Letter 43

Stock market crashes

"History does not repeat itself, it stutters"

Karl Marx

The history of stock markets over the past 120 years has seen many economic and political shocks and crashes but according to the work of the London Business School, the average annual performance of stocks, in real terms, has been 5.2% for the world and even 6.6% for the United States, a performance far superior to bonds, respectively 2.1% in the world and 2% in the United States.

The crashes, one of the moments of ***"market exuberance"*** that Greenspan spoke of as early as 1995, have had various causes, financial in 1929 or 2008, oil in 1973-74 and again in 1980, military during the two world wars, pandemic in 2020, technological in 2000.

There are so many causes to be examined in order to assess the possibility or probability of a new crash, knowing as we shall see that history does not repeat itself.

- ***Wars :***

Between 1914 and 1918, stocks worldwide fell by 31%. The worst performances were recorded by the defeated countries, notably Germany, -66%. Conversely, the Japanese market, sheltered from the war, appreciated by 66%.

Between 1939-1945, the decline was again more marked in the defeated countries, Japan (-96%) and Germany (-88%), while the United States (+22%) and the United Kingdom (+34%) recorded positive real performances.

Specifically, in the United States, the market initially fell by 63% between April 1939 and April 1942, and then appreciated by 94% between April 1942 and September 1945. In real terms, after inflation, the decline was actually 81%.

During the Gulf War, the invasion of Kuwait on 31 July 1990, from the highest to the lowest, the US market lost 17% in 10 weeks, between June 1990 and September 1990, but it returned to its pre-crisis level in 7 months. Markets rose on 17 January 1991, the day of the first American attack. The European market lost 22% and, as is often the case, took longer to recover its pre-crisis level as only three-quarters of the loss had been recovered after 8 months.

Other international crises have also impacted the markets, but on a smaller scale and for a shorter period. We can mention the Korean War (-12% in New York between May and July 1950 then +38% between July 1950 and January 1953), the Cuban missile crisis in October 1962 with a 7% drop in the American index and a recovery in two weeks, the Yom Kippur War in October 1973, with a 16% decline in the S&P 500 and a recovery that is difficult to assess

due to the concomitant oil shock.

A lesson to remember : everywhere, markets rebounded very quickly after the wars. Nearly 170% appreciation between 1919 and 1929 in the world, almost 400% between 1949 and 1959 and, unsurprisingly, the brightest performances were recorded in the defeated countries. Thus, in Japan, the appreciation was almost 1600% between 1949 and 1959.

In short, markets are apprehensive about the threat of war but often recover before the conflicts are over.

What to think about the risk of war today?

While there were 9 million deaths during the first world war and 49 million during the second, between 1945 and the fall of the Berlin Wall in 1989, there were 40 million deaths in 160 conflicts, but these were regional conflicts, often even civil wars.

Without playing the prophet, we can stick to a few observations. In his excellent book, ***Towards War, Graham Allison*** tried to show that when an ascendant power threatens to supplant an established power, danger is never far away. "The rise of Athens and the fear that this inspired in Sparta made war inevitable," he wrote. 12 of the 16 antagonisms that have emerged in history have resulted in a war, the latest being the 1914 war when Germany challenged the English power. Previously, Charles V challenged Francis I, England and Holland clashed four times between 1652 and 1680, Bismarck incited France to declare war on him, the United States against Spain in 1898. This is the famous trap described by Thucydides, ended by the victory of a weakened Sparta. This is the question that emerges from the rivalry between the United States and China, a real "clash of civilizations". Today, everything seems to oppose China and the United States, the former asserting the supremacy of the state over the individual while the latter distrusts the government and sanctifies human rights. Xi has set the goal for China to become the first power. The military budget, 2% of GDP or $146 billion, is in fact $314 billion in purchasing power parities, almost half of the US budget. Skirmishes in the China Sea between Americans and Chinese are frequent, but the Americans are aware that since 1945 they have drawn in Korea, lost in Vietnam, lost in advance in Afghanistan and Iraq and have only managed to push Hussein out of Kuwait.

