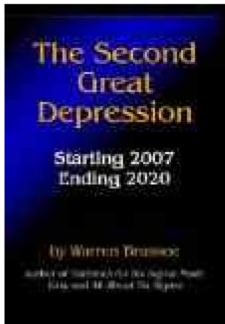
The Second Great Depression by Warren Brussee



The Second Great Depression is a frightening book. It shows how massive consumer debt will trigger the next depression, starting about the year 2007. Most of the logic used to support this premise is based on the government's own published data.

Excerpt

CHAPTER 1
The Crazy Nineties

I had two neighbors in the late nineteen nineties, one a retired doctor and the other a retired small business owner, who were never seen in the daytime when the stock market was trading. But in the evenings, they would have smiles on their faces akin to those of teenage boys who, the evening before, had talked their girlfriends into the backseat of their cars. These neighbors had both become day traders, and each of them felt that they had discovered the secret to wealth. Neither of them ever shared with me their "methods" of playing the market, but their wives worried that they were buying stocks based on hunches, rumors, recent headlines, etc. Apparently no in-depth analysis of stocks was being done, nor did they make any effort to see if they were doing any better than the market in general. All they cared about was that, on an almost daily basis, their on-paper worth was increasing. They believed that they had discovered the secret to making a lot of money without working!

They weren't alone in their craziness. Something strange was happening to most of country during the nineties. Computer nerds, who were never thought to be giants in the practical world of business, were given almost unlimited funds to pursue their latest business ideas related to the net or other software ventures. These newly ordained entrepreneurs told everyone that their dot-com businesses did not have to make a profit; that the idea was to develop a customer base using information technology, and the profits would come later. They used esoteric measures, like "eyeballs," to determine how many people were visiting their websites, which they felt was a measure of their business success. Or they counted how many other worthless web sites were sending visitors to *their* worthless site. They didn't even bother estimating when they would make a profit, nor was there any analysis of what those future profits would be. They said that the important criterion in these new-era businesses was generating customers; profits would just naturally come later. Some of their projections of customer base growth took them quickly to exceed the population of the world, but no matter. Venture capitalists and investors believed them. So did my neighbors. We *all* believed!

Not only were investors like my neighbors sucked in; grizzled CEOs of large companies, who should have known better, gazed at these dot-com companies in awe. These were the same executives that, just a few years before, were trying to look, act, and dress like the Japanese, who were the previous rock stars of industry. These techie-wannabe executives tried to do high-fives and make their companies look and perform like the dot-coms. These experienced executives took crash courses on using the net. Of course, this was only after one of their in-house techies bought them computers and taught them how to boot up. GE's CEO Jack Welch even bragged that investors looked at GE as being equivalent to a dot-com company. He made all GE executives take courses on surfing the net, and each individual business within GE had to set up their own web site where customers could peruse that business's management and product lines. Any project having interaction with the net got priority corporate funding. Jack Welch and many other corporate heads also did what was necessary to make their stock prices act like dot-com stocks. No matter that most of the perceived financial gains during this era came from accounting creativity that made bland corporate performance look stellar by pushing costs into

future years and doing other financial wizardry.

Baby boomers, who were wondering if they were going to be able to keep up with the gains realized by their parents' generation, suddenly saw their salvation. Like my day-trader neighbors, the baby boomers would buy stocks in this new era stock market and watch their riches grow. As more and more of them bought stocks, the demand drove prices up to ridiculous levels. The feeding frenzy had begun. As a result of all this buying pressure, in the later years of the last century the stock market performed brilliantly.

It wasn't just naïve investors who got overconfident in their abilities related to the market. In 1994, Bill Krasker and John Meriwether, two winners of the Nobel Prize in Economics, started a company called Long Term Capital Management (LTCM). These two "geniuses" had done massive data analysis on the "spreads" between various financial instruments, like corporate bonds and Treasury bonds. When these spreads got wider than what was statistically expected (based on their computer program), LTCM would buy the financial instrument likely to gain from the correction that was expected to occur shortly.

Using this methodology, LTCM was unbelievably successful for four years. By leveraging their money, they had gained as much as 40% per year for their investors, and Bill Krasker and John Meriwether got very wealthy.

They were so successful that, by 1998, LTCM had $1 trillion in leveraged exposure in various financial market positions. Then, LTCM became victim of the "fat tail" phenomena, which is where a normally balanced distribution of data now has a lot of data far out to one end of the distribution tail. The reason this happened is that everyone who played in similar financial markets all decided to get out at once, and LTCM was seeing results that their computer models had predicted would *not statistically happen in more than a billion years*! Unbeknownst to them, because of the sudden exit of the others playing this financial game, the relationships of the "spreads" between various financial instruments had changed, which made the earlier computer-generated probability predictions invalid.

