

Commentary

A Brief History of Market Turbulence

By: SEI Investment Management Unit

During periods of turbulence and uncertainty, it's common to look at prior crises as benchmarks against which current conditions can be assessed, and there's certainly no shortage of historic episodes that investors can look to for perspective. Economic and financial crises have been a regular feature of monetary economies throughout history. While no two have been exactly alike—they vary widely in size, scope, causes and length—they do tend to share some common characteristics.

Today, concerns over the debt of many governments in the European Monetary Union (EMU), messy political wrangling in the U.S. and the resulting downgrade of its government's longstanding AAA rating, and the risk of slower growth in emerging markets are all worrisome developments. As in prior periods of economic uncertainty, comparisons are being made to past recessions, including the Great Depression of 1929-1932, the malaise of the 1970s and the global financial crisis of 2008-2009. There are some key lessons that investors can take away from such comparisons.

Common Characteristics of Crises

There are several key characteristics that are common to nearly all periods of severe financial and economic turbulence:

- Loss of confidence in the banking and financial sector
- Political policy errors
- Rising risk aversion and loss of investor confidence

These are all at work to some degree in today's environment. Confidence in the financial sector has been severely shaken again, with European banks at the epicenter. People hold differing views of whether any policy errors are being committed—for example, have austerity measures been enacted prematurely, or do they not go far enough to head off government debt crises?—but they are clearly in play. And judging by recent market action, investor confidence has fallen and risk aversion is once again ascendant.

An Overview of the Great Depression

The Great Depression is the ultimate benchmark for financial and economic crises, primarily because of its depth and duration. Officially beginning in 1929 following the great stock market crash, it spanned a total of nine

years and involved two deep recessions in 1929-1933 and 1937-1938. As economist Robert Margo has put it, "The Great Depression is to economics what the Big Bang is to physics...and it continues to haunt successive generations of economists."

The causes of the Depression have been hotly debated ever since, but there's fairly widespread agreement that what began as a mild recession prior to the 1929 stock market crash was exacerbated by subsequent policy errors, including a global tariff and trade war and tightening measures by the U.S. Federal Reserve (Fed) and Bank of France (BoF). Fed and BoF actions threatened to push world prices to a level that had preceded the start of World War I in 1914, causing massive deflation. Similar measures had been pursued by the Bank of England around 1920, but were ultimately abandoned as they threatened to throw the world into depression. But ten years later, new generations of leadership at the Fed and BoF overlooked that lesson and remained resolutely on course, eventually causing most nations to abandon the interwar gold standard by the mid-1930s in order to provide their economies with some relief from deflation.

As the depression unfolded, unemployment soared well into double digits across much of the world, productive capacity was idled, and deflation caused recurrent financial and banking crises. Deflation has this effect because it causes nominal revenues and income to fall while debt servicing costs typically remain fixed. As a result, creditors eventually become insolvent, banks' assets (loans) start to go bad, and depositors try to pull their money out of a failing bank all at once. The number of bank failures that occurred during the Great Depression remains a staggering figure to this day. The situation became so dire that people largely abandoned check writing, and most transactions took the form of either barter or cash.

The Great Depression versus Today

In the Great Depression, our three key factors were clearly at work: there was a dramatic loss of confidence in the financial system, severe policy errors were committed, and investors exhibited a high level of risk aversion, with the Dow Jones Industrial Average eventually falling by 91% from 1929 to 1932.

However, while unemployment rates and the duration of unemployment remain stubbornly high in many advanced economies, the current environment is not as dire as the Great Depression was. Counter-cyclical policies and institutions such as unemployment benefits, food stamps, and deposit insurance help to ensure this.

Policymakers also take a much more active approach to crises today, as seen in recent central bank actions such as the European Central Bank's (ECB) purchases of Italian and Spanish government debt and the Fed's second round of quantitative easing. Apart from those actions, central banks are, on average, far more dovish today than they were in the early 1930s.

