

## The History of Economic Bubbles

By Timothy Buchanan

*This publication was originally drafted and published in September of 2003. We updated it in 2005, and now again in early 2008 as it appears the five year 'recovery' is coming to a conclusion. Being early (or even very early) with any forecast brings with it the risk of being 'wrong' until that forecast proves to be correct. Conversely, being late with any forecast is of no value to anyone. Note that some pictures tell their own story and are not referred to in the text of the history.*

### The History of Economic Bubbles

Our investment models are, in part, based on research and observations of 27 previous boom and bust cycles dating back 1200 years, all of which are very similar in some very key respects. To begin with, every one of the 27 boom cycles observed experienced enormous amounts of debt. They are commonly referred to as a 'credit' bubble because credit is easily made available to everyone. In every historic case, the boom was effected by a social mania that gripped a society and the competitive human nature of its participants to become rich or famous or both.

Few may know that William Dodge lost control of his automobile company in the early 1920's by leveraging everything he owned to buy more of his own company's stock in an effort to prop up its value, as it fell precipitously. He lived as a pauper in an apartment above a bowling alley during retirement, setting pins for a living.

#### *The Easy Credit and Low Interest Rate Bubble Machine Helps Foster Mania's*

*1620's to 30's - Tulip Bulb Mania in Holland*

*1680's to 90's - British Stock Market Mania (causing some prominent citizens to flee and establish a new land which came to be known as America)*

*1720's to 30's - South Sea and Mississippi Bubbles, cotton, iron*

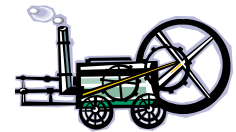
*1780's and 90's - New Railroads*

*1820's and 30's - Southern Reconstruction, wildcat banking fueling demand for canals and railways*

*Late 1800's - New Electric Power Generation*

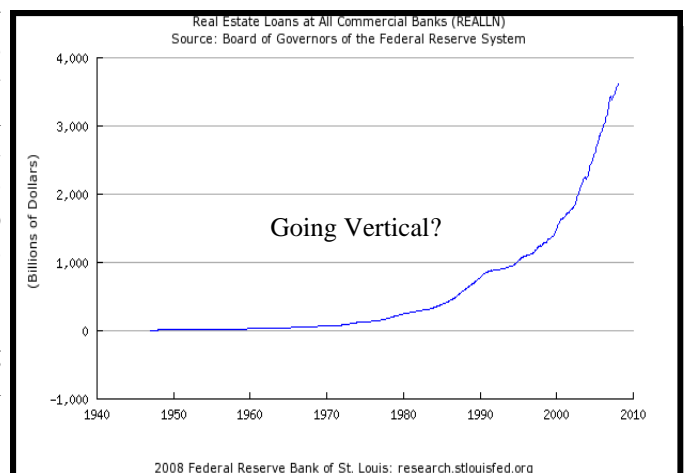
*1920's to 30's - Creation of telephone, automobile, installment credit, margin loans, lending against property*

*1980's to 2008? - Information technology, structured finance, low interest rates, home equity*



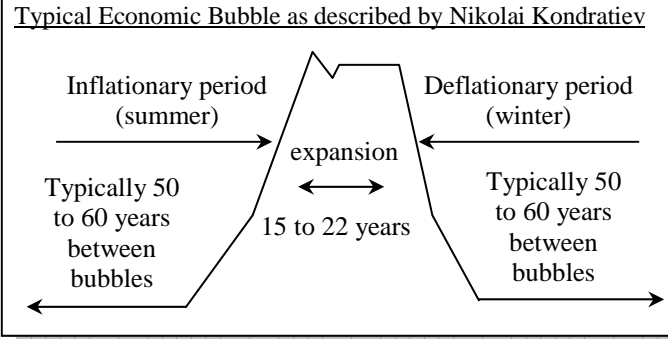
One of the most researched bubbles occurred in the early 1600's, in Holland, when a flower that had the ability to regenerate itself took hold on a society awash with easy credit. Money was heavily borrowed to create strains and breeds of this flower known as the tulip. Tulips were widely viewed as the sure fire way to get rich. Some historians estimate that at the height of the hysteria, tulip bulbs traded for over \$1 million apiece (in today's dollars). Can you imagine?

