the EU-wide consultation of its populations. In part this is because an agile administrative and legislative process which would be up to the challenge of the moment does not exist, in turn because the present EU structure was foolishly created to be a static beast which was intended to 'stay in place and function, dammit'.

Now, exactly at the moment when a dynamic and functional economic solution for the EU has clearly not been fulfilled - nay, never can be fulfilled with the present political and economic structure of the EU - the leaders in the EU have also proved to be incapable of thinking outside the box. Instead they have resorted to re-affirming the same structure but with stronger penalties if any member countries overstep the maximum stipulated budget deficit of 3%. It is an ugly fudge. It was all too easy to get all to agree on something that is nothing.

In time the decision will however mean that many of the very countries that have just voted for this solution will be forced to accept punitive fines and/or default and leave the euro. There will be chaos. I agree with Professor Nouriel Roubini that given the present predicament it would be better for the entire euro zone to dissolve and return to their original currencies after a transitional period in which they maintain dual currencies. The present course is prolonging the agony with death by a thousand cuts which will put both the economy and geo-political stability of the region at risk.

The attitude of the EU leaders to think that they can dupe their electorates by flogging a dead horse is indeed despicable. However it will not fool people around the world. For a limited time the puny measures that have now been taken to extend credit will postpone the ultimate crash, but the result will instead be an accumulating wall of debt which cascades and eventually assumes tsunami force. Thus when the big crash comes it will be far greater than 1929.

So we can now discern a probable window for the arrival of a trigger which will bring about a meltdown. Think June to October 2012 with severe repercussions in the ensuing years of 2013 to 2016. The EU has a shockingly inefficient (and undemocratic) political and economic architecture, with an European Central Bank (ECB) that is in the grip of the austerity mumbo-jumbo of the Austrian School of economics. In the 1930s Germany did not experience the depression to the same extent as the US and the UK because Hitler happened to bring it out of the depression through government-directed infrastructure building and military production which were in turn a side-effect of his megalomaniacal aims.

This is why older Germans instead remember the horror of the runaway inflation of the 1920s when a million marks could not buy you a loaf of bread. It is this inherited collective experience which directed the Germans to insist that the ECB should only have the single mandate of controlling inflation, unlike the US Federal Reserve which has the dual mandate of controlling inflation and promoting employment.

Of course I certainly do not mean that government-directed infrastructure spending is only an option available for authoritarian regimes. The fact is that in such regimes the market is inefficiently managed, and the welfare of the people is heavily constrained by fundamentalist ideology. Government-directed infrastructure spending is far better conducted in democratic political structures where the needs of the people direct what production needs to be stimulated.

Excellent precedents exist. Through the earlier work of Knut Wicksell and Ernst Wigforss the Stockholm school of economics influenced the Swedish government to take various measures to stimulate production for export as early as 1934 and in Cambridge in 1936 John Maynard Keynes published his General Theory of Money and Employment in which he formulated the reasons why when the market fails it is necessary for government and the central bank to intervene.

These events influenced the US government under Roosevelt to intensify the stimulation of production through infrastructure building under the auspices of the WPA (Work Projects Administration). Unfortunately under pressure from the laissez-faire right wing in US politics Roosevelt cut back the government stimulation of production in the first years of his second term in 1937, and the economy fell back again.

The Austrian school austerity freaks argue that Keynesians are only interested in spending and to hell with the consequences. That is a well-crafted lie. John Kenneth Galbraith was influenced by Keynes during his studies in Cambridge in 1934, and in 1942 as the Deputy Head of the US Office of Price Administration, enforced rigorous price discipline. The result was that wages and prices were kept in check, and the U.S. enjoyed rapid growth and price stability throughout the war. Although industrialists hated him for this and lobbied conservatives in Congress to force Galbraith from office in May 1943, accusing him of "communistic tendencies", the ground had been laid for the expansion of the US economy thereafter, and Galbraith went on to serve as economic adviser to several US presidents in the after-war decades.

