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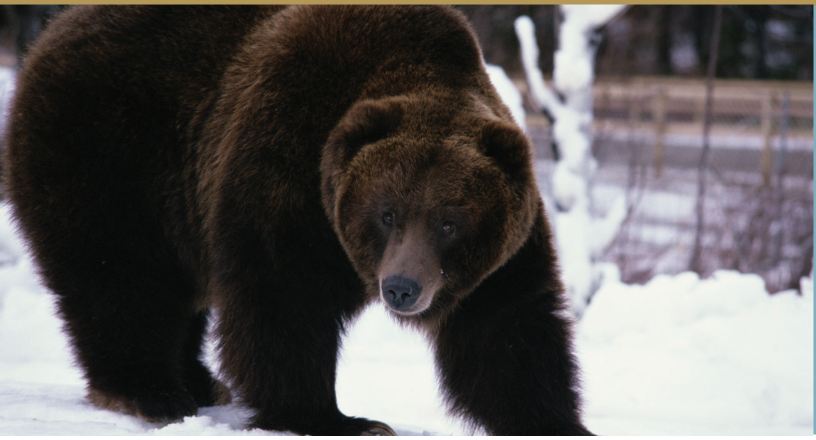
LONGWAVE group

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

WINTER WARNING



Four Long Wave Autumns in the United States

The autumn period of the Long Wave has always been the season of excessive speculation, which has been aided and abetted by a massive expansion in credit. Each of these four Kondratieff autumns has developed along a specific investment theme.

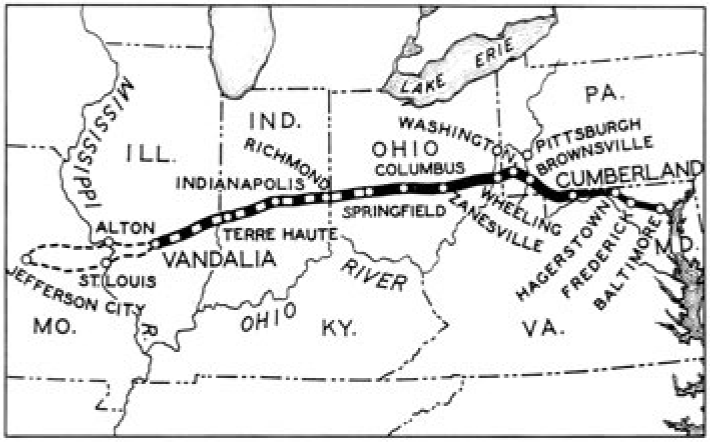
When the speculation comes to a crashing halt it ushers in the onset of the Long Wave winter depression, during which time the credit excesses of autumn are eradicated, resulting in a significant turmoil within the banking system.

The American System 1816 – 1837
Speculative theme – Canal building, road construction and government land sales

In the years following the War of 1812, the American political system was still evolving, with the gradual dissolution of the Federalist Party and the polarization of public support behind the Democratic-Republican Party. James Monroe won the Presidency in 1816 in a landslide vote and under his leadership, partisan political criticism abated. Indeed, the following decade became known as 'The Era of Good Feelings' because one political party dominated the Washington landscape. The President issued the Monroe Doctrine which declared the United States as a sovereign nation and the Second Bank of the United States was chartered in 1816 for a period of 20 years. The maintenance of high public land prices and high tariffs on imported goods garnered political support, in order to protect American industries and generate revenue for the federal government.

Against this political backdrop, it was also a period of economic modernization, industrial development and infrastructure construction. The National Road, frequently called the Cumberland Road was constructed by the Federal Government in response to public demand to connect the east with the early west. The first route surveyed went from Cumberland, Maryland, through southwestern Pennsylvania to Wheeling, West Virginia. In 1806, President Jefferson appointed a board of commissioners who decided the route should be extended through Columbus, Ohio, and Indianapolis, Indiana, to Vandalia, Illinois, then capital of the state. While the first sections were opened to traffic in 1818, they became almost unnavigable before the western sections were completed.

