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CAUSES OF DRASTIC STOCK MARKET BREAK AND THE REASSURING OUTLOOK

RETURNING TO SOUND ECONOMIC FORMULAS AND INTRINSIC VALUES

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(EDITOR'S NOTE: In the preparation of this article for TRUST COMPANIES, Mr. Badger was assisted by Carl F. Behrens, Economist for the Union Trust Company of Detroit. The article envisages the causes which by successive steps led up to the recent violent break in the Stock Market, and the reactions up to the close of the first week in November. The authors frankly face the facts of the present situation and deduct therefrom the sanguine conclusion that no real wealth has been lost or destroyed, that business and industry are basically sound, that the banking system has rendered excellent account and that necessary readjustments provide a more enduring basis for genuine prosperity.)

INVESTORS as well as students of finance may be interested in comparing the course of stock prices during the three week period just closed with other major declines in stock prices since the year 1897. History records five other major declines during this thirty-two year period.

The year 1903 witnessed a decline beginning in February and ending in November which carried the Dow-Jones Industrial averages from approximately 75 to a low point of approximately 42.5. The percentage decline here was 43.4 but the period required for this movement was about ten months. During the years 1906-1907 the industrial averages declined from a high in January, 1906, of about 103 to a low in November, 1907, of 53. Over this twenty-three month period the aggregate decline amounted to 49.5 per cent. Another major decline was initiated in the latter part of 1912, but did not develop into serious proportions until the middle of 1914. Between June and December of 1914 the Dow-Jones Industrial average declined from 81.84 to 53.17, the percentage decline amounting to 36.2.

Drastic Nature of Sales Stock Decline

It will be recalled that the Great War broke out in August of 1914, and that the Stock Exchange was closed from August to December. The behavior of stock prices at this time, was, therefore, subject to influences of a non-financial nature. The same may be said of the recessions in values that occurred from November, 1916, to December, 1917. The 1920-21 bear movement, however, was distinctly financial in character. The seriousness of this movement is indicated by

a drop in the Dow-Jones averages from a high of 119.62 in November, 1920, to a low of 63.90 in August, 1921, a shrinkage in the industrial stock average of 46.5 per cent. From August, 1921, until September, 1929, the Dow-Jones Industrial stock index rose from 63.90 to 381.17 with only minor reactions of small relative proportions and for the most part technical in character. Within the past five weeks, however, a decline oc-



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curred which carried the industrial averages from 381.17 to 230, a shrinkage in values amounting to 40 per cent of the previous high. The drastic nature of this decline becomes more apparent when one recalls that the major portion of the movement was confined to a period of less than two weeks. Other severe downward movements in stock prices, subsequent to the Civil War, occurred in 1873 and 1884. If one considers both the time element and the amplitude of the movement, however, none was so severe as the 1929 stock panic.

Analysis of economic phenomena is the more interesting because no two situations are alike in all respects. Controlling factors constantly appear in new combinations and with different emphasis. Business men, bankers and economists differ among themselves in the proper interpretation of these underlying forces, and in the main, human psychology often overbalances cold reason. Consequently major movements in stock values almost invariably go too far in one direction before a reversal occurs. During the progress of such movements basic conditions change slowly, but culminate and become powerfully effective when a given market terminates. This is especially true at the end of a bull market, with the result that the down swing is usually swift and drastic.

The present situation has emphasized all of these facts. In the first place, unlike any other known crisis, the recent long cyclical advance in stock prices was abruptly halted and followed by one of the worst breaks ever recorded at a time when credit and banking conditions were thoroughly sound, when only a very slight falling off in business had been recorded, when no inventory or price inflation was in evidence, and when domestic and foreign political conditions were generally favorable.

Business and Credit Situation Basically Sound

The fundamental soundness of the general situation at November 1, 1929, is indicated by the following facts. The combined Federal Reserve ratio was 69.8 per cent at November 6, 1929 compared with 67.1 per cent on November 7, 1928.¹ Excess reserves, exclusive of additional gold that might have been withdrawn from circulation and replaced by Federal Reserve notes, amounted at November 6, 1929 to approximately one and a half billions. Aggregate member bank borrowings, at Federal Reserve banks had averaged below a billion dollars for several months prior to November.

¹The average Federal Reserve ratio for the entire year 1920 was 41.5 per cent.

Not only were credit conditions fundamentally sound but there had been no inflation either in respect to commodity prices or inventories. The United States Bureau of Labor, revised index of wholesale prices stood at 98 at the close of August, 1929 (1926=100 per cent). Based on 1913 prices this index stood at 140.2, which is virtually the low point since the post-war inflation set in. Recent financial statements of leading corporations exhibited an extremely favorable cash position and only a normal inventory position. The various indices of industrial activity recorded production and consumption as having been maintained at levels somewhat above normal for the past year, with a slight downward tendency noted since May, 1929. The downward movement in business during recent months, has, however, been slight and gave no evidence of a drastic recession. For example: the Annalist Index of Business Activity stood at 108.8 for May, 1929 and at 105.9 (preliminary) in September. Car loadings for as late as the week ended October 26, 1929 were 1,133,810 contrasted with 1,162,974 for the same week in 1928 and 1,112,816 for the similar 1927 period.