The start of the irresponsible US budget deficit spending can be traced to the time of the Vietnam war which was financed not by higher taxes, but by deficits. This soon forced the US to abandon the gold standard. Each war thereafter has expanded the total debt - the last two wars more than the previous. The entire root of the US debt problem can be traced to its foolhardy foreign policy of supporting dictatorships throughout the post-war period - continued until only very recently.

We now have the unfortunate spectre of a Europe in disarry and in a recession, soon to be in chaos and depression. The reasons are simple.

One has to go back to the days of Walter Bagehot to know why a central bank is not a central bank if it is not a lender of last resort. Why the European architects of the ECB evidently did not know from history what happened when a lender of last resort did not exist is a shocking indictment of the closed bureaucracy of Brussels which promotes incompetent officers to the highest ranks and the most important tasks - that of planning and implementing new systems.

It is very difficult to believe (but cannot be denied) that in this day and age the EU Treaties signed by some of its member states have introduced a common currency (the euro) with a central bank (the European Central Bank, ECB) *that cannot be a lender of last resort!* This is a monumental mistake that came about via an ultimatum from the German government and the Bundesbank that the ECB should be mandated only to fight inflation if Germany was to agree to adopt the euro.

It is for this historical reason that the latest fudge by the current EU leaders this December 2011 is instead for the International Monetary Fund (IMF) to portion loans to struggling euro countries. The mind boggles at this ghastly solution, since the political implications for democracy and self-determination for the peoples of Europe are serious and injurious. The staggering result of the fudge is that the IMF, an international creditor body whose member countries include the US and China, will now control one half of European monetary policy. The other half, setting interest rate levels, will presumably remain with the ECB. The One World Order, long espoused by illustrious actors on the world stage such as Henry Kissinger, the architect of assisting China to economic world dominance, plus successive US Presidents and the recent UK Primes Minister Gordon Brown and Tony Bliar, has taken a big step in through the back door.

The austere demands of the international creditors, in the absence of a democratically controlled Central bank and Treasury, will naturally have no regard to the employment situation and the GDP of the borrowing countries, and will have all regard to the interest they will gain on their lending. The austerity demands currently being enforced are so hard they have already reduced the GDP of the borrowing euro countries. The loss in aggregate demand is infecting the trade balance of the neighbours and trade partners, now including Germany. In this manner the deflation and negative growth is rapidly going into a downward spiral. The creditors have already forced several EU countries into recession and through the spiral effect will automatically bring about a depression in each. Simply put each afflicted country will simultaneously spread negative effects to it neighbours and European trading partners by reduced trade. Germany will eventually get a taste of negative economic growth like all the rest.

In all likelihood this euro-centric depression will begin in earnest before the end of October 2012. The US elections are in early November 2012. Most countries are to a greater or lesser extent dependent on trade with the EU and US, and China is already in the beginning of a contraction as shown by a decline of GDP growth from about 12% to 7% in 2011. The dual mandate of the Federal Reserve Bank to both control inflation and promote employment must be reflected in the policies of government.

If this does not happen and the United States votes for a new Congress, Senate and President at the end of 2012 who do not have a balanced economic policy but a one-sided austerity-driven ideology that only contains inflation and spending and does not promote production and employment, the achievement of a depression across most of the world will be complete.

From 1929 to 1932 Herbert Hoover, the laissez-faire Republican President of the United States, through his lack of massive government intervention in the economy, deepened the recession into a depression. His inaction was exacerbated by the lack of liquidity when the board of the Federal Reserve Bank voted not to increase liquidity into the economy after the first fall in the stock market in 1929. From 1933 to 1936 Franklin Delano Roosevelt (FDR) turned the economy around by cleaning out the rotten banks and began infrastructure spending to boost production and jobs. Over 3000 insolvent banks were closed. Even the stock market began its halting recovery in 1933 and began the long quarter-century uphill haul.

This time events may come in the opposite order if the new US government in 2013 is too austere.

As Mark Twain said "History does not repeat, it rhymes". During his watch, Obama has spent trillions saving the large banks, which should instead have been taken over, cleaned out, re-privatised and re-capitalised. The Swedish procedure in the early 1990s showed the way as a textbook example which clearly worked, yet the method was scorned by Obama. The thousands of smaller US banks would have gladly taken up the slack. Obama's faulty policy rhymes badly with the Roosevelt steel in resolutely dealing with the failing banking sector.

