

# Outside The Beltstreet

SPECIAL EDITION: WORDS DURING THE 20TH CENTURY MONEY GAME

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## Quotes from our past.

Reading in excess of 5000 pages from more than 20 books over the last 18 months has me convinced. There is a massive amount of financial and market history that most individuals, whether general investors or advisors, either do not know or have chosen to ignore as they make decisions about the money game today. The sole purpose of this issue is to give you a better understanding of our current markets by looking at market history. After reading these comments from the past, you will not be able to say, "but this time its different." The following selections are only a **handful** of the thousands of great quotes upon which I could draw.

- George Harrison, Head of the New York Fed, The week of the Crash of '29.

"The Stock Exchange should stay open at all costs. Gentlemen, I am ready to provide all the reserve funds that may be needed." He certainly made good on his promise. From that last week in October until the middle of November the Federal Reserve cut rates from 6 to 4.5 percent and then in 1930 continued to lower them from 4.5 to 2 percent.<sup>1</sup> Sound familiar? Additionally, from January of 1930 until December of 1933 the Federal Reserve purchases of government securities, in order to expand the availability of money, would go from \$485 million to \$2,432 million, an increase of 401 percent.<sup>2</sup> Today, foreign central banks act in a similar capacity.

1. Dr. Murray Rothbard, A History of Money and Banking in the United States, pgs 274-276
2. Dr. Frank Shostak, "Does a Falling Money Stock Cause an Economic Depression" April 18, 2003, [www.mises.org](http://www.mises.org)

**Special Edition: Words from the 20th Century Money Game**

1936—John Maynard Keynes

“Every such attempt to save more by reducing consumption will so affect incomes that the attempt necessarily defeats itself.” (page 84)

“Yet the larger our incomes, the greater, unfortunately, is the margin between our incomes and our consumption.... There must be sufficient unemployment to keep us so poor that our consumption falls short of our income by no more than the equivalent of the physical provision for future consumption which it pays to produce to-day.” (page 105)

“Thus the remedy for the boom is not a higher rate of interest but a lower rate of interest. For that may enable the so-called boom to last.... Thus keeping us permanently in a quasi-boom.” (page 322)

“To suppose that a flexible wage-policy (*set by the free markets and not the state*) is a right and proper adjunct of a system which on the whole is one of laissez-faire, is the opposite of the truth. It is only in a highly authoritarian society, where sudden, substantial, all-round changes could be decreed that a flexible wage-policy could function with success.” (page 269)

John Maynard Keynes, **The General Theory of Employment, Interest, and Money** (1936), (italics and emphasis mine)

The forward in the publication in the Great Mind Series states, “Keynes advocated enlightened government intervention over unregulated laissez-faire policies.”

Another comment worth consideration comes from Dr. Harvey Rosenblum, head of Economic Research at the Dallas Federal Reserve, at a luncheon I attended recently on December 3, 2004. When I asked Dr. Rosenblum what lessons we had learned from the Great Depression, his answer was that the Federal Reserve had not allowed the money supply to grow, but that we should not be too critical of them since they did not have the benefit of Keynes General Theory.

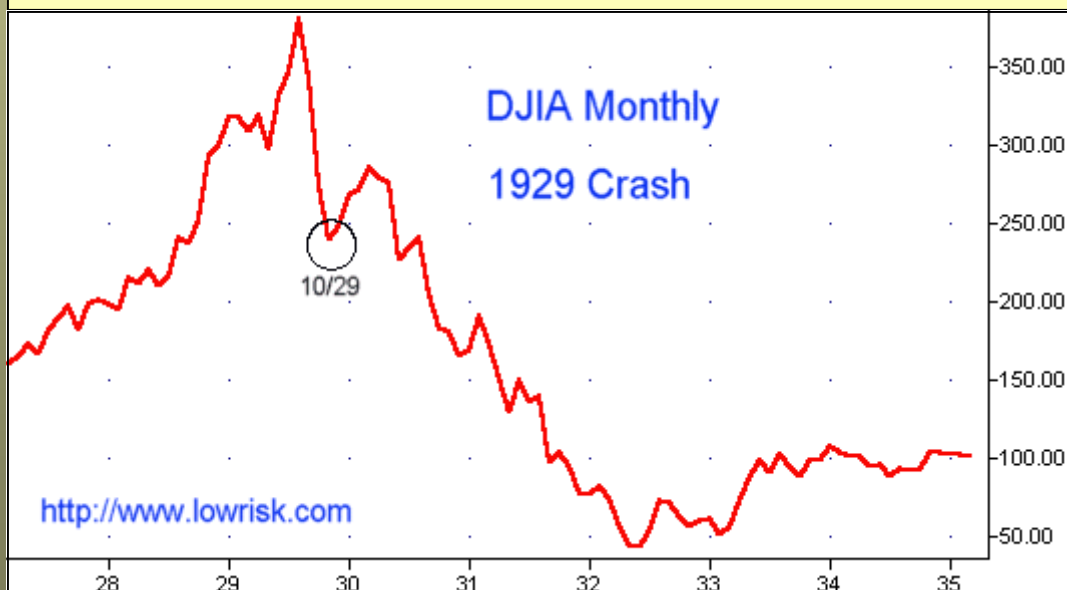
After reading the comments above from Keynes book, I ask, do these look “beneficial” for a country built on free markets and capitalism?

