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April 2021

Thrill and Euphoria

Today's Investor Sentiment, and the Lessons of 1929

Investment advisors generally avoid any mention of the Crash of 1929, or the great bear market that followed it until 1932. The 89% drop in the Dow Jones Industrials from peak to trough during that period left a mark on the psyche of investors for at least two generations. Today, it still sends shudders down the spines of many. We tend to think that the mere remembrance of those events is a jinx to be avoided at all costs.

Yet, history is perhaps life's most powerful teacher. We do a disservice to our grandparents, our parents, and to ourselves if we disregard the dramatic events of 1929 that took a tremendous toll on the whole world.

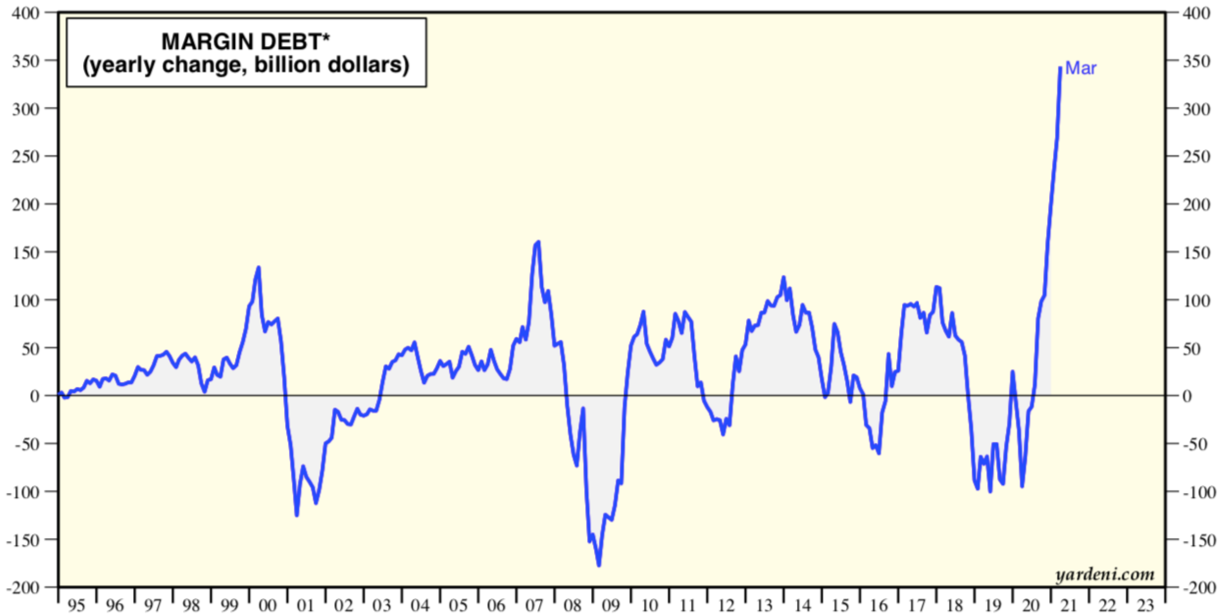
And lessons from history are intensely practical. Like most of life, investment activity moves in cycles over time. Understanding the cycles, even at their extremes, can help us to anticipate what might be in our future.

Euphoria Was the Hallmark Of The Late 1920s, As It Increasingly Is Today

The bear market of 1929 to 1932 has been studied extensively. What characterizes it most prominently is the investor euphoria that preceded it. The mindset of investors that said "this time it's different" was *th*e predominant outlook of the era. It was akin to today's view that we are in a "new normal" requiring us to assess investment prospects differently than we did in the past.

The idea that the stock market was permanently on an uptrend that could never be reversed had taken the imagination of the nation during the 1920s. In that era, the proliferation of telephones, ticker tape machines, and telegraphs made it easy to stay in touch with market activity, and to place buy and sell orders with brokers. Today, smart phones, laptops and easy and cheap online trading platforms have proliferated – they have pulled many people into speculating who otherwise might have been more cautious. Speculation mimics investing, but it throws all caution and risk controls out the window as it looks to make quick profits.

