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Nothing Can Go Wrong

The boast that "nothing can go wrong" is seen usually near the peak of an outstanding bull market. Indeed, it can be considered as an identifying characteristic of a bull market driven too far by speculation, and in making money so readily participants have been reluctant to see the party end. And as the popular economist, John Kenneth Galbraith wrote:

"The euphoric episode is protected and sustained by the will of those who are involved, in order to justify the circumstances that are making them rich. And it is equally protected by the will to ignore, exorcize or condemn those who express doubt."

That speculation has gone too far, for most, is discovered too late.

However, for veteran researchers, becoming "too much" is determined when the credit markets start to change from supporting the boom to not supporting. The transition only becomes evident late in the game.

The strains natural to the culmination of the buying mania prompt officialdom to boast that "nothing can go wrong". Claiming that nicely timed cuts in Fed Funds will keep the boom going. But commercial history back to at least the 1500s, shows that short-dated market rates of interest increase during the boom and decrease during the bust.

Sometimes official reasoning bereft of history becomes weird, and with arbitrary power – dangerous.

Driven by the ancient compulsion of "borrowing short and lending long" the yield curve flattens. The curve is the interest rate difference between short and long-dated maturities and "inversion" is jargon for when short rates are higher than long rates. The demand for funds by speculators drives short rates up. Recent "reaching for yield" has kept long rates lower than otherwise.

To signal a contraction all that is needed is the curve and spreads to reverse, accompanied by rising commodities reversing to weakening.

There is an illustrative description of such speculative positioning with the 1825 Bubble:

"[It] seems mathematically demonstrable that wealth was easily attainable when money could be borrowed from one set of persons at 4 percent, and invested with [others] at 10 percent or even 20 percent, interest."

This would also be the observation with all the great bubbles from the first in 1720 to the fifth in 1929. The latest bull market has accomplished enough of the features to conclude it is a “classic” bubble, so it is number six in the series.

Another compulsion is reaching for the highest yield possible, which with growing confidence provides a bid for risky bonds. Credit spreads narrow. In real time, it is difficult to determine the moment when confidence becomes recklessness, in taking on risk. Then all that is needed to signal contraction is the action in credit markets reversing to adversity.

When both the curve and credit spreads begin to change, it is obvious that strains are building in the financial markets.

And as these become more obvious, the establishment begins to boast that the boom can be extended. For which comforts there are many eager believers, and any agency will do. A central bank or a treasury system have both been celebrated as being able to extend a mania.

Both have been unsuccessful.

In 1873, Walter Bagehot, the esteemed editor of *The Economist,* published *Lombard Street*. In the book on financial markets, he describes how to prevent a contraction. Ironically, just as that Great Depression began:

“A panic, in a word, is a species of neuralgia, and according to the rules of science you must not starve it.”

In taking this apart, a credit contraction, which is the result of too much credit, will go away if you throw yet more credit at it.

Another phrase clearly describes the need and function of a “lender of last resort”.

“In periods of wild alarm, one failure makes many, and the best way to prevent the derivative failures is to arrest the primary failure.”

Of course, Bagehot’s ideal *“deus ex machina”* was the Bank of England, which despite being disciplined by gold, it was thought that it could issue enough currency/credit to prevent a contraction.

The theory was that nothing could go wrong, because England had a central bank.

The 1873 Bubble climaxed amidst the usual strains. As recorded in the senior economy, England, business conditions were unusually weak such that in 1884 economists began calling it the “Great Depression”. This lasted until 1895. Then, as late as 1939, senior economists were still debating its cause and how it could have been ameliorated.

It seems that the intersection of economists and financial markets is an unending source of irony.

As the 1873 Bubble was reaching its best in New York, the "Herald" on September 1st, editorialized:

"True, some great event may prick the commercial bubble…suddenly, and create convulsions; but while the Secretary of the Treasury plays the role of banker for the entire United States it is difficult to conceive of any condition of circumstances which he cannot control. Power has been centralized in him to an extent not enjoyed by the Governor of the Bank of England. He can issue the paper representatives of gold to [any] amount."

Nothing could go wrong because the US did *not* have a central bank, and in London because England *had* a central bank.

Any agency will do.

It is worth noting that the 1929 Bubble was number five in the series that started in 1720 with the South Sea Bubble. All recorded the same setup, which was a commodity crash, followed by a bull market that about a decade later culminated in reckless speculation.

In the final stages of the 1929 Bubble, John Moody (yes, the Moody) condemned the formerly celebrated banking system (well, the late 1800s Great Depression lasted for twenty years). And boasted:

"The old breeder of financial panics…has been replaced by a modern scientific system which embodies an elastic currency and orderly control of the money market."

Also included was:

"They [the times] have changed…and we are in a new and remarkable era."

Is so many words, the 1929 guarantor of good times was a new and "scientific" central bank, with supernatural powers.

In moving this theme along, it is worth reviewing some features of the cyclical bull market that peaked on October 11, 2007.

This researcher's publications placed in perspective the popular comfort that the Fed would lower rates. For hundreds of years, central bank administered rates have plunged with every business and financial contraction. Although widely believed, the first decline in the Fed Rate does not extend a bull market, instead it signals the bear. Furthermore, short rates decline the fastest with the worst parts of the stock market decline.

We compared it to the condition in London just as the 1873 contraction was starting. The one that Bagehot claimed could be prevented. His weekly publication *The Economist* on September 20, 1873, observed:

"The continued abundance of money in Lombard Street inclines people to doubt the necessity for precaution…"

On August 18, 2007, financial writer John Mauldin observed "Credit markets will get back to normal, as there is a lot of money that needs to find a home."

On September 4, 2007, Harris Private Bank boasted "Lowering interest rates will certainly help the stock market. There is no question about it."

Again, examples of "nothing can go wrong", just before liquidity disappears, and the reason why it vanishes so quickly is that so many eager participants have not been buying with cash, but on margin.

During the 2008 financial storm, interest rates plunged to zero.

Already at close to zero percent, actually 0.25%, the action in short rates with a contraction will be interesting.

Otherwise, throughout business history, short-dated rates as represented by Treasury bills, or the equivalent have increased in a boom and have declined in the consequent contraction.

Of course, the latest outstanding "Nothing can go wrong" was recorded in December 2007 when Harvard's Greg Mankiw boasted that the Fed had a "dream team" of economists. The worst contraction since the 1930s started in the credit markets in that fateful June, the stock market in that fateful October and GDP in that fateful December.

In each great bubble, suddenly vanishing liquidity was seasonal as financial markets in London and New York crashed in the Fall. While widely popular, the notion that a cut in the Fed rate will keep a bubble going has been fanciful rather than empirical.

Forces during the transition to contraction have been formidable, with the establishment doing everything possible to keep the mania going. But as speculators become exhausted, prices break and the power shifts from central bankers to margin clerks.

So, in today's reckless world, the Fed needs to keep speculative accounts fully leveraged and the job description of Mr. Margin is to get the accounts in line. And the list of bear markets since 1913 documents which team has the most power.

At the height of any bull market, credit spreads, the curve, the dollar and commodities should be monitored. The path from ecstasy to dismay is an old one, but simple.