1840 THE NATIONAL PIKE



BUREAU OF PUBLIC ROADS — DEPARTMENT OF COMMERCE

In the early1820's, the 363-mile Erie Canal was constructed between Albany, New York and Buffalo, New York to facilitate the transport of goods from New York City to 2,000 inland ports in the Great Lakes region. Dewitt Clinton, elected Governor of New York State in 1817, convinced state legislators to authorize $7 million (U.S.) for the canal's construction. Accordingly, an army of immigrants and draught horses toiled for eight years to complete the canal in 1825. The Erie Canal transformed New York City into a major commercial centre on a global basis and brought prosperity to cities and towns upstate, such as Rochester, Syracuse and Buffalo.

The Great New York Fire was a conflagration – an uncontrolled burning that threatens human life, property or ecology – that destroyed the New York Stock Exchange and most of the buildings on the southeast tip of Manhattan around Wall Street on December 16 and 17, 1835. The fire began in a 5-storey warehouse at 25 Merchant Street (now Beaver Street) at the intersection with Pearl Street. Manhattan was snow covered and the fire was being spread by gale-force winds blowing from the northwest towards the East River. Since temperatures had dropped to minus 17 degrees (F) and the East River was frozen solid, firefighters had to cut holes in the ice to obtain water, which then froze in the hoses in pumps. Property losses were estimated at $20 million (U.S.), which in today's terms would be in the hundreds of millions of dollars.

Since the fire occurred in the middle of an economic boom period precipitated by the opening of the Erie Canal, the destroyed wooden buildings were quickly replaced with larger stone and brick ones that were less prone to widespread major fires.

Coincident with the widespread infrastructure construction of the 1830's were millions of acres of government land sales, mostly to speculators, who were hoping well-located parcels would increase in value as the railroads expanded and canal construction lured more settlers into their areas. So much money was being accumulated by the federal government that by 1835 it had become debt free. President Andrew Jackson was not an advocate of fiat (paper) currency, rather he preferred settlements to be made in specie (silver and gold). He opposed the renewal of the federal charter for the Second Bank of the United States because he believed it concentrated the nation's financial strength in a single institution and it exposed the government to control by foreign interests.

Eventually, some surplus monies were distributed to the States, who used the funds to construct more infrastructure projects. President Jackson, alarmed at the growing amount of State bank notes being used for land purchases, issued the Specie Circular in 1836, ordering the U.S. Treasury to no longer accept paper notes as payment for such sales. Early in 1837, banks began to restrict credit and call in loans which caused bank runs by depositors. Then, unemployment began to increase and food riots occurred in several cities. The ultimate failure of canal and railroad projects caused the financial ruin thousands of land speculators. The impact of the impending economic depression lingered until 1843.

The Second Industrial Revolution 1864 – 1873
Speculative theme – Railroad construction

U.S. Treasury Secretary Salman Chase introduced the National Bank Act of 1864, which authorized the Office of the Comptroller of the Currency (as part of the U.S. Treasury) to regulate nationally chartered banks. Money raised by the issuance of Government bonds during this period was used to fund the Union army in the fight against the Confederacy. Following the end of the Civil War in 1865, the westward expansion of the railroads accelerated in earnest. Commensurate with the railroad expansion was a steady westward migration of the population, requiring more construction of infrastructure in the form of roads, bridges and canals. New towns sprang up across the American prairies, following the railroad tracks to the west as the country's economic development entered a new phase.

However, the economic road of expansion was not always a smooth one. Several scandals rocked the Presidency of Ulysses S. Grant, including the Fisk/Gould Scandal. These two speculators attempted to corner the gold market on the New York Stock Exchange. Convinced that the government was going to redeem the paper currency ('the greenback') with gold, they began buying and hoarding gold in the summer of 1869, causing bullion prices to rise and stock prices to plummet. When President Grant was made aware of the scheme, he ordered the Treasury to sell $4 million in gold. On September 24th.(Black Friday), when the government gold hit the market the premium quickly fell, forcing speculators to sell their gold holdings and many of them were ruined.