One interesting point made by proponents of continued stimulus efforts (or opponents of premature austerity) is that the 1937-38 recession was precipitated by premature fiscal and monetary tightening. However, the jury is still out on whether the measures being implemented in many countries today will prove to be more than the global economy can bear.

The Turbulent Seventies

Another well-known period of market and economic turbulence occurred from the late 1960s into the early 1980s. The world endured several crises, including the end of the post-World War II global monetary system, wars and political upheaval in the Middle East, and multiple oil price shocks in the wake of Saudi Arabia's emergence as the world's swing producer and marginal price setter of crude oil.

The turbulence of the period was due in part to trends that began prior to the 1970s, and it continued into the early 1980s. The economies of Japan and West Germany completed dramatic returns to their pre-World War II prominence. Baby Boomers across many developed economies began entering their household formation years *en masse*, leading to changes in economic activity and sharp swings in relative prices as demand patterns responded to demographic shifts. Household and consumer credit began a four-decade expansion in this era. Emerging markets, especially oil-producing ones, became hot destinations for financial capital. High inflation accompanied by high and volatile levels of unemployment and interest rates contributed to uncertainty among policymakers and a general malaise in financial markets. From roughly 1965 until 1982, stock markets exhibited high volatility but went nowhere.

One clear parallel today is the upward but volatile trend in most commodity prices. This has caused investors, policymakers and the general public to worry about rising inflation. However, in most advanced economies, these have largely remained relative price shifts, meaning that when consumers are forced to pay more

for certain goods such as food and energy, they have to cut back on other purchases. As a result, inflation in the classical sense of the term (too much money chasing too few goods) has not taken hold in developed economies, a marked departure from the 1970s. In fact, as Baby Boom generations now enter their retirement years, there's a fair amount of concern that deflation will pose a greater risk than inflation (it's also interesting to note that Japan's baby boom preceded those of other developed economies by about a decade). In the same vein, interest rates today are at historic lows rather than the double-digit levels of that period.

However, it's important to acknowledge that many developing economies have experienced inflation and interest rate pressures over the last decade that are reminiscent of what developed economies went through in the 1970s. It's clear that economic development around the world has played the primary role in the rising prices and volatility of many commodities. While it's by no means certain, this demand may be driven in part by the passage of Baby-Boom cohorts into adulthood in those countries. Commodity-price volatility may also reflect secular changes in the portfolio preferences of investors worldwide, as an increasing number of asset allocation experts have recommended commodity allocations.

In the early 1980s, inflation and stagflation gave way to what became known as "disinflation," or a sharply falling inflation rate. The period can also be seen as the start of the modern financial era, marked by one of the first banking crises of the post-Great Depression era. Following a period of deregulation, financial institutions in the U.S., including savings & loans, were able to borrow and lend more aggressively, which they did until tight financial conditions and a deep recession caused them to begin failing at alarming rates.

The U.S. government created the Resolution Trust Corporation (RTC) which ensured that failed institutions were unwound in an orderly fashion. The RTC is a good example of how different the modern institutional landscape is from that which prevailed in the Great Depression. However, it's fair to ask whether post-Depression policy approaches have fostered a proclivity for deregulation and excessive risk-taking, as there have been many similar occurrences around the world in the last 30 years, culminating with the global financial crisis of 2008 and today's renewed sovereign debt stresses. It's also important to note that measures similar to RTC have not been implemented widely since the 2008 crisis and are not on the table in Europe yet, due to the controversial "too big to fail" phenomenon.

Then versus Now

There are some interesting similarities between today and the 1970s, along with some clear differences:

- In both periods, institutional settings and behavior differ markedly from the Great Depression era. Policymakers have been far more active and have far more flexibility than in the 1920s and '30s.
- Financial deregulation and private-sector credit expansion, hot-button issues during the last five years, have their roots in this earlier period. However, where the earlier period marked the beginning of these trends, the current period seems likely to mark their end.
- Pronounced shifts in demographic composition may be playing a key role. However, this time around, inflationary pressures are focused on emerging economies, while deflationary tendencies are more likely to be at work in advanced economies (and Japan may be the most relevant—and leading—example).

