

The Ghosts of 1937, Revisited

September 27, 2017

Scott Wren
Senior Global Equity Strategist

Key Takeaways

- » *Federal Reserve (Fed) history buffs are well aware that fiscal and monetary policy mistakes in 1937 prolonged the damage done by the Great Depression.*
- » *Fortunately, Fed Chair Janet Yellen is also a history buff and no doubt wants to avoid the same mistakes now, 80 years later.*

Last Week's S&P 500 Index:
+0.1%

Former Fed Chairman Ben Bernanke is quite an economic historian, publishing numerous essays on the Great Depression in the early years of his career. In these writings he analyzed the cause-and-effect relationship of various government policies that ended up prolonging the economic and stock market pain of this bleak period in American history. As the economy continues to slowly rebound from the 2008 financial crisis, many pundits are wondering if poor fiscal and monetary policy decisions will similarly bring the current recovery to an abrupt halt.

A short history lesson will help readers understand some of the concerns being voiced today that have parallels to the past. By 1937, U.S. growth had bounced back from its low point in 1932 when the economy contracted by more than 13 percent. Similar to recent years, interest rates had spent time near zero as the Fed attempted to stimulate growth while asset prices, especially stocks, had rallied strongly from their lows. In addition, the unemployment rate fell precipitously and banks held large reserve balances of loanable funds. All appeared good with the world—a little too good according to many economists at the time.

Those economists were worried that so much liquidity sloshing around in the domestic economy was powerful fuel for an inevitable inflationary fire. The economy, they argued, no longer needed massive stimulus to continue to grow at a good pace. The Fed agreed and began to tighten monetary policy. At the same time, President Franklin Roosevelt and his Treasury secretary decided they wanted to balance the federal budget. The president made huge cuts in government spending in 1937. Congress and the president also legislated large tax increases as the concept of the payroll tax was introduced to the American people. The result was a lethal combination of fiscal and monetary tightening that sent the economy into a tailspin and hammered the stock market.

Some of you are no doubt seeing at least a few parallels with the present-day economy. Interest rates spent a lot of time near zero in the years following the financial crisis; there is plenty of cash in the system available for lending after the Fed's quantitative easing/liquidity efforts; and the rate of unemployment has dropped like a rock from its (10 percent) peak. In addition, taxes on income as well as many other taxes (like property taxes) have risen and Congress isn't making much progress in reversing the trend.

We continue to argue that equity investors should be concerned about the magnitude of the Fed's rate-hiking efforts as we look ahead through 2018. Historically, Fed rate-hike cycles have been a headwind for valuation multiples (like the price-to-earnings ratio). The good news is, at least in this strategist's opinion, that Chairwoman Janet Yellen is also a history buff and is well aware of the mistakes the Fed made 80 years ago that helped prolong the pain of the Great Depression. She does not want those mistakes to be repeated. History does often repeat itself, but the ghosts of 1937 should remind the Fed that it needs to be careful as it continues to slowly tighten monetary policy in a modest-growth economy that is unlikely to meaningfully accelerate any time soon.

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