More disaster soon followed. The Great Chicago Fire of 1871; remembered as one of the most spectacular events of the 19th. century. On the night of October 8th. a fire broke out in the O'Leary's barn at 13 DeKoven Street and quickly raged out of control. The blaze spread to the east and north consuming private mansions, wooden houses and commercial and industrial buildings. At least 300 people died, 100,000 people were homeless and $200 million worth of property was destroyed. The entire central business district of Chicago was leveled.

In 1872, an outbreak of equine influenza, known as the Great Epizootic, brought the entire U.S. economy to a virtual standstill. The outbreak was first noticed near Toronto, Ontario in October and in the next three months the contagion had spread across the entire continent. It spread down the eastern seaboard all the way to Havana, Cuba and westward across the United States and Canada to the Pacific Ocean. The epidemic forced men to pull wagons by hand, while trains and ships full of cargo sat unloaded, tram cars stood idle and deliveries of basic consumer essentials were curtailed. According to a New York Times article of October 24th. "There is hardly a public stable in the city which is not affected, while the majority of the valuable horses owned by individuals are for the time being useless to their owners. It is not uncommon along the streets of the city to see horses dragging along with drooping heads and at intervals, coughing violently."

Another significant event during this period occurred in February, 1873 when the Fourth Coinage Act was enacted by Congress; embracing the gold standard and demonetizing silver. Comparatively little silver had been coined since 1834 and it was generally believed that the immense annual output of gold would establish the yellow metal as the standard of the world. The 1867 Monetary Conference in Paris had advised the demonetization of silver and the United States had agreed to this recommendation.

The financial panic of 1873 began with the collapse of the Jay Cooke investment bank of Philadelphia. The bank had been prominent in selling government bonds to finance the Union's war with Confederacy, but in the post war era the bank had become the government's agent in financing railroad construction. Since the end of the Civil War, railroads had laid 35,000 miles of new track in the United States and had become the nation's largest employers. By 1873, the U.S. economy had over-expanded, particularly in railroad construction. Bankers in Europe (already in a state of economic depression) began to call in American loans, causing the New York Stock exchange to close for 10 days. Railroad construction was curtailed with some railroads defaulting on their bonds. The unemployed began to move about the country seeking jobs and bread lines appeared in some cities. Three years of economic depression ensued, during which time 10,000 U.S. businesses failed.

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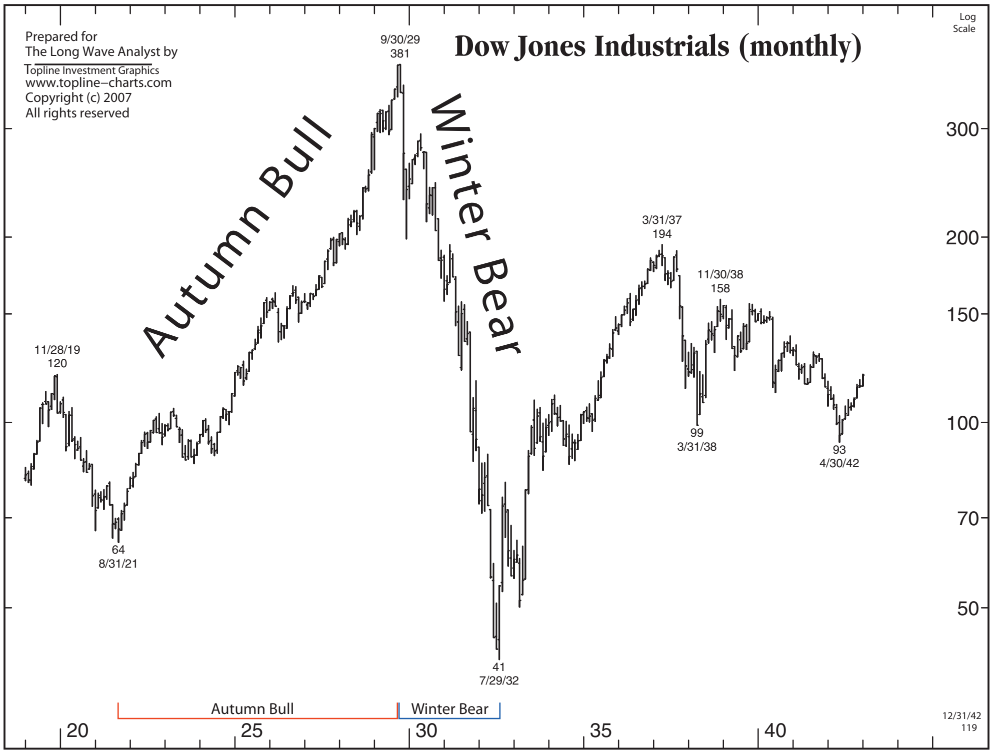
The Roaring Twenties 1921 – 1929
Speculative Theme – Industry growth; automobiles, aeroplanes, radio, refrigeration