Without believing in ***Kant's*** proposals for ***Perpetual Peace,*** it is true that between 1500 and 1700 the great powers were at war more than 75% of the time, as ***Pinker*** noted in ***The Triumph of Enlightenment,*** but since the invasion of Iraq in 2003, and apart from Afghanistan, it has almost never. When 9 countries possess more than 10,000 warheads, each of which can destroy a city; when a hundred of these warheads could destroy 200 million people in an instant, when the soot spread into the atmosphere by the blazes could wreak havoc on the ozone layer and cool the planet, thus reducing food production for a decade, the relationship to war is evolving. Wars today are concentrated in an area stretching from Nigeria to Pakistan and are mainly civil wars. Importantly, the percentage of combat deaths has dropped significantly, 300/100,000 during the second world war, 1.2/100,000 in 2016.

If military confrontations, such as the second world war, seem more unlikely, war can take other forms such as cyberattacks, drone attacks... Wars are no longer limited to front lines, employing fewer and fewer military personnel and more and more robotics. Increasingly, the

quest for influence prevails over the ability to destroy... and it is difficult to evaluate the stock market consequences.

- ***Oil :***

Between 1 November 1973 and 10 March 1974, the U.S. S&P 500 fell 48%. Between April 1973 and September 1974, following the quadrupling of oil prices, the European market lost 38%.

An oil crisis today would not have the same impact as in 1973 because the energy bill now represents only 3% of GDP. In history, there has never been an oil crisis other than a political one because there has never been a shortage of oil. In the Arctic, there is the equivalent of a third of Saudi Arabia's oil reserves, so there will be no shortage of oil.

But an energy crisis could take other forms because there has been a lack of investment spending in recent years. According to figures from the IEA, the International Energy Agency, in 2021, global energy investments are worth $1.9 trillion, and of this total, renewable energies account for only $350 billion. An insufficient amount according to the IEA which considers it essential to triple this amount, on the one hand to ensure the energy transition, on the other hand, because the peak of oil demand should be in 2025 at 97Mb/day. The decline in supply is perceptible in several countries, in Nigeria, Algeria, Mexico, Great Britain and, in Russia, as production seems to have reached its ceiling.

The energy transition, as everyone is beginning to sense, will require an energy price higher than current prices and this is likely to put a strain on purchasing power and/or spread inflationary pressures, which could be detrimental to market appreciation.

- ***Systemic financial crises :***

During the crisis of 1929, between the high of 9 July 1929 and the low of 6 January 1932, the American index, S&P 500, fell by 86%, GDP fell by 30%, unemployment rate rose from 7% to 25% and a third of the banks in the United States collapsed.

A notable difference from today is that the international spread of the crisis was slow. The crisis started in the United States in 1929 but did not reach Austria with the bankruptcy of the Kreditanstalt until May 1931 and France only in 1932. Today, the international spread of a crisis occurs in 48 hours.

At the time, the Fed did not understand the need to inject liquidity, the New Deal was initiated only in 1933 and did not prevent the country from facing difficulties again and then a recession in 1937. Thus, the markets experienced several downturns, -40% for the American index between July 1932 and February 1933, -34% between July 1933 and March 1935, -54% between March 1937 and March 1938. It was not until 1955 that the pre-crisis peak was reached in real terms.

Between May 2007 and February 2009, a new financial crisis emerged, the "sub-prime" crisis in the United States, and the European market fell by 53%.

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What about the future? We are not convinced that a new financial crisis is impossible but, as we saw in 2020, the combination of monetary policies, liquidity injections and supportive fiscal policies have changed the situation. In 1929, the Fed had not injected liquidity, in 2020, very quickly, in a few weeks, the Fed injected $700 billion and launched various support programs for $1.95 trillion, including monthly purchases of $120 billion, which are still in effect. The ECB has mobilized €1.35 trillion for an emergency plan and €1.35 trillion for long-term refinancing.