Our current bubble was financed initially by leveraging to invest in technology startup companies during a period of progressively declining interest rates during the 1980's and 90's. Following the bursting of the technology bubble, the Federal Reserve again reduced interest rates which fueled the real estate bubble. Recently the debt was being transferred to home equity values by way of the home equity ATM. Every one of the



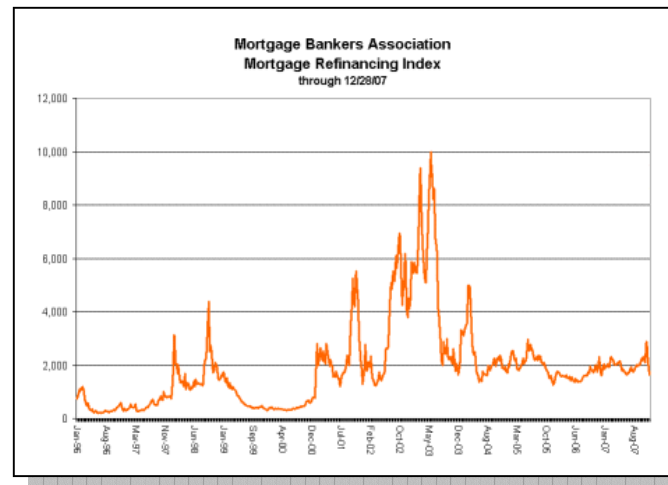
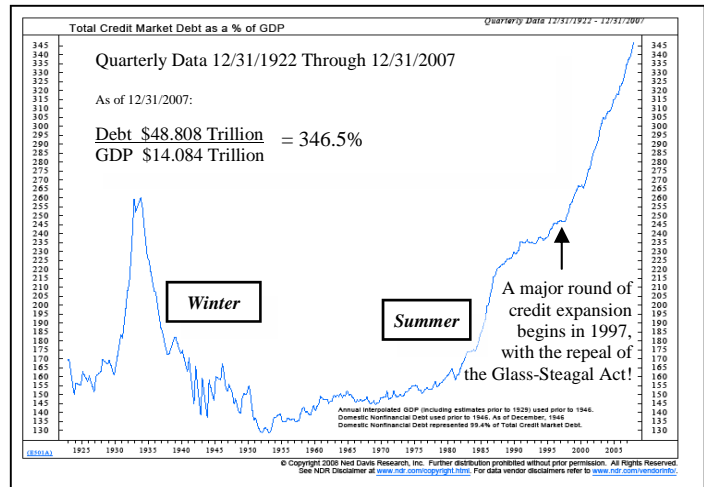
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previous 27 bubbles was actually a credit bubble disguised as something else. Every one of them deflated through a subsequent tightening of credit...every one. What we're talking about here is a process that will likely take three to four decades to complete from start to finish.



In the 1930's during the Great Depression, Russian economist Nikolai Kondratiev concluded that credit and thus economic bubbles had repeatedly occurred throughout history. Today, contemporary observers including the faculty from the University of Washington and others such as Jeremy Grantham, a Harvard graduate and co-founder of the money management firm Grantham, Mayo, Van Otterloo & Co. (GMO) are among several who have painstakingly detailed the history of these bubbles collecting data from as far back as 900 A.D.

There are minor bubbles that occurred in between the larger ones. There is also a time span of some 50 years or more between each one suggesting a generational influence on the creation of bubbles. In other words, the reason they keep reoccurring is because we're human and when we die, so does our recollection of the events surrounding the creation of the bubble. For example, anyone who actually lived through the depression of 1930's, and was also old enough to understand and appreciate how it occurred, would likely have been at least 30 years old at that time. So that by the time the year 2000 rolled around they would have to be 100 years old and there would be little or no influence on society from that small group of people. The reason it is difficult for us believe that such an event can even occur is because it hasn't happened during lifetime, which also why it does occur.



When the tech bubble burst starting in 2000, the loss of capital caused a loss of U.S. jobs and that caused a loss of personal income, which created an immediate need for cheaper goods. That's when the migration of jobs to China and India moved into high gear. More than 2,000,000 U.S. jobs were lost during this transition. While this was occurring the Federal Reserve again reduced interest rates to help soften the landing. America, now fully intoxicated on low interest rates spurred another round of mortgage refinancing and real estate buying. Indeed it is well documented that all historic economic expansions of substance have a foundation in wage growth. The current recovery has its' foundation in real estate price appreciation.

Ultimately, it appears the debt bubble simply *must* deflate. After all, it has done so on every previous occasion. It would seem that the anomaly would be for it *not* to occur, based on historic precedence. Once public psychology begins to shift, there likely will be no stopping it. Commodity prices, such as gasoline or various foods may rise, interest rates may rise due to inflation, utility costs rise, taxes rise and then one day, Mr. and Mrs. Consumer decide they need to tighten their belts so they can make the mortgage payment, which, this time around is also rising.