Truly, the 1920's represent an era of vigorous and vital economic growth for the United States. Three main factors fueled this economic growth: machines, factories and the manufacturing process of standardized mass production. The most significant economic change was the country's increasing dependence upon automobiles and trucks, for both business and pleasure. As a result, new and better roads and bridges had to be constructed for improved transportation; as well as more infrastructure construction of dams and airports. There was also a construction boom in factories, office buildings and homes, as more Americans became attracted to life in the suburbs. Expanded usage of electricity and the telephone opened new business opportunities in utilities, manufacturing, energy and tourism industries. Technological improvements in the phonograph, radio and motion pictures launched new businesses in the entertainment industry. Professional sports franchises became major businesses.

Attendant with the economic growth during the 1920's was the excessive speculation in stocks, which saw share prices (as measured by the Dow Jones Industrial Average) rise by about 300%, from their low in early 1920 to mid-1929. Speculation is always at its peak when equity prices are at their highest point and the investor herd is at its most bullish sentiment and outlook. In our Long Wave Analyst special edition This Is It, of November, 2007, we emphasized that "these speculative manias only occur once in a lifetime and that is during the Kondratieff autumn. These speculations are always initiated by a huge expansion in the supply of fiat money. As the great bull market progresses, it draws everyone into its embrace. It becomes the center of attention; the talk on the cocktail circuit and in the factory lunch rooms. Everyone follows its progress on television and in the newspapers. In this milieu, a cadre of experts comes to the fore and the investor herd leans on their every word."