In parallel to these monetary policies, fiscal support and stimulus packages have been massive. In the United States, as in Great Britain, the budget deficit exceeded 13/14% of GDP. More important today is the effectiveness of international coordination between several states or different central banks.

Today, in a world of indebted state and private actors, the theme of a new financial crisis revolves around trust. In one year, between 2019 and 2020, global public debt rose from 83% of GDP to 98% of GDP. This is true of developed countries indebted to the tune of 122% of GDP and emerging countries. On the surface, the debt of the latter is only 64% of GDP but was 54% a year ago and some countries, such as Brazil, are dangerously indebted at 99% of GDP. Let us not forget that emerging countries have less latitude to manage their debts, are more sensitive to changes in the $, imported inflation, interest rate movements and capital outflows.

For developed countries, according to the IMF, the global debt reached $226 trillion, and the balance sheets of the major central banks are equivalent to 60% of GDP.

In the event of a crisis of confidence, not yet perceptible, gold and cryptos would offer alternatives.

If inflation were to return, markets would fall. Thus, between 1966 and 1982, between the beginning of rampant inflation and the two oil shocks, the US market declined by 60% in real terms. The big losers of this period were – besides long fixed-rate bonds of course – companies with low pricing power and technology stocks whose prices did nothing while their volume of activity grew strongly. The market boom that followed between 1982 and 2000, more than 500% in the United States in real terms, corresponded to a long phase of disinflation and falling interest rates. During this period, gold lost 5%/year. These are all elements to remember when defining investment strategies.

- ***Technology :***

Sectoral bubbles did not start in 2000. Forgotten by many, the railroad and electricity bubble in the United States burst in 1901. Rail-related companies accounted for more than 60% of the U.S. market capitalization in 1900! Then came the radio bubble in the 1920s...

Between August 2000 and March 2003, the bursting of the technology bubble caused all stock markets to fall, and the European index lost 53%.

Today, if technology stocks seem expensive in the eyes of some, if some are worried about the weight of GAFAM in the Nasdaq index or the S&P 500 index, the environment is different from the late 90s. At the time, investors, for the lack of profits for these groups, valued future

sales multiples, which were therefore uncertain. Today, major technology groups are rich in cash, have dominant positions and have high margins. It should be recalled that the 5 largest American digital companies have made more than 400 acquisitions worldwide in 10 years.

Tomorrow, the thing to fear would be a dismantling of these groups or even, as China offers an example, repeated attacks from the government. Another possible risk is technological obsolescence. Kodak and Polaroid have disappeared from the Nifty Fifty of the 70s. After 2000, Sun Microsystems or Lotus also disappeared.

- ***Environmental disasters :***

After the Kobe earthquake in Japan in 1995, the market lost 20% but recovered this loss in 1 year.

After the Fukushima disaster on 9 March 2011, the Nikkei index fell by 18% until 15 March and did not return to its pre-crisis level until January 2013.

There will be more and more, but it is impossible to analyze the stock market impact in advance.

- ***The pandemic :***

Between 19 February 2020 and 18 March 2020, the MSCI EuroStoxx was down 35%, all major markets declined but today they have generally recovered, and the US market is even significantly higher than in February 2020.

As ***Pinker*** reminded us in ***The Triumph of enlightenment,*** in the 20th century, a hundred or so scientists, inventors (vaccines, discovery of blood groups ...), saved 5 billion lives when 70 million people died of famines, mainly in countries struggling with collectivist regimes of inadequate planning.

This pandemic has shown the vulnerability of states but has also reaffirmed the virtues of innovation, as emphasized by Pinker, the capacity for international mobilization, the speed of reaction. Other pandemics will occur but, between relocations and reorganization of stockpiles, the states have learned.

Conclusion

Let us be modest in our foresight. ***Popper*** stressed the impossibility of having an acceptable representation of the future. Psychology shows that human beings fear losses more than they hope for gains. In ***Antifragile,*** a book with global success, ***Nissim Taieb*** showed that scientific prediction is an illusion (for example the Fukushima accident), political interventionism is naïve (for example in China, between 1959 and 1961, 30 million people died of famine), and planning is a myth for the company because evolution is too random. Most of history is due to "black swan" events, unpredictable events, and therefore we live in a world that is difficult to anticipate.