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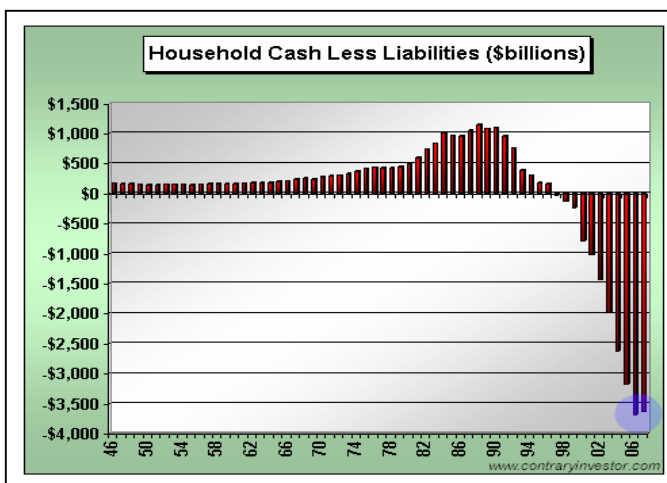
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### Macro-Economic Consistencies

History shows a convergence of economic activity has consistently defined the beginning of each of the previous 27 bust cycles. They include low personal savings rates, rising commodity prices, interest rates beginning to rise, a weak domestic currency, large levels of consumer, corporate and government debt, large trade and current account deficits, rising bankruptcies, wars, government manipulation of the system to fix problems in order to appease society. Sound familiar?

Issues effecting our macro-economic perspective include our expectation that oil should continue to climb to record highs. After all, just like the common real estate adage, there's only so much of it to go around. Demand in developing country's, such as China and India, continues to grow. We expect \$200 per barrel within the next few years.



We think the U.S. Dollar will continue its disastrous five year trend of heading lower. And while we're discussing the Dollar, let's address this oft heard argument that a declining dollar is supposed to help our economy. The argument goes like this: As the dollar falls it is supposed to create economic expansion because our products become cheaper overseas. This is only part the argument. In order for this to work, we need to actually make *stuff* here in the U.S., so that people can go back to work making that *stuff*, to meet the foreign demand and thus improve the domestic economy. Since World War II, our manufacturing base has been on a steady decline. In fact, just since the Bretton Woods agreement in the late 1980's, our manufacturing base is already more than 40% smaller!

Gold should continue to rise significantly over the next several months and years, but not as a result of inflation. We expect it will become the standard bearer for wealth. Gold knows no currency exchange. This, too, is consistent with past bubbles. Our nations forefathers founded this country requiring the use of a gold standard in the Constitution. They were fleeing the tyranny of England's fiat (paper) standard of wealth. Our nations founding follows shortly after the British Stock Market Mania noted on page one.

To be sure, our observations have been one of caution for the past five years. We view the rise from the March 2003 lows (or October 2002 lows, whichever you prefer) to be a cyclical bull market rally completing a major multi-year top and the beginning of a secular bear market. Is it possible to survive and even thrive in such an environment? Our answer is yes!- but you need to be open to changes.

### The Psychology of Bubbles

The issue of human psychology is probably the most underrated yet most important issues relative to bubbles. Again, consistent with all previous bubbles, the common widespread disbelief that anything so terrible as an economic bust could possibly occur is a hallmark of all previous bubbles. This is because it has not yet happened to anyone alive at the time. So there is no institutional fear or concern. The new generation considers itself to be better prepared than previous generations.

In his book Psychology of the Stock Market, David Dreman describes an experiment that demonstrates the "pressures of compliance". In a study conducted, one subject (out of eight) was asked to choose which of three lines on a card was the same size as a single line on a second card. Dreman wrote, "The lines were of such disparate lengths that there should have been no difficulty in immediately choosing the one of proper length."

There were eight people in each subject group. One was the actual subject while the other seven were instructed to collectively misguide the subject and choose the wrong lines. As the experiment progressed, the 'confederates' would go from indicating the correct line to calling out wrong answers. The subjects began to 'go along' with the group and ultimately the pressure of societal 'compliance' increased the subject's rate of error ten-fold!

