

The Lessons From Past Bear Markets

Portfolios heavy with under-performing stocks almost never outperform the market. Ignat's Law

“Empirically it seems true that each generation develops a series of blind spots which prevent it from seeing the dangers of too great a credit expansion over a period of years and which allow it to rationalize these aberrations under the cloak of “things are different now.”

Money and Investment Profits

Hamilton Bolton

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Market Dynamics

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Bear markets in stocks are neither new nor mysterious. Bear markets are almost always the result of monetary tightness and a lack of liquidity in the banking system. The source of the monetary tightness is usually the direct result of a decision to tighten monetary policy by the FRB, but the monetary tightness can also be the result of purely market forces.

My “baptism of fire” with bear markets in stocks occurred in 1966. By historical standards the bear market was of average severity and average length but it was certainly caused by tight money as a direct result of Federal Reserve Bank monetary policy. The FRB in 1966 was extremely concerned about the administration’s policy of guns and butter and the probable inflationary consequences of those policies. The chairman of the FRB demanded a 10% tax increase to offset the budgetary consequences of the costs associated with an expanding war in Viet Nam and the major social entitlement programs that were being developed by the Federal government at that time. He made this the primary theme of his many speeches during that time.

When the President didn’t respond quickly enough to the request for a tax increase, the threatened tight money policy was applied. The effect on the stock market was immediate and very negative, with the Dow Jones Industrial average declining over 20% in about nine months. The tax increase was finally passed and the FRB relaxed its tight money policy and the stock market started a bullish recovery into 1967 that led to a stock market peak in early 1969 when another round of tight money was applied and a bear market followed.

This was an especially important experience for me, at that time. The senior officials in the trust department

where I worked were avid followers of the Bank Credit Analyst investment service and they were especially attuned to the analyses of monetary conditions provided by the BAC under the editorship of Hamilton Bolton. It is interesting that they “pooh-poohed” technical analysis but they paid close attention to the Elliot Wave forecast that was an integral part of the BCA at that time.

As a junior analyst in the investment division, I was expected to read and follow the prognostications of the BCA service and this made the tight money and bear market episode of 1966 and the subsequent recovery in the stock market so impressive to me. I bought a copy of Bolton’s book “*Money and Investment Profits*” and this gave me an even better understanding of the influence of monetary policy on the stock market. I was lucky enough to hear Mr. Bolton speak about his studies of monetary history here in Denver in the late 1960’s. I also read books and articles by Dr. Beryl Sprinkle of the Harris bank in Chicago who was an expert on monetary policy and its influence on the stock market.

Later on, in my graduate studies at the University of Denver, I was heavily influenced by a professor in the Finance Department at DU who was an avid follower of Milton Friedman and who promoted Friedman’s brand of monetary economics to his students. It is interesting to note that this professor had worked in the economics department of a major New York City bank under the direction of Dr. Paul Volker. This did much to prepare me for understanding the bear markets since the 1960’s and up until today.

The lesson seems to be clear—bear markets are usually created by the FRB’s tight monetary policies, but also the bullish recovery from the bear market can be anticipated when the Federal Reserve Bank relaxes its tight money policy and starts to stimulate the growth of liquidity, as is the case now, in March of 2008. It is also clear that many investors do not understand or appreciate the ability of monetary policy and liquidity flows to stimulate the ups and downs of the stock market.
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