The risks that LTCM had taken were so dangerous that LTCM was close to upsetting the whole world's financial institutions. Fed Chairman Alan Greenspan and several of the world's major banks got together to offer additional credit to LTCM to successfully avert this potential global financial disaster.

The two "geniuses" still lost over $4 billion, and the relaxed credit that was established by the banks to save LTCM later enabled companies like Enron to do their thing. This story is indicative of the overconfidence shown throughout the nineties. If LTCM had not been leveraged to such an extreme level, they probably would have survived this event. But they had gotten overconfident and greedy. Everyone in the nineties thought they could get something for nothing by playing financial games, which in this case included being leveraged to the hilt.

Anyone who was able to capitalize on the market gains of the nineties was fortunate indeed. In fact, if you bought the S&P 500 stocks in 1994 and sold them in 1999, your investment tripled in value. Figure 1-1 is a graph of the real gains (discounting the effect of inflation) of the S&P 500 stocks since 1900 showing how unusual and dramatic those 1994-1999 gains were, as evidenced by the huge upward spike on the right-hand-side of the graph (graph can be viewed in the pdf excerpt HERE).

However, buying stocks in 1994 and selling in 1999 is not the normal way people invest, nor were many people fortunate enough to time the market that well. The general way of saving is to invest on a consistent basis and then hold the stocks. This is also the savings method advised by most market "experts." If someone saved a fixed amount every year, starting in 1994, the same beginning year as above, and was still investing this fixed amount through 2003, he or she would only be ahead 33% (including inflation). This assumes a 1.5% annual mutual fund management cost, which is typical of

what most 401(k) pension savings programs charge. This 33% gain is almost identical to what someone would have gotten with a basically zero risk Treasury Inflation Protected Security (TIPS) paying 3%, which we will discuss in a later chapter. So even for those who started to invest in the dramatic market of the nineties, without some fortunate market timing, the gains realized by most investors were not all that phenomenal.

Others have come to similar conclusions on the stock market. John Bogle, founder of the very successful Vanguard Group, estimates that the average return for equity funds from 1984 through 2001, a time period which includes the great stock market bubble of the nineties, was just slightly more than inflation! Contributing to this disappointing performance were the fees charged by mutual funds and the "churning" of stocks – constant stock turnover, which not only adds trade costs, but also causes any gain to be taxed as regular income, rather than at the reduced tax rate of capital gains.

However, in most people's memories, the nineties were a time of great gains made in the stock market. They can't get out of their minds the 200% gain that could have been realized by buying in 1994 and selling in 1999.

Let's try to identify what made the stock market grow like it did at the end of the last century. When we look for the most likely cause, let's keep in mind Occam's razor, a logical principle attributed to the mediaeval philosopher William of Occam, which emphasizes that the simplest explanation is usually the best.

Between the years 1990 and 2000, due to the baby boomer surge, the number of people in the age group 30 through 54 increased almost 25%. These are the primary stock buying ages. Below the age of 30, people are involved with getting an education or starting their careers. Once people become 55, some of them begin to move investments into more conservative areas, getting ready for retirement. Figure 1-2 is a chart showing this 25% increase in the age 30 through 54 potential stock purchasers. (Chart can be viewed in the pdf excerpt HERE.)

At the same time of this surge of potential stock buyers, there was an increase in awareness of and participation in the stock market. Stock ownership by families went from 23% to over 56% in the period of 1990 to 2001, largely due to the growing number of 401(k) pension plans whose regular savings from income were designated for mutual funds. This is shown below in Figure 1-3. (Figure can be viewed in the pdf excerpt HERE.)

This increased stock market interest, coupled with the previously noted increase of people aged 30 to 54, meant that there were approximately three times as many potential stock buyers at the end of last century than at the beginning of 1990. This put an unusual pressure on the demand side of the traditional demand-versus-supply relationship. This is not a difficult concept, and its importance has been known for hundreds of years. There are other more esoteric explanations given for the nineties stock price rise, but this is the simplest and therefore most likely cause.

We must emphasize the importance of this increased demand. A relatively small percentage of stocks are in play on any given day. When one of these stocks becomes available for sale, if there are a large number of people interested in buying that stock, the stock will trade at a higher price than normal due to the demand. Simply put, that is what happened in the nineties. People weren't analyzing whether a stock was priced correctly or doing any in-depth analysis of a company's potential. There were just a lot of people who wanted to buy stocks at any price because they believed that the price would go even higher in the future.

This was not only true of individual investors, but it was also true of the professionals picking stocks for the mutual funds. Every week, the increasing number of automatic investment dollars generated by 401(k) savings plans was dumped on mutual fund managers' desks. The fund managers could delay the

investment of this money for a few days or weeks if they thought the market would go lower. But they would eventually have to jump into the stock market, driving up demand. No mutual fund manager could keep large portions of their investment money out of the stock market for extended periods of time. After all, their customers wanted to invest in the market.