The common denominator between the Roaring Twenties and today is an ever-increasing nonchalance about highly speculative activity. In the 1920s, brokerage firms for their part made access to their services and to stocks within the reach of the masses. Beyond the increase in the number of brokerage offices during the decade, brokerage firms made credit, or "broker's margin" plentiful even to inexperienced investors. With margin debt, investors and speculators could put down 50% of a stock's price and then own the whole share. We are seeing the same phenomenon today as margin debt has spiked, as in this graph:



* Debit balances in margin accounts at broker/dealers.
Source: New York Stock Exchange through December 1996, FINRA thereafter, and Haver Analytics.

But, it was not just brokers and investors who encouraged this rising optimism and risky behavior in the stock market during the 1920s. The general public, the press, business leaders, and even government officials played their part in perpetuating the myth that stocks, like the American companies they represented, were on a permanent path higher. America had won the First World War and was on the ascendant. Optimism was both natural and patriotic.

Perhaps just as importantly for that time, the Fed helped to foster that optimistic mindset by keeping interest rates steady despite the country's growing wealth. The Fed is doing a similar thing today, only to a more extreme level with rates near zero.

Today's Euphoria Is Unsupported By Facts

As we look for direction in the stock and bond markets, one important observation is worth noting. Overall, recent key economic and market datapoints continue to be mixed, offering us less than desirable clarity and making the current wave of euphoria questionable.

Inflation is becoming a concern for many, especially in light of the unprecedented increase in the money supply over the past year. Both the Federal Government and the Federal Reserve Bank (the Fed) have done their parts to inject cash into the system in order to keep the economy from shrinking. Talk of hyperinflation has surfaced since the start of the pandemic-induced money printing that injected over $4 trillion into the economy, with perhaps much more on the way soon.

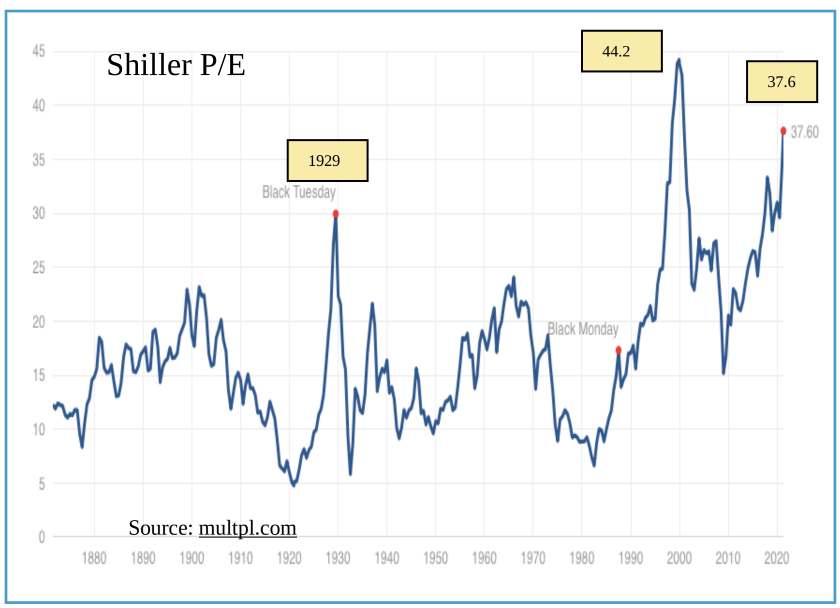
However, to-date, we have not seen evidence of widespread high levels of inflation in the real world, although pockets of it do exist. Commodities such as copper and lumber are a standout, as are assets such as real estate, and stocks, among others. The official inflation rate at the end of last year was a modest 1.4% on the Consumer Price index, the CPI. Today the CPI stands around 2.6% annualized, but that figure is likely to fluctuate up and down from quarter to quarter. It remains to be seen whether inflation will continue to rise throughout the year.

Interest rates are ultra-low and will probably remain so for another two years, according to the Fed. But the Fed's ever-lengthening timeline for a rate increase raises questions about the true strength of the U.S. economy. If the decision makers at the central bank see no reason to raise rates during the next two years, then either they believe rates are at optimal levels for economic expansion, or the economy is so weak that it requires considerable support and time to recover. In a recent webcast, Boston Fed President, Eric Rosengren, indicated that rates will stay low until the country reaches "full employment", by which he meant a level of 4% or less.

