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Global Meltdown 1929 Repeated..

Stock Market is at all time low and everyone is discussing about Global Meltdown and its all possible effects on Indian economy and Indian Investors. Fear has taken toll over Greed and now everyone is worried with one Common Question – What's NEXT?

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Stock Market is always acting as a barometer of any Economy. Current level of stock market has pushed us to the year 2006 where Sensex was at the level of 10,000. It took 28 years for Sensex to reach at the level of 12000 in year 2007 and Sensex took only one year to reach at the level of 21000 from 12000. What happened during 2007 to 2008? Was it over optimism? The current downfall of Sensex is attributed by unprofessional practice and misjudgments of so called Master Brains. Analysts say that the current global meltdown is similar to Great Depression of 1929. Let's look at great depression and check its similarity with current slowdown.

World war in any case is root cause of any development or devastation of economy. The freeing of capital from government to use to commercial use following World War 1, caused commodity price to inflate. In 1920, Ben Strong of the US Federal Reserve Bank of New York raised interest rates sharply to prevent inflation. This caused a recession and the stock market to fall. Once hard assets like commodities and real estate were no longer rising in price, money began to pour into stocks and bonds. The Dow started climbing from its low at 63.90 in 1921 and rose 150% over the four years to 1925.

It was in 1925 that Ben Strong made a secret commitment to Montague Norman, Governor of the Bank of England, to help England reinstate the Gold Standard. This action would later be shown to have undermined the British economy but the Pound had been the main medium of international exchange at that time and it was felt to be in everyone's interest to have it be exchangeable for gold. With moral support from the US Treasury, Strong chose to help strengthen the value of the Pound by depressing US interest rates. This depressed the value of the US Dollar and caused the already robust economy to boom. It was suddenly cheaper to borrow money to invest in the stock market (called margin investing). With artificially low interest rates and a booming economy people and companies were more apt than ever to invest in grandiose business expansions and over-priced stocks. Mergers and acquisitions soared.

In 1927, Britain ran into trouble with its gold standard again and Ben Strong lowered US interest rates in sympathy for a second time. This ignited the boom into the speculative frenzy that brought the market to its peak on September 3, 1929. It was like pouring gasoline onto a fire - the flames rose up, no lasting fuel was added, but the economy sure *looked* great. Ben Strong died in October 1928. George Harrison, his successor immediately lobbied for higher interest rates to cool the speculative fervor. Rates were finally raised 1% in August of 1929, but by then it was way too late. The Dow peaked at 381.17. The market and the economy had buoyed itself from one source of hope to the next for a whole decade. First it was the end of war-related inflation and booming exports for war reparations, next artificially low interest rates in 1925 and 1927 and booming exports due to a reduced value of the Dollar vs. the Pound. There were major tax reductions instituted by the Republicans under Hoover and finally in June of 1929 an international accord was struck with the Germans (albeit short-lived) over the financing of war reparations, a major issue of the decade.

By Monday, October 28, 1929 the Dow had fallen 20% to 300. It fell 40 more points that day and another 30 on Tuesday (Tragic Tuesday or Black Tuesday) to reach a temporary bottom at 230.07. It was down 40% from the peak 56 days earlier.

The root cause of the current crisis has a similar pattern. It all started a decade back with a booming housing market in America. The boom was later fueled by expansion of liquidity in the system in the form of "Mortgaged backed Securities" and "Collateralized Debt Obligations (CDO)' invented by Wall Street. In the first few years there was just too much demand for all 'Investment Grade' properties as the same were used as underlying assets for CDOs. When the investment grade CDOs saturated, investors started looking for subprime borrowers. Mortgage brokers and Mortgage Lenders were more than happy to look for 'anybody and everybody' who wanted a mortgage (Which in simple terms means home loan).

