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100 Years Ago

DAVIS HAMILTON JACKSON & ASSOCIATES

Song titles have appeared at the top of these letters on a number of occasions, and so it is with this one. Appearing on the Rolling Stones 1973 release of *Goats Head Soup*, "100 Years Ago" is a catchy tune and one that I've never forgotten since first hearing it thirty-five years ago. I'm reminded of it today because I just finished reading a transcript from one of NPR's *All Things Considered* broadcasts which contained the following paragraph:

"In the months preceding the panic, the stock market was shaky at best; banks and securities firms were contending with major liquidity problems. By mid-October, Wall Street was paralyzed; for days, there were runs on several large banks. Millions of dollars were withdrawn, and banks closed their doors. New York City was on the brink of bankruptcy."

It's a reasonably accurate summary of the current credit crisis, but the topic of this August 2007 broadcast was actually the banking panic of 1907 – 1908 (or, '100 years ago'). Indeed, the history of capitalist societies is replete with similar such episodes. Practically every instance has the same set of root causes and can be generally summarized by the above paragraph. Furthermore, they almost all end with a massive deleveraging of the financial system. In short, the financial panic of 2008 was not a new phenomenon. Very similar panics have occurred many times in the past and will most certainly happen again.

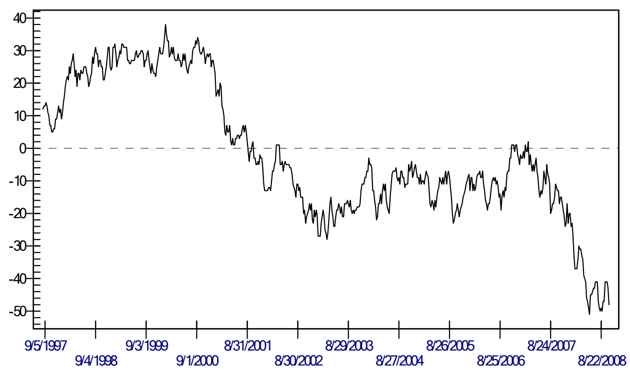
More recent episodes have resulted in government intervention and new legislation. The banking crisis that ended in 1908 spawned the Federal Reserve System, while the 1929 panic resulted in the New Deal. The current crisis has given rise to TAFs, TARPs, SPVs, and numerous other plans of alphabet soup aimed at restoring confidence in the system. Various gauges of investor fear and risk premiums have begun to suggest the rescue efforts are working and that the worst of the crisis of confidence is behind us.

What varies from crisis to crisis, however, is the subsequent impact on the real economy. Inevitably, the reduced availability of credit that results from deleveraging the financial system has a negative impact on economic growth. The only questions relate to the duration and severity of the slowdown in real activity. The 1929 panic, for example, caused a severe and protracted depression while the 1907-08 crisis resulted in a relatively short recession.

The current economic slowdown seems almost certain to be between these two extremes. Although improved (vs. 1929) fiscal and monetary policies will mitigate the severity of the downturn, the health of the American consumer's balance sheet will most surely lengthen it. I will leave the causes and implications of deleveraging the consumer for future letters and, for now, simply highlight the chart below. It summarizes how the average citizen feels about their financial situation, and reminds me of a line from "100 Years Ago":

"Now all my friends are wearing worried smiles"

ABC News Washington Post US Weekly Consumer Comfort Index



Sources: Bloomberg, DHJA Research

In summary, the markets have survived the worst of the crisis of confidence and are now trying to handicap the severity and duration of the ensuing economic slowdown. Although we have no way of knowing either of these variables for certain, our valuation models for equities and Treasuries suggest the markets are currently priced for a very severe and protracted recession. If the historical accuracy of these models is any indication, future surprises may well be of the positive variety

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