## Bear Market 3- History

1929 – Robert Rhea – The Story of the Averages (1934)

“...many observers took it to be a bull market signal. I can remember having shorted stocks early in December 1929 (*The Dow went down over 24% in a week from Wednesday October 23, 1929 through Black Tuesday Oct 29, 1929.*) after having completed a satisfactory short position in October. When the slow but steady advance of January and February carried above [the previous high], I became panicky (*even the best technicians on the markets can be overcome by their own emotions*) and covered at considerable loss..... I forgot that the rally might normally be expected to retrace possibly 66% or more of the 1929 downswing. Nearly everyone was proclaiming a new bull market. Services were extremely bullish, and the upside volume was running higher than at the peak in 1929.” (italics and emphasis mine)

Since Rhea went on to call the market bottom in 1932 and urged his readers to buy back **in** the markets **long**, using the Dow Theory to determine his call, the record above is a great lesson on how hard it is to go against your emotions when investing, especially when facing bear market rallies. William Hamilton used Dow Theory from 1902-1929 to call market turns, and to tell investors to get **out** of the Markets in the **Friday, October 25, 1929** edition of the Wall Street Journal. By the way, The Dow Theory’s oldest technician today is Richard Russell. He is 80, and has been giving commentary since 1958. He believes we are currently in a bear market rally.



**Special Edition: Words from the 20th Century Money Game****From the 30's to 2000. Do we REALLY understand risk?**

“Unlike the straitlaced bankers of old, Leach (*Ralph Leach, the treasurer of Morgan Guaranty in 1960*) would place large bets on the direction of interest rates. In 1960, Leach saw an excellent chance to speculate on one-year treasury notes being auctioned by the Fed. When he calmly proposed a huge bet to the Morgan board, Henry P. Davidson, the vice-chairman, asked, “Ralph, what kind of numbers are we talking about?” Leach said airily, “Oh, \$800 million to \$1 billion.” Swallowing hard, Davidson replied, “This is going to take time to digest, Ralph. That was the size of our entire bank a year ago.”

“...In August 1962, The Treasury auctioned \$1.3 billion in bills maturing in 3 months. Leach placed a shockingly large bid—\$650 million, the largest bid ever submitted for T-Bills. Wall Street saw an opportunity to corner the market.”<sup>1</sup> After this the Treasury set forth a new policy which would not award any one bidder more than a quarter of the bills at any weekly auction. If you think these big bets were only placed in the 60's, think again. Consider the following comments from another source looking back on the 90's.

“In May 1990, he (*Paul Mozer, the Arbitrage Group, Salomon Brothers*) tried to corner a Treasury auction by boldly bidding for more than 100 percent of the notes. By submitting more bids than there were bonds for sale, Mozer improved the chances that he would receive most, if not all, of the bonds being auctioned.... The U.S. government frowned on traders submitting such large bids, because they did not want one investment bank to be able to control the price of recently auctioned bonds..... At this point, Mozer had to be reined in.”<sup>2</sup>

So as we use words such as “conservative” or “aggressive” to describe investment policies without an understanding of what is being done at the **top** of the money game, we must realize these terms are increasingly less meaningful. Because of a debilitating lack of information in regard systemic level risks, many investors are ignorant of the amount of they are actually taking day to day.

1. Page 540, **The House of Morgan**, Robert Chernow, 1989.
2. Page 98, **Infectious Greed**, Frank Partnoy, 2003.

## Bear Market 3- History

One glaring area that most advisors and individuals have little knowledge of, is the growth of currency speculation. Any investor who sees stock markets going up while the nations currency is declining and **ignores** that nation's currency dilemma, is playing a fools game. Consider the following:

“Relatively few people in the United States contemplated foreign exchange as a liquid asset, or were inclined to speculate in favor of or against foreign exchange in the 1930's. Many more did in the 1950's and a for even a stronger reason more did in the 1960's.”