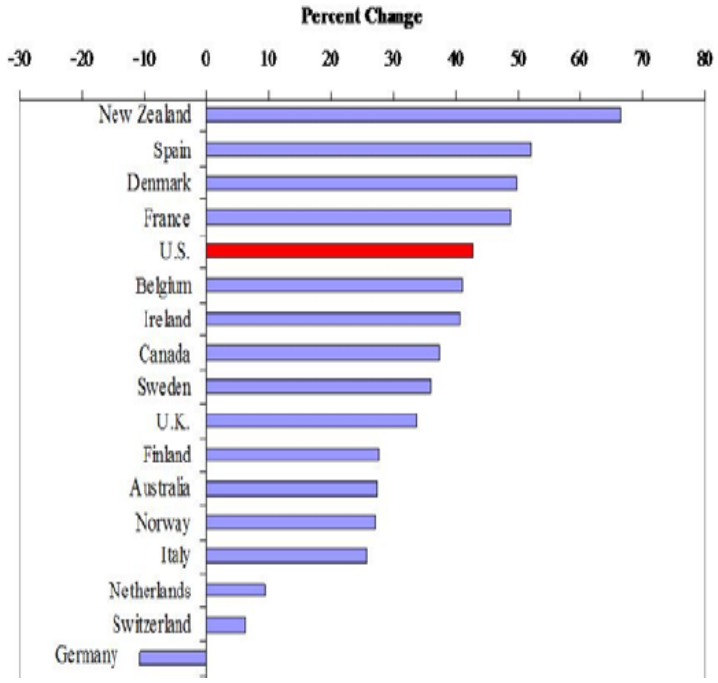
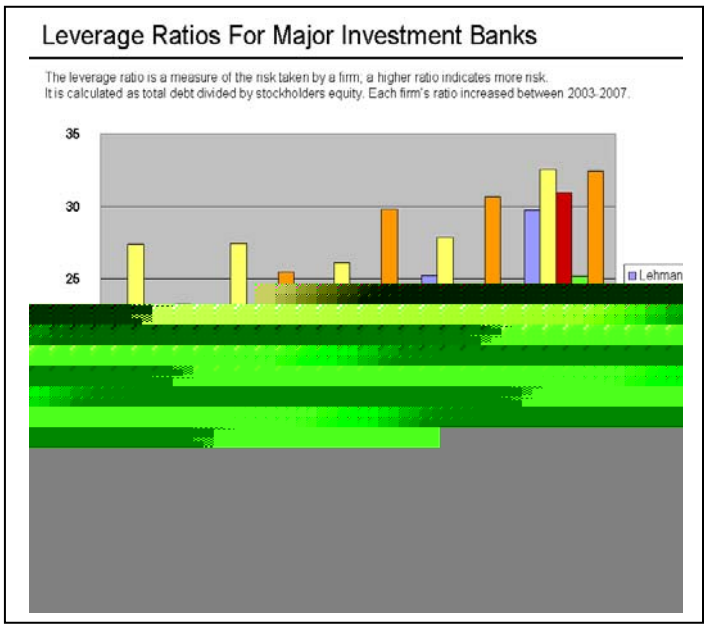


Table 1 : **Housing Sector Price Trend : 2002 - 2006**

In Initial few years boom was observed in American Housing Market because of Subprime Lending and CDOs. Between year 2002 and 2006 property price was increased by almost 40% (Please see the graph)

In case of Subprime Lending no one is taking enough care to see the repayment capacity of borrower, in some cases even margin money was waived off. This was a perfect foundation for disaster.

There was simply too much liquidity in the system and now American Investment Bankers and Money Lenders turned their eyes to developing economies like Brazil, Russia, India and China. Bankers started diversifying globally and started pouring money to Stock Markets. This was a primary reason for unrealistic momentum in stock market during 2006-07. Other reasons might be too much focus on India Shining, Equity as the only preferred destination to be millioners. Looking at the future optimistic prospects of Indian economy, Indian companies also started buying overseas companies. Other Indian companies planned their heavy expansions. Picture was too rosy for all of us. Job Market became employee driven rather than employer driven in 1990s. If someone stays in an organization for more than 2 years people started looking at him/her with suspicious look. The GREED was at all time high, be it with employer, employee, customer or investors. As per Abraham Lincoln, "Change Is the only permanent thing in this world", few intelligent investors were waiting for change to happen.



During year 2003- 2007 the balance sheet and profit loss account of Investment Bankers, Banks and Financial Institution was favorable and running the ride of optimism. This helped banks inflate their earnings and profit forecasts and in turn their valuations. Bankers started leveraging their own banks in stock market. If we closely look at the leverage ratio of five top brass of USA, it was all time high during 2003 to 2007. Higher the leverage ratio higher the default risks. If any bank is leveraged by 10 times, positive change of $1 can bring $10 profit but negative change of $1 can bring $10 loss. But during that time who was thinking about negative sentiments of market? Though these bankers have hedged their position through swaps but GREED was becoming heavy and people were irrational in their judgments.

Equity was scarce and short in supply. People were buying as if there was no tomorrow. In year 2005, boom in economy was halted. In year 2006, there was marginal increase in property prices. In Year 2006, Fed has increased its Interest rate which in turn affected lending rate of subprime loans. As interest rate shoot up, borrowers started defaulting. As they did not pay, Bank started possessing their houses and started selling off in market, which resulted in increased supply and reduced prices. Contraction of liquidity means no aggressive lending, which in turn affected rollover of existing leverage, forcing most of the lenders to wind up outstanding positions before underlying assets start falling in values. This cased downward spiraling effect on stock price. The value of CDO started going downward. It was unable to pay neither the capital nor the returns.

The common Factors 1929 & 2008

Interest Rates	First it was increased and later decreased.
Sector affecting most	Housing
Behavior of Stock Market	All time HIGH and then ALL TIME LOW
Projected Loss in Stock Market	Approx 80%

The total investment made by Indian Banks in these CDOs was around $1 billion and total loss was around $450 million, whereby major loss was booked by private banks. (ICICI Bank alone booked loss or Rs 1000 Crore) however such losses were very small compared to total net worth of these banks.

The way in which India dealt with the Global Financial Crisis has been widely appreciated by the World. India survived because of our efficient regulators and financial reforms and other nations are learning from us. The history has a RULE, when one Empire ENDS, Other BEGINS…..

"When Everyone is GREEDY

you should be FEARFUL

and

When Everyone is FEARFUL

You should be GREEDY."

Warren Buffet

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