Does History Repeat or Rhyme?

By: Daniel W. Vasquez[i]

What a crazy two weeks in the markets.

Although the Dow Jones Industrial Average (DJIA) only declined 0.29% for the week, the events that occurred between Monday morning and Friday afternoon were of historical proportion: market volatility shot through the roof; venerable pillars of Wall Street investment banks vanished overnight; unprecedented government bailouts of private sector institutions questioned the very foundation of capitalism as we know it.

In an uncertain world, there is certainty in one area – this financial novella is far from over.

Economic and financial history teaches us that we have had in the past: 1) credit crunches; 2) housing crises; and 3) dollar crises. But, having all chickens coming home to roost at the same and interacting with one another is unique. We have historical perspective on the parts, but not the whole, and that makes things both interesting and scary. In these volatile times the goal for investors right now should be survival and asset protection, not making a killing . . . that comes later.

Facts about the week that was:

- On the heels of 158-year old investment firm Lehman Brothers (LEH) declaring bankruptcy, the DJIA on Monday tumbled 504 points, the worst point drop since September 17, 2001, when stocks reopened after the September 11 attacks.
- Hopes on Thursday – followed by confirmation on Friday – of a big government plan to take over debt instruments linked to bad homes loans leads the Dow Jones to their biggest one two-day gains since March 2000.
- The total estimated government financial bail-out: $700 billion. The cost of the Iraq war: $580 billion to date. The size of the government bailout is nearly 40% of the California economy ($1.8 trillion) – the eighth largest in the world.
- On the New York Stock Exchange (NYSE), trading volumes on Thursday for all shares traded by the NYSE Group spiked to 4.2 billion: the highest on record.
- On Wednesday, the volatility index (VIX), otherwise known as the market fear gauge, spiked to 41.97 on the Chicago Board of Options Exchange: its highest level since August 2002.
- On the same day, gold jumped more than $70 an ounce on the New York Mercantile Exchange, its biggest one day jump in dollar terms since at least 1980. In electronic

trading Friday, the precious metal then tumbled by more than $68, its biggest drop in 28 years.
- As emerging markets tumbled in unison with Wall Street early in the week, Moscow's Micex index plunged more than 17% Tuesday, before surging nearly 30% Friday: its biggest one day gain ever.
- Oh yeah. The Dow ended little changed on the week, while the S&P 500 and NASDAQ composite actually rose.

<u>Goal for investors</u>

By historical standards, Monday's 504-point decline in the DJIA was indeed large – the 86th largest one-day percentage loss since 1928, and the 17th biggest since World War II. Does this mean it is time to jump ship?

To answer, let's look at the 16 postwar declines in the market that were larger than Monday's drop and ask the following question: What happened afterward? The answer may surprise you.

On average the DJIA was: 10.4% higher six months after the decline; 13.8% higher one year after; 27% higher two years after; and 45.6% higher five years after.

So, if history is any guide, you would be foolish to succumb to panic. In fact, you may want to increase your holdings. Notice that for periods of up to two years, the market has tended to perform far better than usual following large declines.

In the end, it's a question of whom you're going to trust – the media, your own emotions or the guidance of history. I know which I'm putting my client's money on, and mine.

It is difficult to write about economic and financial crises without referencing the upcoming presidential election. Investors should consider the following outcomes and their impact on portfolios.

<u>Presidential elections and asset allocation</u>

- Impact of a recession – When the economy has been in or entering a recession during past presidential elections (1920, 1932, 1944, and 1960), the S&P 500 has fallen -3% on average and the incumbent party has lost 3 of the 4 contests.
- Pharmaceutical and Bio-Tech have historically underperformed in election years (+8% vs. +13% annual average return overall), but tend to bounce back strongly in the first year of a new presidential term (usually because investors tended to become overly pessimistic on the Healthcare outlook as the election race was unfolding).

- Should there be a White House Republican victory, owning companies, exchange-traded funds, closed-end funds, and open-end funds focused on the following sectors would be beneficial to individual and household portfolios: Asset Managers, Brokers and Investment Banks, Coal, Credit Card Companies, High Dividend Yielding Companies, Large Cap Pharmaceuticals, Managed Care, Oil & Gas, and Student Loan Providers.
- Should there be a White House Democratic victory, owning companies, exchange-traded funds, closed-end funds, and open-end funds focused on the following sectors would be beneficial to individual and household portfolios: Biofuels, Generic Drug Companies, Geothermal, Healthcare IT, Hospitals, Medicaid Companies, Natural Gas Companies, Solar Power Companies, and Wind Power Companies.

Was Keynes right?

We have witnessed a historic event in financial markets over the past two weeks. The seizures of Fannie Mae and Freddie Mac, the failure of Lehman Brothers, the takeover of Merrill Lynch and the government ownership of AIG represent an unprecedented string of systemic distress in a two week period. One would have to go back to the Great Depression to find anything which measures up to this level of catastrophe. Yet, the danger to the U.S. economy has been remarkably contained. Events that would have thrown the country into economic turmoil in previous eras were absorbed by the government and the financial community with an ease and order that was truly remarkable – although there are concerns that these government bailouts could be inflationary over the long term.

In the past two weeks, investors worldwide have seen the creation of a different kind of capitalism: a free market economy greatly assisted by government, combining to reward companies that are run efficiently and penalizing companies that are poorly managed – 'Socialist Free Markets," if you will. Regardless of size or market share, an enterprise will grow if it builds a better mousetrap and cease to exist in its current form if it does not. It speaks volumes to the initiative, talent, skill and resolve of the private sector and the public sector that events that have triggered calamities in years past were nothing more than news headlines this month.

Yet it remains to be seen whether these joint actions of the private sector and public sector help or hinder the manner in which the U.S. economy functions over the long run. However, in the short term, the events of the past two weeks could have forced the U.S. to the brink of panic and depression. The fact that we are not in such a state is no small accomplishment. While he advocated interventionist government policy, by which the government would use fiscal and monetary measures to mitigate the adverse effects of economic recessions, depressions and booms, it appears that the century-old spirit of John Maynard Keynes and Keynesian macroeconomics is the natural order of the day.

To quote Mark Twain: "History doesn't repeat itself, but it does rhyme."

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