The US is now itself in the beginnings of a debt crisis. When the EU disintegrates and the EU countries fall like nine-pins the US will be the next target for the international creditors and bond vigilantes. Imagine that. China and other nations in the IMF demanding that the US apply severe austerity measures at each repeated application for loan assistance. Obama, by propping up the banks, has verily divested himself of the opportunity of promoting employment by starting a Works Project Administration. The US ammunition box is now empty.

Perhaps a depression is necessary for the world population to take more than the usual passing interest in politics and economics and throw off the increasingly authoritarian and austere government and institutional attitudes towards the general population in the majority of countries. The risk is however that without sufficient knowledge the fear in their limbic systems (the human inner 'reptile' brain) will be manipulated by populist dictators and populations will backslide into nationalism, racism, intolerance of religious beliefs, and world war.

For over six decades since the second world war the rich and the ruling classes have had their chances to build a truly better world, but their inhuman ethics and lack of empathy for their fellow man have failed them. An insatiable greed and lust for power and status has been their driving force, not service to society and humanity. The chilling egoism of Ayn Rand has been the zeitgeist of the last 31 years and has now come home to roost. Interestingly the ruling classes too now risk being wiped out in the approaching cataclysm. Their torture and murder squads and FEMA (concentration) camps will not save them. I do not say that will be poetic justice. Instead I say that it is tragic and a pity for all that they did not think of that possibility before. I do know however that they were too completely enamoured by their own aggressive successes ever to think that any other outcome might be possible.

We now know more than ever before about the factors that lead up to economic bubbles and busts. Paramount is insecure lending and especially loose credit for building houses for sale, those costly items of capital which firstly cannot produce anything, and which secondly leech away the spending power of the house-buyers, making the demand for other general goods less than otherwise. The allocation of resources becomes skew, until the country does not produce enough to support itself, and increasing numbers of its population become in hock to the money-lenders. Likewise, runaway military spending cannot produce anything. When it is used it destroys even more of the world's capacity, whether in the form of killing civilians or their means of production.

The Florida Housing Bubble of 1925 set the stage for the stock market rumblings three years later in 1928 and finally the 1929 stock market crash one year after that. Too much unsecured money was allowed to chase houses and too much borrowed money was allowed to chase stocks.

The sub-prime housing bubble which came to a final halt in 2008 has its mirror image in the Florida Housing Bubble. Three years later we had the stock market rumblings of the fall of 2011 from an artifically inflated level. Why? Trillions of QE had been pumped into propping up banks instead of into production during 2009-2011 and a good deal found its way into the stock market. Why? The US Republican right-wing dodos plus Obamas 'inherited' right wing advisers believed that central government stimulated production is communism. They preferred to save the banks at the taxpayers' expense. For them it was fine to privatise the gains and socialise the losses. In the EU the majority of EU countries in their pact last week believe that austerity, of a kind far more stringent than the laissez faire policy of the US government of Herbert Hoover, is the solution to the sovereign debt crisis in European countries.

They are having their day, but the proof of the cooking is in the eating. Will the catastrophe be far greater than the first Great Depression? You bet. Less than one year from now in the fall of 2012 we will get the Second Great Stock Market Crash and the Second Great Depression. It is right on track. Whether you live in the US or the EU you voted for what you voted for, and you voted for who you voted for. A people get the goverment they deserve. Therefore, collectively, you asked for it. Your voted representatives have not been able to manage the economy, nor cope with the crises, nor plan and build for the future. You and everyone else will have to take the consequences, and they may be the end of civilisation as we know it.

* Paul Sandison, 64, is a social critic of contemporary society. Although born in South Africa, he has lived in Europe for nearly 40 years. His forebears include an ancient ancestor to King Niall of Ireland and Charlemagne. Paul is currently promoting American and European arrangements of contemporary Irish music. His hobbies are reading, development economics and jogging.