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It is natural and human to want to remain apart of the community. Exclusion from the community often results in being labeled as “wrong”. Compliance is a strong element in our behavior. It seems that any market seer in society today who is negative about the stock market runs the risk of being labeled as being negative about every other aspect of life. It’s as though there were some cosmic force that has settled over society.

“Near the end of an expansion, few creditors expect default, which is why they lend freely to weak borrowers. Few borrowers expect their fortunes to change, which is why they borrow freely. Deflation involves a substantial amount of involuntary debt liquidation because almost no one expects deflation before it starts.” writes Robert Prechter, Jr. The technology bubble morphed into the real estate bubble by way of the mortgage cash out refinancing or home equity ATM. Easy credit flows freely. How many credit card offers do you get in *your* mail every day?

On September 5, 1929 Roger W. Babson wrote, “Sooner or later a crash is coming which will take in the leading stocks and cause a decline of from 60 to 80 points in the Dow-Jones barometer.” Dow theorist William Peter Hamilton warned of and confirmed a Dow theory sell signal in early October 1929. Both were market technicians (technical analysts). Few people listened because it wasn’t what they wanted to hear. The public wanted to hear that everything was going to be OK. Considering Mr. Mellon’s comment below, clearly things were deteriorating before the crash.

**① September 1929**

“There is no cause to worry. The high tide of prosperity will continue.”  
-Andrew W. Mellon, Secretary of the Treasury

**② December 5, 1929**

“The governments business is in sound condition”  
-Andrew W. Mellon, Secretary of the Treasury

**③ January 21, 1930**

“Definite signs that business and industry have turned the corner from the temporary period that followed deflation of the speculative market were seen today by President Hoover. The President said the reports to the cabinet showed the tide of employment had changed in the right direction.”  
-News dispatch from Washington

**④ March 8, 1930**

“President Hoover predicted today that the worst effect of the crash upon unemployment will have been passed during the next sixty days.”  
-Washington Dispatch

**⑤ June 29, 1930**

“The worst is over without a doubt.”  
-James J. Davis, Secretary of Labor

**⑥ September 12, 1930**

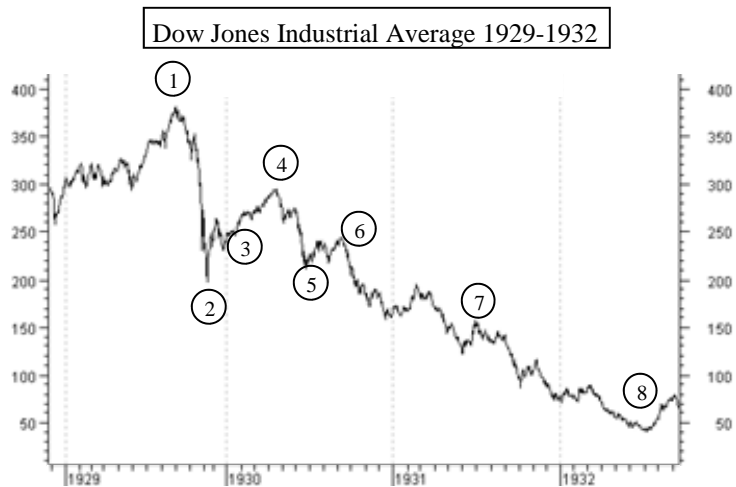
“We have hit bottom and are on the upswing.”  
-James J. Davis, Secretary of Labor

**⑦ June 9, 1931**

“The depression has ended.”  
-Dr. Julius Klein, Assistant Secretary of Commerce

**⑧ July 21, 1932**

“I believe July 8, 1932 was the end of the great bear market”  
- Dow Theorist, Robert Rea (technical analyst)

