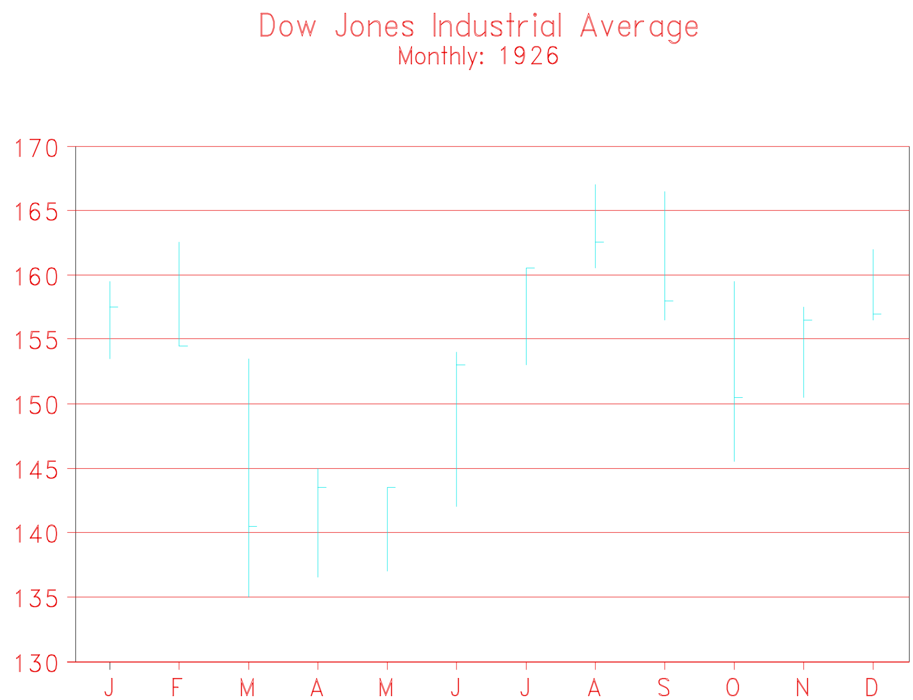
Chapter VI

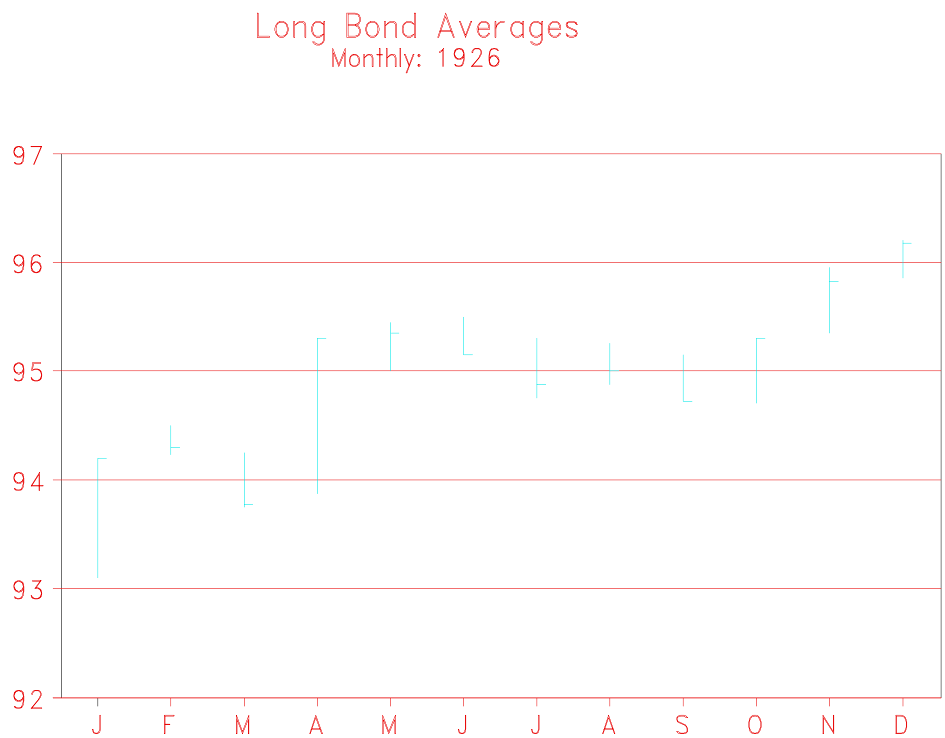
1926



With all the intrigue awaiting the curtain's rise in one of Shakespeare's plays, the year 1926 dawned upon the stage before an audience who remained quite sheltered from the ideas flourishing among the central characters at the free world nations' central banks. "Friends, Romans, Countrymen, lend me your ears. I have come to bury Caesar, not to praise him." As the cunning words of Marc Antony gained the ear of the mob and then manipulated them into following the triumvirate into a war for world dominance, 1926 had begun quite unknowingly in the shadow of such secrecy and intrigue.

It could not be found among the pages of the press for they were unaware of its existence. Nonetheless, a great triumvirate was indeed underfoot. From Britain, one arrived clad in his brilliant ideas for a new era of