Richard Cooper emphasizes the change:

“A crude quantitative indicator of these developments is provided by contrasting the maximum daily speculation of under **\$100 million** against the pound sterling, in the “massive” run of August 1947, with the maximum daily speculation of over **\$1.5 billion** in favor of the German mark in May 1969, and the movement of over \$1 billion into Germany in less than an hour in May 1971. Moreover, as the barriers of ignorance fall further, there is no reason why **\$1.5 billion** should not rise to **\$15 billion** or even **\$50 billion a day.**” (1972)

The comments above are from the 4th Edition of Dr. Charles Kindleberger's (Professor of Economics at MIT) famous book, “**Manias, Crashes, and Panics**”. Mr. Cooper would be amazed to know how vastly he underestimated the volume of currency trading.

“The Foreign Exchange Market is by far the largest and most liquid market in the world. The estimated worldwide turnover of reporting dealers, at around **\$1.5 trillion a day**, is several times the level of turnover in the US Government securities market, the world's second largest market. The dollar is the most widely traded currency. According to a 1998 survey, **the dollar** was one of the two currencies **involved in 87%** of global exchange transactions, **equal to \$1.3 trillion a day.**”<sup>1</sup>

When we consider that the currency markets trade a 50 times the volume of the New York Stock Exchange, not knowing what the currency markets are doing, while watching the stock markets, is like dancing while ignoring the proverbial elephant in the room.

1. The Federal Reserve Bank of New York, The Structure of the Exchange Markets, chapter 3.

<http://www.newyorkfed.org/education/addpub/usfxm/>

## THE BEAR MARKET 3- HISTORY

### The Booming Government– 1950s and 1960s

“...payroll-financed “Social Security” [became] a cornerstone of postwar middle-class life. In 1950, 1952, and 1954... Congress voted to more than double the benefit level and get rid of the remaining tie between each worker’s benefit and the number of years he or she had been paying into the system. In just six years, 1949 to 1955, the number of families receiving Social Security tripled and the total cost grew sevenfold.”

Having supported the Republican party all my life, I am sad to say that the vote to approve this expansion was with a Republican Congress and was signed by a Republican President (Eisenhower). However the Democratic majorities in the 1960’s, under the Leadership of President Lyndon B. Johnson, did not slow this federal spending train down either.

“It was the founding of Medicare, however, that towered above all of these other efforts in terms of its ultimate impact on federal spending.... When President Johnson signed the Medicare act of 1965, he reassured voters by saying that ‘an extra \$500 million’ (that’s right, *million*) of new spending would pose ‘no problem’. Today, thirty-nine years later, Medicare spends \$294 billion per year– that is more than *five hundred times* that original estimate.”<sup>1</sup>

1. **Running On Empty**, Peter G. Peterson, pages 114 & 115. (2004) emphasis his

So as the stock market heads for a second year of **gains** after the worst losses since the 1930’s, (i.e.2000-2002) did the years 2003 and 2004 reveal a change from the rapid government spending of the 1950’s and 1960’s? From the hundreds of government numbers I have looked at during these last 2 years, it would appear the answer is no. So, the current elevation of the stock and real estate markets is only a mirage built on the backs of massive consumer and government borrowing. It has worked over the last 2 years. Will it over the next two? Based on a look at history and the level of the stakes in the casino, when the foreign lenders get tired of loaning the US money, the money game will change for years.

As I have stated for almost a year, please share this information with anyone you care about. As we see from natural disasters, things can change rapidly and without much warning. However, with a study of history, the warning bells have been sounding for a long time. Unfortunately, rather than preparing, many are being lulled to sleep since the “wolf” did not come when they thought he would.

## Solutions

1. Diversify among traders versus asset classes. In the 3rd quarter of 2002, 99% of equity funds lost money. While some lost less, those who were inverse the markets made money. It is imperative that money managers use tools that go inverse the markets at times.
2. Consider using a short only manager. While this will absolutely lose you money in bull markets, it can work to your benefit in bear markets. For this reason you need to study history and many technical and economic factors. However, this tool gives the investor a way to grow your money in a long term bear market.
3. Buy Gold as an asset—While I would not recommend this asset unless you have an entrance and exit strategy, gold can benefit investors in the proper context. Even though (as of this publication) I am not recommending holding gold, it is an option that I review weekly in consideration of the long term view(4-5 years).
4. Consider other currencies – While this does carry risk that **must** be understood before using this tool, holding dollars when the dollar falls sharply as it did from 2002-2003, is a risk most individuals do not even realize they are taking. For a great understanding of currency moves and bear markets, read Balance Sheet Recession by Dr. Richard Koo. He is the Chief Economist of Nomura Securities in Japan today and started his career with the Federal Reserve in the 1970s. The Nikkei 225 averaged 38,916 in December of 1989. It closed at 11,278 on October 4, 2004.
5. Be content with less – The more inflexible you are with your current lifestyle, the fewer options you leave yourself in the long run. Enjoy the simple things today!

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