Unemployment now stands at a nominal rate of 6%, although the true level is probably closer to 11% if we consider the broader and more realistic U-6 level. That measure counts all those who are actively looking for work, plus all those who are in temporary jobs or part-time jobs but who would prefer to be employed full-time, and those who are discouraged from searching, but who would like to work.

The Fed may also be constrained in its actions by political considerations. At 129% of GDP at the end of 2020, America's **national debt** is now so large and growing that an interest rate hike would mean higher interest payments on any new debt Washington issues to fund the deficit. That would create an additional burden on the Treasury, on tax policy, and on the taxpayer. For reference, in 1929 America's national debt-to-GDP ratio stood at a mere 16%. It peaked in 1946 at 118% just after the Second World War, and has averaged 58% per year ever since, until now.

And lastly, **stock market valuations** are near their highest levels in decades, reflecting the euphoric expectations investors now have for post-pandemic corporate earnings growth. The Shiller P/E stands at 37.6, a level that is only surpassed by the stock market's valuation of 44.2 during the Dot-com bubble in late 1999. In that era, much like today, companies with no earnings, but a great deal of promise were eagerly bid higher by speculators.



As a reminder, equity valuations have great relevance for investors. Valuations measure investor interest in a particular stock, or in the stock market as a whole. High stock market valuations mean that investors have high expectations for corporate earnings growth. Low valuations mean the opposite. The ideal situation is something in between that more reasonably reflects reality.

The Lessons of 1929 Are Relevant For Today

To be clear, so far in 2021 we are not in a full-fledged “1929 moment”, where markets are cracking and margin calls are being made. The bulk of the similarity is in the increasing euphoria and speculative mindset.

Yet, let me also be clear that this time things are *not* different, and we are *not* in an uncharted “new normal”, as some have suggested over the past year. To quote the ancient sage, “There is nothing new under the sun.” From my perspective, we are in an “old normal” for human behavior, namely in a crescendo of euphoria and the FOMO, or fear of missing out, that goes with it.

As I noted in my January 2021 investment letter, human emotions move the markets in cycles from despondency and depression at the very bottom, to hope and optimism in the middle, and finally to thrill and euphoria at the very top. Euphoria is the pinnacle in the cycle of sentiments, and corresponds to stock market peaks. Euphoria is the emotion that loudly shouts, “Nothing can ever go wrong again!” Euphoria might best be described as hope and optimism on steroids!

Risk Management Takes Center Stage

Risk management should be at the heart of investment management, especially when euphoria and high valuations pervade. The two sides of the investment coin are risk and return. Without risk controls, there may eventually be no returns.

In 1929, as the stock market started to crack from the weight of its all-time highs and investors began to worry, Assistant Commerce Secretary Julius Klein went on national radio to reassure the country that all was well. He said, “The number of citizens whose buying ability has been affected by the decline in the value of speculative securities is not very large. Their purchases do not make up a very significant fraction of the demand for goods. There is no reason why the twenty-five or more million families, representing over 95 percent of our population whose incomes remain undiminished should cut down their purchases of commodities, and therefore very few industries should see any appreciable reduction in the sales of their output."

On its surface, this reasoning makes sense. Most Americans were employed in 1929, were earning their wages, and were able to spend their earnings if they chose to.

However, what Klein missed was that euphoria is a fragile sentiment. It can turn on a dime when bad news appears, as it did throughout the remainder of 1929 and into 1930. As markets started to decline and as brokers began to make margin calls, investors and speculators easily lost their starry-eyed optimism. They had never known losses during their brief romance with the stock market. This new reality of falling share prices came as a complete shock to them.

In the current environment, where the economic picture and the datapoints are mixed, investor sentiment becomes all the more important as a guide to our investment strategy. Recognizing euphoria and avoiding its spell, goes a long way to managing risk. It puts us in the driver's seat and helps us to make rational long-term investment decisions. Remembering the lessons of the past reinforces our resolve and keeps us on track for the long-term.

V. Henry Astarjian