internationalism. His name was Montagu Norman, Governor of the Bank of England. He held the vision of an all-powerful European unity, an international system encompassing both trade and banking power. Although new to the position since his appointment in 1920, he held the view that only bankers were even remotely capable of comprehending such a vision. His ally in the States was Benjamin Strong, Governor of the New York Federal Reserve.

This elite group of bankers in many ways chose to usurp a financial power on their own, and documents later proved that discussions had taken place even prior to 1925 without the knowledge of either the British or the American government.



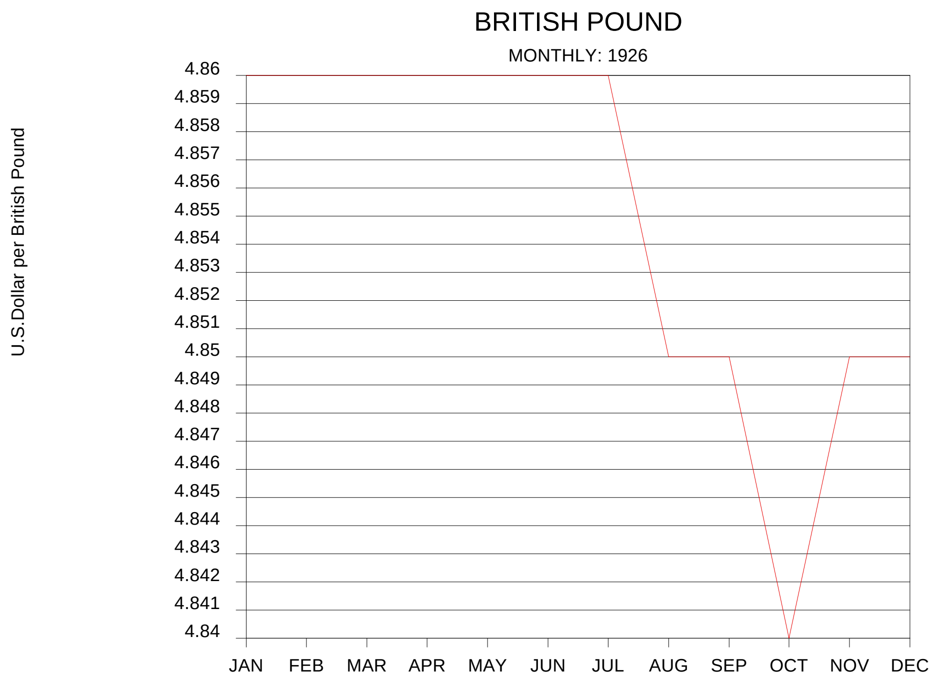
The quest for power and the idea of controlling the world economies at their will was perhaps no child's dream. But, it was a lofty goal and one which should have been thought out carefully, but was not.