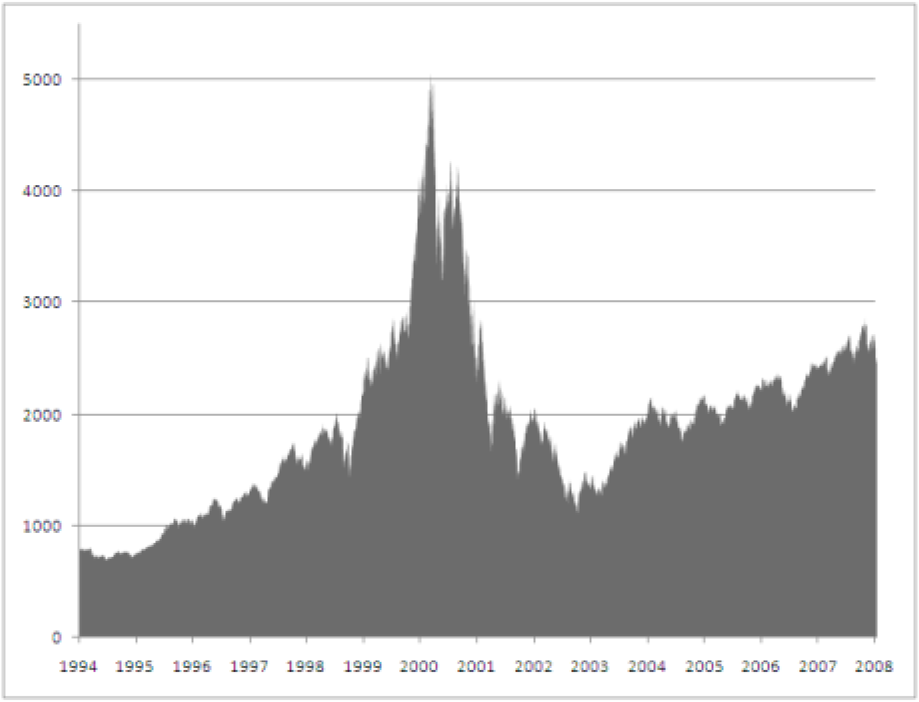
Indeed, in Niall Ferguson's book, The Ascent of Money, we read where "RCA, the tech stock of the 1920's rose by a dizzying 939% between 1925 and 1929; its price-earnings ratio at the peak of the market was 73. (Investor) euphoria encouraged a rush of new initial public offerings (IPOs); stock worth $6 billion (U.S.) was issued in 1929, one sixth of it during September." The bursting of the 1920's stock market bubble was most dramatic during October, 1929, which marked the onset of the great depression. From its low point in 1932, it would take the Dow Jones Industrial Average another 22 years, until 1954 to match its zenith set in early September, 1929.



1982 – 2000
Speculative theme – High technology and Dot-com

In the early 1980's, the U.S. economy was caught in a 14% inflationary spiral, along with many other countries, including Canada. Long-term U.S. Treasury yields were trading upwards of 12%, the unemployment rate was at 10% and the U.S. had a projected deficit of $80 billion, the largest in U.S. history. In February 1981, President Reagan presented the Economic Tax Recovery Act to Congress, calling for massive corporate and personal tax cuts, reductions in government spending and a balanced budget. By July, President Reagan's economic plan had won enough Democratic support to gain the approval of Congress. In 1983, the economy began to improve and during President Reagan's second term, America began the longest sustained peacetime prosperity in its history. However, through this same period, the federal debt tripled from $930 billion in 1981 to $2.6 trillion in 1988; and large U.S. trade deficits begin to emerge. Also, legislation was passed in favour of the deregulation of the energy, communications, transportation and banking industries.

During the 1990s, the U.S. national debt grew by 75% and the U.S. gross domestic product increased by 79%. By the mid 1990s, stock prices were soaring for technology and internet companies. Initial public offerings (IPOs) of high tech and dot-com companies were all the rage with the investor herd and most issues were listed on the Nasdaq Exchange. From the more successful Amazon.com and E-Bay to the many companies taken over, or just forgotten; the investing multitude believed that the internet was to be the future of business. Most new dot-com companies had poor business plans and others had little or no prospect of even turning a profit, however, the great investing hordes were smitten with the IT concept and eagerly purchased the new issues. Inevitably, the stock market became overvalued and with corporate earnings scarce, the dot-com stock speculation /momentum peaked on March 10, 2000 at a level of 5,048 on the Nasdaq and relinquished most of its gains over the next three years.



Source: Wikipedia

Summary

By comparing the four autumn economic waves in the United States chronicled above, we can discern a commonality that whether the primary focus of an economic wave is government land sales; railroad construction; industrial stocks/equities; or high tech/internet IPO's; the bubble patterns are always the same. The natural progression of a bull market – rampant speculation and excessive debt creation – always leads the long term business cycle from the Kondratieff autumn to the bursting of the bubble and into the economic depression of a Kondratieff winter – deflation, high unemployment and economic contraction. This is why the current winter cycle will end badly; because the massive debt accumulation has yet to be expurgated from the American economy. Will we witness the bankruptcy of U.S. states and municipalities, or even the U.S. itself during the current Kondratieff winter cycle?

Written By: Ian Gordon & Christopher Funston