In summary of this Letter on crashes, we will retain seven main points :

World wars have been less damaging to equities than bear markets in times of peace :

Performance was much more negative in 1929-1931 (-54%) or during the oil shock (-47%) than during the Second World War (-12%). Shareholders in the United Kingdom and Japan also suffered much more during the 73-74 crisis (-71% and -52%) than during the crisis of the 1930s.

The performance of equity markets is remarkable :

We have analyzed the most significant crashes, while we could also have examined the 1987 crash, the impact of the crisis in emerging countries in the mid-90s, let us not drown in the numbers and return to the guiding thread at the beginning of our letter, namely the incomparable outperformance of equity markets over the long term, the often rapid reversal of losses for even very substantial ones recorded by the markets.

Dividends are sometimes a component of performance :

In real terms and on average, dividends brought 1%/year to the United States between 1900 and 2004 and 0.5% in United Kingdom according to Dimson's calculations. But in Switzerland, the contribution was -0.1% and in France -0.4%. These figures are instructive because they are lower than the general belief. They corroborate an idea often developed in our Letters : we buy shares for their growth potential and, with rare sectoral exceptions, not for dividends, which are moreover often taxed.

A country's strong economic growth is not the key to stock market performance :

The observation of the markets since 1900 illustrates this point and the exceptional economic growth of China over the last 30 years confirms it.

The best stock market performances in the world over more than a hundred years comes from countries with moderate growth.

The exceptional performance of the US stock market between 1981 and 2015, more than 6.5%/year in real terms, is disconnected from real GDP growth, 2.7%/year. While earnings appreciation has not been totally disconnected from real growth, it has been higher than GDP growth, as evidenced by the growth in the net income-to-GDP ratio. There are two main reasons for this : the shift in the distribution of value added in favor of capital and away from labor over a period of time, and the rise in share buybacks in recent years.

Switzerland is the best refuge on the planet.

Taïeb notes this in the conclusion of his book, ***Antifragile.*** Between 1925 and 2000, if the Swiss market fell three years by more than 25%, for 14 years its gains exceeded 25%. And the appreciation of the currency reinforces the analysis. Since 1900, the Swiss Franc has been the most appreciated currency in the world : $1 against CHF today is worth one-sixth of its value in 1900. Nevertheless, if a defensive approach leads to a preference for Switzerland, a dynamic investment profile will lead to favouring the American market because, according to Credit Suisse's calculations, over a long period, 1925-2000, an investor in CHF gained 40% more on the American market than on the Swiss market.

Crashes are more frequent but better managed :

The abundance of liquidity, the interpenetration of markets, the speed of information circulation, and the famous consequences of the butterfly effect, make the markets extremely sensitive to the slightest political, financial, pandemic, military, or commercial crisis.

Since 2000, there have been three crashes. But crisis management tools have been perfected and capitalism has demonstrated its ability to correct excesses and adapt quickly to changes in supply or demand.

It is easy to write scenarios about risks and future crashes, but it is impossible to predict the timing. ***Nissim Taieb*** has shown in his books, a crash is in essence a "black swan", an event that occurs in a moment of euphoria.

Trust in the system :

Let us end on an optimistic note. If today excesses have a name : pollution, inequality, indebtedness can lead to environmental, political and financial crises respectively; innovation, the flexibility of democracies, the agility of central banks should be able to help overcome these challenges.

Stopping growth, or worse degrowth, is not the solution to the ecological challenge, just as democratization is not the solution to the challenge of inequality, just as protectionism is not the answer to financial globalization. ***''Misfortunes often sharpen the genius,''*** wrote ***OVID.***

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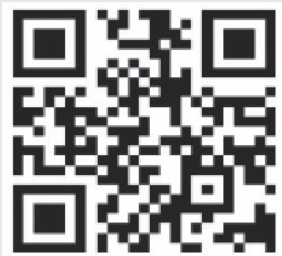

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