Economic Viewpoint

Hindsight bias, Ponzi and the great depression of 2019-21

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KEY MESSAGES

- Optimism regarding a Fed put and economic rebound in 2019/20 is most likely misplaced. The loudest echo from the laboratory of history could well be that of the Great Depression of 1930-2. Read on!.

Which echo – 1926-8; 1930-32 or 1937-8?

Let's move on from the wild swings across multiple markets from Monday to Wednesday this week which leave little net change from the end of last week.

Some pundits talk of the short squeezes which are typical along the way in bear markets, accentuated of course by thin trading conditions and end-year window-dressing.

The profound question which transcends all this day-to-day drama action is the nature of the economic slowdown now occurring globally including the US. And one data point over the holidays – the slump in the Richmond Fed manufacturing index – reminds us of the issues at stake. (The composite index dropped from 14 in November to -8 in December, weighed down by drops in the indices for new orders and shipments. At -25 the shipments index was at its lowest reading since April 2009).

In reviewing the laboratory of history – especially those experiments where there have been episodes of severe asset inflation unaccompanied by high consumer price inflation – three possible "echoes" (see below) deserve attention in coming weeks and months. (History echoes rather than repeats!).

The behavioral finance theorists tell us, with the benefit of hindsight which echo and which outcome occurs will seems more obvious in hindsight than to anyone in real time.

As Daniel Kahneman writes (in "Thinking Fast and Slow"):

The core of hindsight bias is that we believe we understand the past, which implies the future should also be knowable; but in fact we understand the past less than we believe we do – compelling narratives foster an illusion of inevitability; but no such story can include the myriad of events that would have caused a different outcome.

Whichever historical echo turns out to be loudest as the Great Monetary Inflation of 2011-18 enters its late dangerous phase – whether 1927-9, 1920-3, 1937-8 – the story will seem obvious in retrospect, at least according to skilled narrators. There may be competing narrators about these events – even decades into the future, just as there still is today about each of the above mentioned episodes. In particular the Austrian School, the Keynesians and the monetarists, tell very different tales and the weight of historical evidence does not knock out any of these competitors.

And on the subject of behavioral finance in assessing potential echoes and possible outcomes we should consider Robert Shiller's insight (Irrational Exuberance):

Speculative feedback loops that are in effect naturally occurring Ponzi schemes do arise from time to time without the contrivance of a fraudulent manager. Even if there is no manipulator fabricating false stories and deliberately deceiving investors in the aggregate stock market, tales about the market are everywhere….. The path of a naturally occurring Ponzi scheme – if we may call speculative bubbles that – will be more irregular and less dramatic since there is no direct manipulation but the path may sometimes resemble that of a Ponzi scheme when it is supported by naturally occurring stories.

Bottom line: great asset inflations are populated by "naturally occurring Ponzi schemes", with the most extreme and blatant including Dutch tulips, Tokyo golf clubs, Iceland credits, and less extreme but much more economically important featuring in recent history say financial equities in 2003-6 or the FANMGs in 2015-18; and perhaps the biggest in this cycle could yet be private equity.

Back to the historical echoes

First, could 2019/21 feature a loud echo of 1926-8 (which in turn had echoes in 1987-9, 1998-9, and 2015-17)?

The characteristic of 1926-8 was a "Fed put" in the midst of an incipient cool-down of asset inflation (along with a growth cycle slowdown or even onset of mild recession) which succeeds apparently in igniting a fresh economic rebound and extension/intensification of asset inflation for a while longer (two years or more). (In mid-1927 New York Fed Governor Benjamin Strong administered his coup de whiskey to the stock market (and to the German loan boom), notwithstanding the protest of Reichsbank President Schacht).

The conditions for such a Fed put to be successful include a still strong current of speculative story telling (the narratives have not yet become tired or even sick); the mal-investment and other forms of over-spending (including types of consumption) must not be on such a huge scale as already going into reverse; and the camouflage of leverage – so much a component of "natural Ponzi schemes" must not yet be broken. The magicians, otherwise called "financial engineers" still hold power over market attention.

The central view here (Economic Viewpoint) is that we have passed the stage in this cycle where such a further kiss of life could be given to asset inflation.

And so we move on to the **second** possible echo: could this be 1937-8?

There are some similarities in background.

Several years of massive QE under the Roosevelt Administration (1934-6) (not called such and due ostensibly to the monetization of massive gold inflows to the US) culminated in a stock market and commodity market bubble in 1936, to which the Fed responded by effecting a tiny rise in interest rates whilst clawing back QE. Under huge political pressure the Fed reversed these measures in early 1937; a weakening stock market seems to reverse. But then came the Crash of late Summer (and early Autumn 1937) and the confirmed onset of the Roosevelt recession (roughly mid-1937 to mid-1938) – even more severe than the 1929.30 downturn. But then there was a rapid re-bound.

On further consideration, there are grounds for scepticism about whether this will be loud echo of the near future.

In 1937 there had been barely three years of economic expansion. Credit bubbles and investment spending bubbles (mal-investment) were hardly to be seen. And the monetary inflation in the US was independent and very different from monetary conditions in Europe, where in fact the parallel economic downturn was very mild if even present. And of course the re-bound had much to do with military re-armament.

It is troubling that **the third possible e**cho – that of the Great Depression 1930-2 – could be the most likely to occur.

The Great Depression from a US perspective was two back-to-back recessions; first the severe recession of autumn 1929 to mid-1931; and then the immediate onset of an even more devastating downturn from summer 1931 to summer 1932 (then extended by the huge uncertainty related to the incoming Roosevelt Administration and its gold policy). It was the global credit meltdown – the unwinding of the credit bubble of the 1920s most importantly as regards the giant lending boom into Germany – which triggered that second recession and snuffed out a putative recovery in mid-1931.

It is possible to imagine such a two-stage process in the present instance.

Equity market tumble accompanies a pull-back of consumer and investment spending in coming quarters. The financial sector and credit quakes come later as collateral values plummet and exposures come into view. In the early 1930s the epicentre of the credit collapse was middle Europe (most of all Germany); today Europe would also be central, but we should also factor in Asia (and of course China in particular).

And there is much scenario-building around the topics of ugly political and geo-political developments that could add to the woes of the global downturn. Indeed profound shock developments are well within the normal range of probabilistic vision in the UK, France and Germany – a subject for another day. And such vision should also encompass China.

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