Bankers Trust Securities Research

Special Situation

NO CRASH OF 1989

Friday's 195 point fall of the Dow Jones has raised fears of another October 1987-style crash. These fears are unfounded.

The fall on Wall Street has several causes:

Tight money and bull market could not coexist

◇ For a long time, U.S. money supply has been tight, and recently money supply growth has been less than inflation. This is inconsistent with a long-term bull market in equities.

◇ High U.S. rates, the resultant strength of the dollar, and rising European and Japanese inflation recently led other countries to tighten also.

◇ Currency interventions have been worsening the contraction of the world monetary base.

◇ Investors now believe the U.S. Congress will not pass a capital gains tax cut.

◇ Tight money raised questions about the viability of many leveraged buyouts, particularly the more aggressive LBOs, and other low-quality debt.

◇ As a result of such fears, the proposed United Airlines buyout failed to get adequate financing.

◇ This created a widespread flight to quality in bonds and away from equity investments which had soared to a degree that made investors nervous.

◇ The coincidence of dates with the October 1987 crash heightened nervousness and worsened the fall.

Thus the fall is caused by medium-run fundamentals and is not just a fluke. On the other hand, the fundamentals are so different from October 1987 that the fall should not be of similar magnitude.

In 1987, the crash was caused by the bursting of a bubble of global proportions. The mid-1980s financial bubble was the product of:

Crash of 1987 caused by a great bubble

◇ disinflation releasing vast funds previously invested in commodity inventories

◇ vast and rising U.S. twin deficits

◇ massive liquidity creation for competitive devaluation

◇ low interest rates compared with expectations (although rates were high in absolute terms)

◇ tax changes in the U.S. and elsewhere that greatly increased investible wealth in the hands of individuals

◇ tax changes that made real estate investment less attractive

◇ uncertainties about currency, debt, future interest rates, and protectionism that inhibited investment in nonfinancial assets and thus increased purely financial investment

◇ as a result, U.S. equities had ballooned to a price of 22 times earnings

The crash was caused by the inflation of the bubble followed by some policy changes that pricked the bubble.

No great bubble in 1989

In 1989, there are some policy similarities (the tightening of money), but no comparable bubble exists to be pricked:

◇ there has been no comparable buildup of inflation-driven commodity inventories and no dumping of them for financial assets

◇ the U.S. twin deficits have been contracting for some time rather than expanding

◇ money has been tight for some time

◇ exchange rate intervention has been oriented to strengthening of non-dollar currencies and has contracted the global money base, rather than being devaluationary and expansionist

◇ interest rates have been high compared to expectations

◇ tax changes and prospective tax changes have had limited bubble-inflating consequences, so the reversal of expectations regarding U.S. capital gains taxes has limited consequences

◇ U.S. stock prices have been at 14 times earnings, not 22

Junk bonds a U.S. phenomenon

It is important to add that, whereas market conditions throughout the world shared in creating the bubble of the mid-1980s, the junk bond phenomenon in 1989 was largely a U.S. phenomenon.

What, then, are the likely consequences of October 1989?

October 1989 is a correction, not a crash

◇ The fall in New York should be quite limited.

◇ Japan and Europe are likely to hold.

◇ The smaller Asian markets are likely to react strongly in sympathy with New York but rebound quickly.

Equities bull market finished

◇ Mid-October should mark the end of the period when the U.S. experienced a simultaneous bull market and real money supply contraction. Such a paradox can only persist for a short time, and it was the junk bond-backed takeover activity that was allowing the New York market to defy gravity.

◇ The flight to quality in bonds will continue. Financial institutions with large portfolios of low-quality bonds, with high dependence on such bonds for income, or with underwriting commitments to such bonds could be badly hurt. (Third world debt will get marked down along with junk bonds.) Indeed, the risk to our "optimistic" analysis would come from the possibility of unexpectedly large institutions, or an unexpectedly large number of institutions, being badly hurt.

◇ There will be virtually no wealth effect from the fall in New York and elsewhere, since it erases only a fraction of this year's gains. However, there may be an additional conservatizing impact on consumer perceptions of the financial environment. Trends toward increased savings and reduction of the rate of increase of consumer expenditure may be enhanced.

Major bond bull market

◇ The U.S. Federal Reserve will accommodate any emergency needs, and it had already begun to ease monetary policy a bit at the end of last week due to the extent of weakness in the manufacturing sector. This should ensure a major bull market in bonds.

◇ As U.S. interest rates decline, the rise of the dollars should cease or reverse.

Disinflation squeeze will continue

◇ But none of this means that the Fed is likely to be deterred by a stock market correction of a few hundred points from pursuing its disinflationary policy. Under Greenspan, the squeeze will continue as long as is necessary to defeat inflation; interest rates will decline because inflationary pressures are perceived to be declining, not because the Fed is abandoning its policy.

If inflation and interest rates do in fact decline without creating a recession, the stage will be set for the next rally of the stock markets. In the meantime, Asian stock markets should outperform the U.S. because earnings are not not under comparable pressure in most Asian countries and sectors.

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