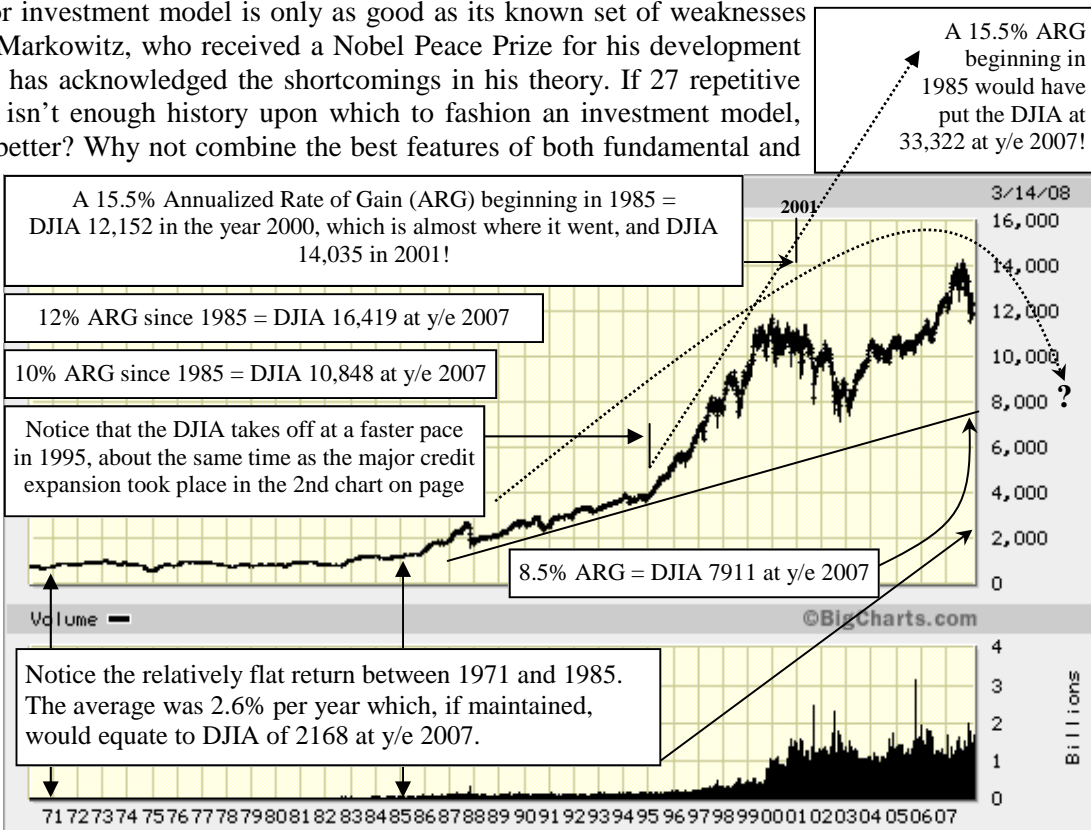


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As it turned out, facing reality could have saved a lot of pain (not to mention assets). How can we possibly know when it's the right time to become more defensive and protect assets from an erosion of value?

Dow Theory (a form of technical analysis) has at least one thing in common with Modern Portfolio Theory; *both* of them are theories. Any business or investment model is only as good as its known set of weaknesses and assumptions. Even Dr. Markowitz, who received a Nobel Peace Prize for his development of Modern Portfolio Theory has acknowledged the shortcomings in his theory. If 27 repetitive cycles spanning 1200 years isn't enough history upon which to fashion an investment model, how could 75 years be any better? Why not combine the best features of both fundamental and technical analysis?

Our approach is to take a 'big picture' historical perspective of previous boom and bust cycles and let history humbly remind us of what can occur. All of this leads to the obvious next question... "What should we expect to occur from here in the financial markets? For the stock markets, our position is a regression (or return) to the long term mean (or average). In the case of the Dow Jones Industrial Average, that would suggest somewhere in the 8000 area as a target.



Using an historically consistent 8.5% rate of return for the stock market (not including dividends) the Dow would be in the 7900 area right now. We have also shown the effects of 2.6%, 10%, 12% and the 15.5% bull market average from 1985 to 2001 for comparative purposes. Also historically, and not unlike the bull market rally from 1982 to 2000, the market has and can move to extremes in *both* directions.

**What's next, Inflation or deflation?**

The answer may be surprisingly simple. Let's start with the definitions for these two words from Webster's Dictionary (the emphasis is ours).

**Inflation**— "An *increase in the volume of money and credit* relative to available goods resulting in a substantial and continuing rise in the general price level".

**Deflation**— "A *contraction in the volume of available money or credit* that results in a decline of the general price level".

Between August of 1982 and January of 2000 the 'volume' of available money and credit as measured by M3, had expanded from \$2,396 billion to \$6,605 billion or 5.48% per year. During the same time, consumer credit grew from \$383 billion to \$1,541 billion or 7.6% per year. On page one there is a chart for Real Estate Loans at All Commercial Banks. In August 1982 that number stood at \$301 billion. By January 2000, it had risen to \$1,491 billion, an annualized rate of 8.79%. These were fostered through both a declining interest rate environment and a general easing of lending standards, creating a 'credit' bubble. By definition, this is inflation. During the 1990's the Federal Reserve reduced to nearly zero the amount required by a bank to be set aside for bad loans. This had also contributed to the easing of credit standards.