The European triumvirate was composed of Montagu Norman of Britain, Hjalmar Schacht of the Reichsbank in Germany and Charles Rist of the Bank of France. It was learned that these distinguished men urged Benjamin Strong to lower the discount rate to help Europe attract much needed funds. Britain's motive was perhaps to find a means to firm the pound at the par value of $4.86 under the prewar gold standard. This was a clear overvaluation by at least 10%.

Of course, Germany and France were still both motivated by their own difficulties, which left them with unbalanced budgets unleashed by military and public works expenditures.

In his memoirs, Herbert Hoover wrote that he first learned of the pact from Adolph Miller who was a member of the Federal Reserve Board. Miller relayed to Hoover that Strong and his "European Allies" proposed still further "easy money policies" for the United States, which meant additional discount rate reductions. Miller had disagreed with Strong's proposals and felt that he was working for the interests of Europe and not the United States.

At the time, Herbert Hoover was Secretary of Commerce and upon learning of this plot from Miller, he protested to Daniel Crissinger who was Chairman of the Board of Governors. Hoover warned him that "such action would further stimulate speculation and was not the remedy for Europe's ills anyway." Hoover commented that Crissinger was a political appointee who was "utterly devoid of global economic or banking sense." Miller and Hoover could not overcome Benjamin Strong's influence. Hoover then appealed to President Coolidge but was rebuffed and told that the Fed was a separate agency and the law prohibited him from interfering with it.



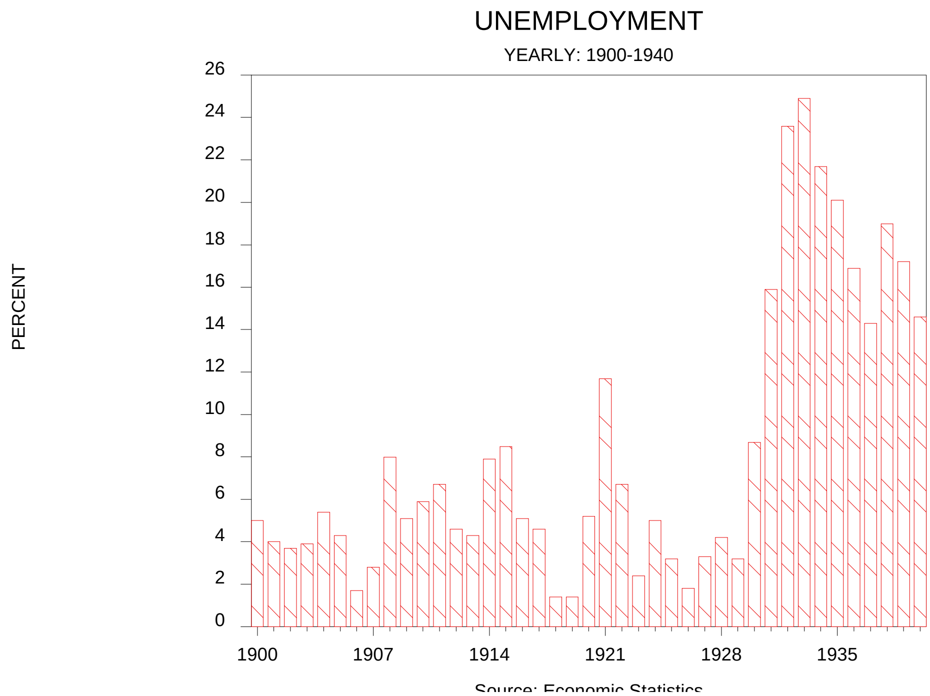
Hoover then wrote: "I was so alarmed, however, that I took up the matter with members of the Senate Banking Committee - the legislative father of the Board." Senator Irvine Lenroot wrote at length to the Board, building upon information which Hoover was supplying. In a memorandum from Hoover to Lenroot, the following passage appeared: "The effects of these policies upon the United States mean inflation with inevitable collapse which will bring the greatest calamities upon our farmers, our workers, and legitimate business."

Senator Lenroot also politely hinted to the Board that "public exposure" of the ploy would not be a desirable outcome. The end result of the efforts of Herbert Hoover, Adolph Miller and Irvine Lenroot was that the central bank conspiracy was brought to a halt, at least for a while.