If there's one clear parallel, it may be that stock markets in the earlier period moved sideways with significant volatility for almost twenty years, and many of the world's stock markets are following a similar pattern today.

The Global Financial Crisis of 2008

Perhaps the most natural comparison investors are making is to the recent global financial crisis and recession of 2008-2009. Concerns around systemic fragility of the financial sector and the actions of policymakers, along with spiking volatility and sickening market plunges, are certainly reminiscent of that period.

In an interesting editorial, the Wall Street Journal's Francesco Guerrera recently argued that there are some fundamental differences between 2008 and today: the prior crisis began in the mortgage sector, while today's is emanating from government debt markets; households had gorged on credit in the run-up to 2008, but are continuing to de-lever today; and the solution to the prior episode, which was largely a liquidity crisis, was straightforward, while today's problems are a lack of confidence and overall shortage of demand, which will require far more creative (and potentially risky) responses.

Guerrera's first two points might not be as straightforward as he supposes. If a long era of financial deregulation has been one of the primary causes of recurring financial crises over the last several decades, then the current crisis, like 2008, is simply another step in that progression. And while the private sector has been diligently saving and de-levering in some key advanced economies in recent

years, it has been less virtuous in other parts of the world; in some countries, household debt ratios are at levels seen in many developed countries prior to 2008.

His third point is an important one, especially in the context of global policy tightening. In 2008-2009, there was a risk that governments would go too far in their efforts to stimulate their national and the global economies. Today, almost everyone would agree that global economic growth is running well below potential. The pressing question is whether governments have sufficient room and policymakers possess the creativity (and in some countries, the collegiality) necessary to unleash the full potential of the private sector. That certainly has a different feel than 2008 did.

Our View

In almost every era and episode in financial markets, investors have tended to believe that "this time is different." And to some extent, that will always be true. Each crisis presents a unique set of challenges that combine to create difficult economic and political circumstances, market volatility, and investor fear and uncertainty.

Despite a rather gloomy near-term outlook, S&P's lowering of the U.S. government's AAA rating is not the start of the next Great Depression. The same is true for the European debt crisis, as long as the ECB stands ready to back up troubled government debt when necessary. And it's reasonable to assume that policymakers will coordinate measures to deal with any as-yet unknown crises that might come out of emerging markets. The one parallel of interest is that premature austerity in 1936-1938 seems to have caused a "recession within a depression." Some argue that policymakers risk making the same mistake today, but so far that remains to be seen.

While the parallels are more striking between today and the period from the mid-1960s to the early-1980s, there are also some important differences. This time around, emerging markets are having to endure inflationary dynamics, while advanced economies struggle with slow or no growth and plenty of economic slack. And the multi-decade trend of financial deregulation and credit expansion, which had its start in the earlier period, may be coming to an end in the current one, at least in developed economies.

If we take a long-term view of the current crisis, placing it in context of 2000 through today, and compare it to the earlier episodes, the differences far outweigh the similarities. The few common characteristics are:

- Political and financial uncertainties are ever-present.
- Investors vacillate between fear and greed, bouncing between risk-on and risk-off.

- Stock markets can move in a volatile and sometimes turbulent fashion for an extended period of time. If history is any indication, the trendless swings of the last eleven years may continue for several more.

In challenging and turbulent market environments, it is important for investors to:

- (1) Employ and stay focused on a time horizon appropriate to their circumstances;
- (2) Adhere to a well-designed asset allocation strategy and adjust it as their circumstances change;
- (3) And maintain a sound rebalancing discipline that allows them to take advantage of market volatility by “buying low and selling high.”

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