Media coverage of the market became intense, and many people began to actively trade stocks on the internet. The almost instant investment information on the web enabled many people to become day traders or self-proclaimed investment experts. The trade costs of playing the market dropped dramatically with the advent of discount brokers and on-line trading. The almost continuous rise of the market just fed the self aggrandizing of these investors.

Many people began to extrapolate their paper gains for the next 20 years and could see themselves as millionaires with little more effort than the few minutes it took at a computer keyboard to enter their current stock picks. This was how they were going to get their proverbial pot of gold. There was no point in trying to save outside of the stock market. Even if the market took a temporary drop, the stock market gurus assured them that it would always come back and go even higher.

At no point did these people stop to wonder if the stocks they were buying were over-priced, or whether the companies really had growth potential. Nor did they ever stop to think that there was not enough money in the world for every investor to become truly wealthy. They couldn't conceive that, when they finally decided to sell their stock, there could be no one to buy the stock - that everybody would already be fully invested with no additional money to put into the market. Sure, if their timing was right, they could be one of the lucky early sellers and do very well. But the following sellers would do worse, and the next sellers even worse, until perceived stock gains miraculously turned into losses. The demand-versus-supply relationship would be turned on its head, with more stocks available than there would be buyers for those stocks.

In the nineties, there was no reason for investors to question the wisdom of what they were doing. The Motley Crew was on the radio on weekly broadcasts explaining how *they* were doing it. Investment groups were rampant, including a group of grandmothers who got national attention based on their claim of beating the market experts. People regularly monitored the on-going media competition between the dartboard stock picks and the market experts. Chat lines gave "inside information" on stocks. Anyone *not* playing the market was obviously naïve or stupid.

TV business news guests were explaining how the information age was enabling companies to realize efficiencies-through-knowledge with little capital investment, thereby justifying the unusually high stock prices. Instant information enabled companies to have minimum inventory and to adjust product mix quickly if consumer tastes changed. This was predicted to eliminate the normal up-and-down cycles in the economy. The market would just consistently go up!

Industrial processes could be fine-tuned using information system feedback, and methodologies like Six Sigma promised only three defects-per-million-parts-produced if data were used to drive decision making. There was no need to invest in new production equipment because the old-era equipment would run so much better with this new-era information knowledge.

There were books that touted the Dow at 36,000 or even 100,000. No matter that the rationale for the high Dow values was based on fantasy future earnings that would never come to be. Also, these books stated that there was no more risk in investing in the stock market than in other more traditionally conservative investments, such as bonds. All the stock investor had to do was wait out the downturns in the market – the market always came back and went to even higher levels. Of course, the books didn't mention that, when the effect of inflation was included, it may take well over twenty years before the investment recovered, and most people's investment window couldn't tolerate that. All the misleading information on the market's potential would have been humorous, if it weren't for the fact that many

people were risking their lifetime savings on the unrealistic dream of getting rich with no effort!

Then, in 2000, the Motley Crew began to lose money. It was starting to become obvious that information technology in most cases just enabled more junk mail and junk information. People already had more information than they could handle *before* the information era started. The additional information just caused people to spend more time sorting.

Someone discovered the accounting error in the Grandmas' claimed gains in the market. The Grandmas forgot that they were regularly infusing additional funds into their investment club, which was not factored in when they calculated their supposed gains. Efficiency gains touted in government statistics on productivity were found to be largely due to changes in the government's accounting system baseline; like counting productivity gains based on the increased speeds of computer processing, rather than any real gains truly affecting productivity. The hyped image of the new era market strength was beginning to get blurry.

We started to see our neighbors out walking during the day, no longer day trading in the stock market. They grumbled that the market was *no longer acting rationally*! Again, they did not choose to share their results with me, but their wives indicated that all their paper gains had been lost, along with a bundle more. The market fooled many people in the nineties because it seemed so logical, and it just kept going up; investors began to feel invincible in their stock-purchase decision making.

This nineties stock market price bubble is obvious in retrospect when we look back at the Gross Domestic Product (GDP) for this period and see that it was literally unaffected by all the fuss. The Gross Domestic Product is the total market value of all final goods and services produced in the United States in a given year, equal to total consumer, investment and government spending, plus the value of exports, minus the value of imports. If companies had really gotten superb performance during the late nineties, it would have been evidenced in some measurable effect in the GDP and would certainly have been seen by now. After all, at some point the value of these new era companies should have increased the output of the country in a very measurable manner. Instead, the GDP just marched on pretty much as it had in the past. Figure 1-4 is a graph in logarithmic scale showing this lack of a GDP spike. The graph is shown in logarithmic format because a constant improvement will show itself as a straight line when plotted logarithmically. (For anyone wanting an explanation on how a logarithmic chart makes a constant improvement appear as a straight line, see the end of the Appendix. But it is not necessary to understand this to be able to read this chart or understand the information.) (Graph can be viewed in the pdf excerpt HERE.)