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Most people think of inflation only in terms of rising prices for things such as gasoline or healthcare or a steak dinner. However the inflation of asset prices, such as stocks and real estate can also occur as a result of an 'increase in the **volume** of money and credit' or inflation.

Stocks have risen steadily over the past few years because people were able to borrow money to buy 'things' made by companies whose earnings rose because sales were strong (because they were bought on credit) causing stock prices to rise. Real estate prices continued to rise because people borrowed easy money to buy it. The environment even offered no equity loans. Indeed stocks had appreciated too rapidly, which caused a bubble to burst. Back in 2005 we posited, what *should* be next for real estate? Currently we do expect further price deterioration from current levels. A wonderful buying opportunity awaits in the next few years.

Rising asset prices (stocks & real estate) can conceal rising prices in other things simply because those other things are rising less rapidly. That's why we didn't 'feel' the effects of inflation. Logic would suggest that since 'an increase in the **volume** of money and credit' (inflation) has been expanding for so long, and since history suggests it can't last forever, watching for signs of a reversal of that trend should warn us of an impending 'contraction in the volume of money and credit' or deflation. Historically this shows up in the form of 'involuntary debt reduction' such like we are now witnessing in the form of real estate foreclosures and bankruptcies.

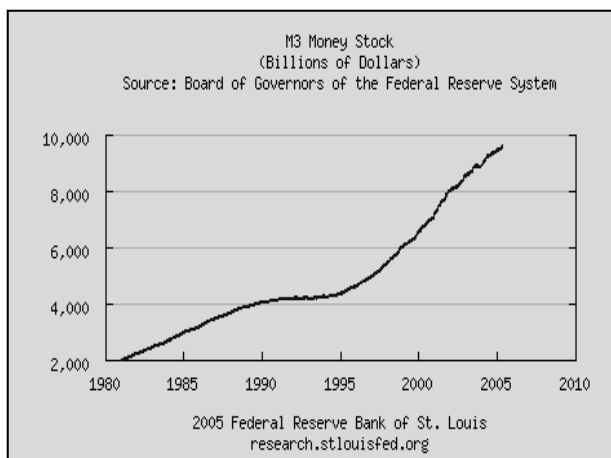
Consider the announcement made on May 16, 2005. A jointly issued statement by the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation (banks), the Office of Thrift Supervision (Savings & Loan Institutions) and the National Credit Union Administration (credit unions). "Guidance", which is increasingly a code word for regulation, urged banks, thrifts and credit unions that their "**credit risk management practices have not kept pace with the products' rapid growth and easing of underwriting standards**". Drawing again from the history books, this is how credit bubbles have begun to deflate, through government intervention, leading to a 'contraction in the **volume** of available money or credit. Deflation...(economic) depression.

### Conclusion:

Embedded in this document is a single, simple message - That just as daytime turns into night, and nighttime turns into day, throughout all history of mankind, so too, have difficult, contracting economic conditions slowly and gradually given way to easy, expanding economic conditions, and easy economic conditions slowly and gradually have become more challenging. No amount of optimism nor human or government intervention has ever been able to modify this cycle, although in every case, attempts have been made.

The reason that most investment advisers and market participants were surprised by the ferocity of the 2000 to 2002 bear market is because the industry is generally trained to understand and recognize business cycles rather than credit cycles also known as credit bubbles. Today, six to eight years later, most market observers are convinced that a typical boom-bust business cycle was all that ever occurred during that time frame. Credit bubbles, which come into being as a result of low priced (low interest rate) and easily accessible credit, manifest themselves by way of several smaller bubbles. This was true in the 1920's with automobiles, telephones and real estate. The current credit bubble manifested itself into the recently imploded technology bubble but also into consumption bubbles such as the real estate bubble, a luxury automobile bubble, lotto, gambling casino and poker bubbles, sports and athletics team bubbles, and several smaller bubbles.

How do you survive? For starters, eliminate as much debt as possible as quickly as possible. If you have any money left over after that, call us at (904) 332-8000 and inquire about our Global Total Return Portfolio which was specifically built as an 'all weather' portfolio. Or visit us at [www.buchananfs.com](http://www.buchananfs.com) to learn more.



*This is a chart of M3, which the Federal Government stopped publishing in March 2006. For Fed watchers such as us, it was the best indicator of Fed 'money printing' activities. We've always wondered why they stopped publishing it!*