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# Why This Isn't Like 1938 -- At Least Not Yet

*By Donald L. Luskin*

The stock market tells us that last year we avoided a new Great Depression -- barely. It was a close call, but we're not headed for 1932. Now, as stocks correct from their April highs and fears of a "double dip" recession mount, should we be worried about an economic relapse like 1938?

First, the good news. An important milestone was passed last week for stocks. Friday, July 2, was the 997th day since the all-time high in October 2007. That's how many days the bear market in the Great Depression lasted, starting at the high several weeks before the Great Crash of 1929 and ending on June 1, 1932, one month before Franklin Delano Roosevelt was nominated to run for president.

At the bottom in 1932, stocks (as measured by the S&P 500) had lost 86.2% from the 1929 top. Last Friday, stocks were only off 34.7% from the 2007 top. "Only"? To be sure, losing 34.7% is no buggy-ride. But to match the devastation in the Great Depression, the S&P 500 would have to fall 806 points from Friday's level, or 78.8%.

This comparison is no idle thought experiment. In 2008 and 2009, based on what the stock market was indicating, we really were headed for a new Great Depression. At two crucial junctures in 2008 and 2009, stocks had fallen further than they did in the Great Depression the same number of days after the 1929 top.

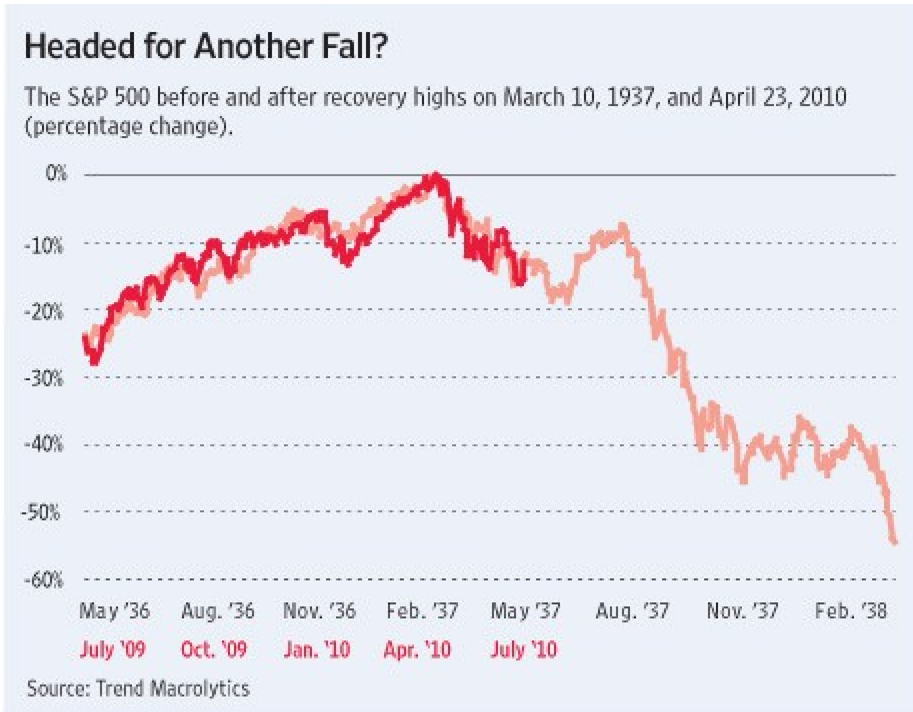
The climax came in early March 2009. Then, with the banking system still feared to be insolvent, the hasty passage of a massive deficit-busting "stimulus" bill sent the message that an all-powerful new president and Congress would just as quickly enact their strident antibusiness agenda. At the worst, stocks plunged to show a loss of 56.8% from the 2007 highs. At the comparable point in the Great Depression, stocks were off only 49%.

But a funny thing happened on the way to the new Great Depression. Chairman Ben Bernanke's Federal Reserve announced a massive program to buy Treasury bonds and mortgage-backed securities to pump liquidity into the banking system. Treasury Secretary Tim Geithner deftly executed "stress tests" enabling the largest banks to be recapitalized in public markets. And one agenda item at a time -- socialized health-care, cap-and-trade energy tax, unionization "card check," mortgage "cramdown" -- got diluted, slowed down or stopped.

From there, as the economy embarked on recovery, instead of following the path of history to massive further losses, stocks embarked on an upside run. In 14 months, the S&P 500 surged 79.9%. That still leaves us 34.7% from the 2007 highs. But consider the alternative. After the June 1, 1932, bottom in the Great Depression, stocks rallied more than twice that, 177.3%, over a similar period -- for all that, they were still down 61.7% from the 1929 peak.

In fact, it took 25 years before stocks clawed their way back. We probably don't have to be quite that patient today, because in the recent bear market we simply didn't lose as much. But we shouldn't have illusions about how easy it is for stocks to recover from severe bear markets, especially those associated with systemic credit crises. After the bear market in the banking panic of 1907 -- which was very similar to the recent bear market in magnitude and duration -- it took 10½ years for stocks to get back to the old highs.

The most worrisome analogue is the great bear market that began in March 1937. From the top stocks lost 60% of their value, making it the second worst bear market in history. Not ending until April 1942, it was the longest ever.




That's worrisome because, as the nearby chart demonstrates, over the last year the stock market has followed a path eerily similar to 1937. First, a strong, rapid run to a recovery high -- same pace, same magnitude. Then a correction -- again, the same. Will we continue on the path that led the correction of 1937 into a collapse in 1938? This question would be nothing more than a technical curiosity for chartists if it weren't for alarmingly similar economic backdrops between the two periods.

In 1937 the economy was in a strong recovery from a severe crisis, and there was complacency that the worst was over -- much like the exuberance about a "V-shaped' recovery this April. But after 1937 the economy relapsed into what historians call "the recession within the Depression," a downturn so severe that in any other context it would qualify as a depression itself.

It was triggered by a set of very specific policy mistakes. The Fed tightened by raising reserve requirements. Consumers were hit with new taxes to pay for the then-new Social Security program. Worried about excessive deficits, Roosevelt cut government spending. At the same time, his administration accelerated antibusiness rhetoric and regulation.

Sound familiar? We're repeating some of the same mistakes right now, even as fears of a "double dip" recession mount. Antibusiness rhetoric from the Obama administration is at toxic levels, and the pending Dodd-Frank financial reform bill is the harshest regulatory initiative in a generation. Taxes are set to rise, to support new social spending such as health-care reform, and if for no other reason because no one will stop the expiration at the end of this year of the 2003 Bush tax cuts.

It's not clear whether cutting government spending at this point would help or hurt -- most debates about that are political, not economic. We'll find out soon enough. For now, half of last year's $862 billion stimulus package has yet to be spent, but there won't likely be much more after that.

At least there's not the slightest sign that the Fed is going to tighten any time soon. Dodd-Frank would effectively raise reserve requirements, but Chairman Bernanke is a student of the Great Depression and has learned its lessons, even if no one else has.

The stock market, that great self-organizing supercomputer that weighs all possible futures, is telling us to be very careful here. Pro-growth tax and regulatory policies that encourage business confidence and job creation can keep our fragile recovery alive. But make no mistake about it, stocks are warning that we're still in a fragile state. We avoided 1932. Now let's avoid 1938.

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