Figure 1-4 shows that in the nineties there was no sudden change in the on-going quantitative gain in the GDP. The line showing the GDP just continued upward at the same rate it had been the forty five years before the nineties. The new-era information driven society had absolutely no effect on the GDP.

Besides being invisible to the GDP, the stock dividends did not justify the high prices of stocks. Figure 1-5 is a chart showing that in the nineties the stock price versus dividend *ratio* just took off and still remains high at the end of 2003, compared to price/dividend ratios before the nineties. The increase in the price/dividend ratio means that people are paying far more for the same amount of dividend that they were previously getting at a much lower stock price.

(Figure can be viewed in the pdf excerpt HERE.)

So dividends didn't seem to justify the high stock prices. Some investors felt that the high prices were justified because *future* dividends would jump dramatically as the expected gains realized by the new era technology took hold. Below is Figure 1-6, plotted logarithmically, that shows that dividends have grown consistently since the early 1960's, and there has been no spike related to the nineties' stock price increases.

(Figure can be viewed in the pdf excerpt HERE.)

Note that the above graph includes nine years after the stock price spurt starting in 1994, and the dividends have shown no corresponding jump. The straight line superimposed over the last forty years is there to emphasize that the average dividend has been growing at a reasonably uniform rate during that period.

Dividends are the criteria we must use to measure long term company performance, because they are the profits that the owners actually get out of their investments. If you bought a pizza restaurant, you may choose to use initial earnings to expand or improve the restaurant, but at some point you will want to take some money out of the company for personal use, because that is the whole purpose of investing. Dividend payout can be delayed while growing a business; but if the earnings *never* generate dividends, then real earnings were either never there, were wasted on bad investments, or were used to enrich others' pocketbooks rather than the owners of the business. Just as with the pizza restaurant example, someone may choose to buy stock in a company that is temporarily investing in growing the business rather than paying dividends. But if this were to go on for too many years, prospective stock purchasers will begin to turn away because they will begin to doubt whether the company will *ever* pay dividends. Then the stock price will level off and eventually start to drop. The fact that Microsoft is now paying dividends is evidence that even the ultimate high tech company had to eventually turn to paying out cash.

Published earnings are so easily manipulated, as evidenced by the failures of Enron and the like, that it is now difficult to evaluate the real worth of a company using earnings reports, especially if a company is very large and diverse. In the nineties, companies became expert at making earnings appear to be whatever they wanted. Real spending on research and development (R&D) was reduced and replaced by "accounting R&D" that labeled any project with even minimal risk as being R&D. This gave the misleading appearance of continuing investment for future growth while getting the resultant tax benefits. Individual pieces of equipment, which were previously depreciated separately, were now "bundled" together, then amortized over a larger number of years. This reduced current expenses and made profits appear larger. No matter that this action would make it far more difficult to replace individual pieces of equipment in the future as new technology made them outmoded, because to replace one piece the whole bundled assembly had to justify recapitalization. Items that previously had been expensed were now classified as investments, making current earnings appear more robust by delaying current costs into the future while showing high investment numbers. Outsourcing generated instant gains, but sacrificed the manpower skills needed to grow future businesses. The list goes on. Note that all these changes were legal and separate from the more obvious shenanigans of the likes of Enron.

Since the price/earnings ratio is by far the most popular measure to determine if stocks are overpriced, I am including the below graph, Figure 1-7, for the edification for those who want to see it for a reference. In the graph, the vertical axis of earnings is proportioned to optimize the fit with the S&P 500 price or value. This chart shows that the earnings and price grew somewhat in concert until 1995, when the price just took off. As is true for the price/dividend ratio, this chart shows that the stock market is overpriced versus the historical relationship between price and earnings. However, this book will *not* be using this graph or earnings in any analysis, because of the aforementioned reasons that the earnings are too easily manipulated.

(Figure can be viewed in the pdf excerpt HERE.)

So we have seen by looking at the GDP and dividends that there was no real performance improvement that justified the dramatic rise in stock prices in the nineties. *The most logical reason for the rise in stock values in the nineties is that the price increase was due to the unusually high demand for stocks,*

driven by the increase of the buyer base overwhelming the supply of available stocks. Sure, there were some new dot-com companies that were added to the milieu of stocks (of which many eventually rewarded their investors by going belly-up), but the pressure on almost all the stocks to be bid up due to the high demand was intense. This is what caused the stock market price jump in the nineties.

This craziness in stock market prices started a series of events which are the precursors for the coming depression. Along with the "irrational exuberance" of stock prices, people stopped saving because they thought that the stock market gains would guarantee their future. They also became irrationally exuberant on going into debt, with no concern on how they were going to pay it all back. After all, they were going to become rich through their stock market investments!