What Were the Causes of the Recent Stock Debacle?

In the face of this evidence it may well be asked, what were the real causes of the 1929 "Prosperity Panic?" Difficult as it is to predict the time and intensity of movements in stock values it is always easy to analyze causes for events once they have occurred.

A brief retrospective view of the situation during the past six years emphasizes the following facts. The investment value of high grade common stocks has received widespread publicity. Overabundance of banking reserves, and a series of reductions in the discount rate of the New York and other Federal Reserve banks, culminating in a rate as low as 3 per cent in 1924, greatly facilitated the use of borrowed money for carrying stocks. Heavy gold imports during the years 1926 and 1927 continued the ease in credit conditions and further encouraged the use of borrowed capital for purposes of security speculation. Gradually the idea became prevalent that business crises of the old order could not recur under our present banking system. Faith in the fundamental soundness of American institutions and industry, and a belief that well managed concerns should inevitably grow led to a belief, especially evidenced

after 1927, that stocks could be purchased regardless of current earnings or dividends.

The new doctrine in essence, was that asset values, past or present earnings, and current dividends were of little or no value in determining the real worth of a stock, but that management and future prospects were the essential value determining factors.

On the basis of the preceding hypotheses the broadest bull market this country has ever known developed. The volume of trading on the New York Stock Exchange increased from an average of 22,000,000 shares a month in 1922 to an average to date in 1929 of 96,000,000 shares a month. People of all classes, occupations, ages became involved. As values increased less and less attention was paid to present earnings and dividends. Banks were called upon to loan more and more money on securities. From 1922 to 1929 member bank credit outstanding increased from about \$23,500,000,000 to approximately \$36,000,000,000. About 75 per cent of this entire increase represented either loans against collateral and presumably made to finance security purchases or direct security purchases by the banks themselves. At the time of the break it may be estimated that 60 per cent of all member bank credit outstanding was devoted to the financing of security purchases.

New Theories of Banking and Financing

In reality a new theory of banking had developed during the past two years. This theory in substance held that it was perfectly proper for banks to loan heavily against collateral, presumably stocks, such loans to replace the old type of commercial loan. If a corporation needed additional cash why should it not issue "rights" to present stockholders instead of discounting its notes? Stockholders might easily finance the exercise of such rights by collateral loans. In this way banks were actually furnishing the required funds, it is true, but by discounting a number of collaterally secured notes instead of a relatively few commercial notes of the old type.

In addition to the funds borrowed by investors at banks rather large sums were borrowed in the call money market. The maximum figure for brokers' loans was recorded for the week of October 2, 1929, when such loans stood at \$6,304,000,000. Before the present new era the essential source of call money was found at New York banks. More recently large funds have been diverted to the call money market by "others." Corporations with surplus funds, investment

trusts, the so-called "sold out bulls," and even conservative old time investors have used this market for employment of their funds. The return on such funds has been particularly attractive at times during the past year and a half.

Interpretations of Call Money Market

The behavior and economic effects of the call money market have recently been subject to various interpretations. A substantial proportion of brokers' loans during the past several years has probably been generated by Stock Exchange operations themselves. During a long rising market investors sell stocks purchased earlier at lower prices. Reluctant to reinvest at then prevailing high prices such individuals either loan the proceeds of their stock sales in the call market or purchase bonds or notes. Their choice will depend on the rate of return offered in the one market compared with the other. Insofar as the stock seller places the proceeds of this sale in the call market, to that extent has he provided the call funds necessary to finance stock purchases.

If the feeling is prevalent that stock prices will continue to rise buyers will be willing to pay high rates for call money when necessary and others will require high rates if they are to be induced to give up their position as owners of equities, or to refrain from becoming equity owners by loaning their funds instead of purchasing stocks. Under fairly static conditions there should be an equality of return in all markets expect for variations in risk. It should be a matter of indifference whether one purchases stocks, buys bonds or makes loans in the call market. A higher return in one market should only offset the elements of risk there involved as compared with the return in other markets.

If this theory is correct the culmination of a bull market would be preceded by a fall in call rates and by an increase in brokers' loans while stock prices remain stationary or fall. This in fact was the precise situation during the latter part of September and the first of October. Apparently many individuals sold stocks during that period to people who were willing to borrow, the sellers themselves providing the added call funds necessary to finance such purchases. Similarly when stock prices remain stationary or advance after a period of liquidation, and when brokers' loans decrease, the theory would be justified that former lenders had changed their position by becoming equity owners, having with-