Back on the surface and away from the political intrigues at the Fed, the year 1926 brought many changes in how people began to look at the market. The Dow Industrials continued the rally which had begun during 1925 but came to an abrupt halt by February. A very sharp reaction took place during March; then April and May spent a lot of time going nowhere fast. By June the market began to rally and eventually made new highs again during August before correcting sharply lower for another two month period.

The bond market pressed higher throughout most of 1926. Advertisements pushing bonds as the "safe and risk-free" investment became commonplace. The railroads, long regarded as the finest area of stock investment, followed the industrials in a very choppy trading pattern during 1926.

The tone of the market place and the economy was fairly well summed up at the beginning of the year by Time magazine: "Business prophets have spoken both optimistically and pessimistically at the year's opening, and as usual the future remains obscure to the average businessman. Current business is good; none except the anthracite miners and a few others question



that statement. This real interest in business relates to how long the present prosperity will last."

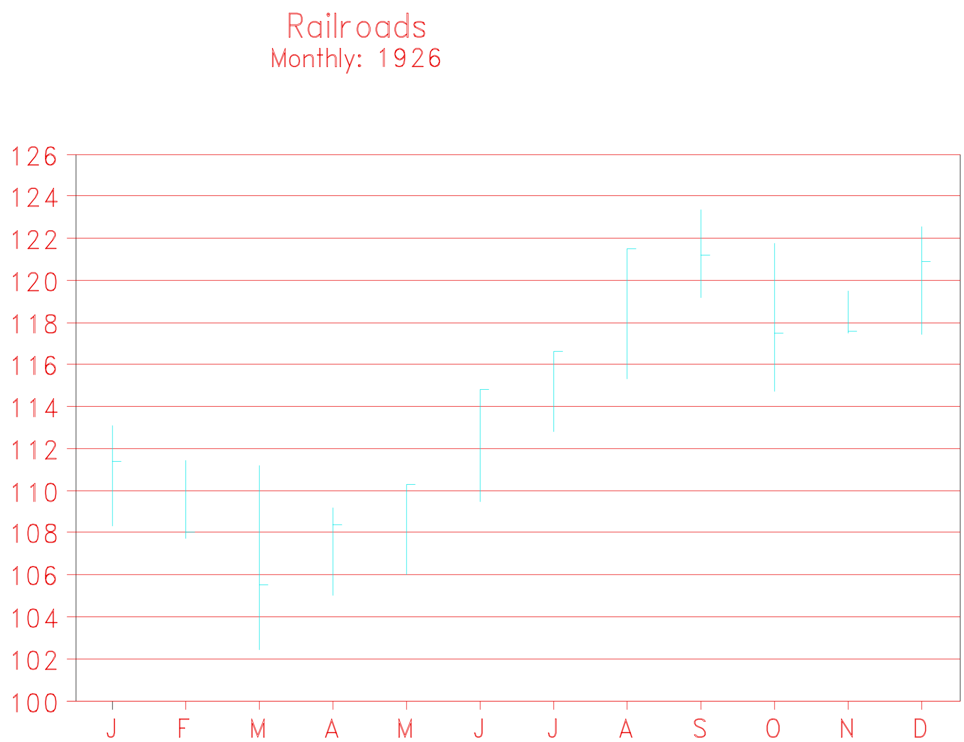
During early 1926, the general tone of the Press still sounded a little bit like a doubting Thomas. The memory of the panics and crashes, which had been numerous between 1901 and 1920, still lingered on in the minds of many. Business was good. Innovation in the United States had continued to progress and the growth in the stock listings themselves attested to the number of new business ventures. A comparison to January 1, 1925, just one year prior, showed that at the start of 1926, trading on the New York Stock Exchange had grown in both the number of issues as well as value.

It is interesting to note the trend. The number of corporate bond issues had increased by only 35, whereas the number of new issues in the stock arena was 118. Corporations began to shift their borrowings from bonds to stocks. This would be a trend that deceived many in the years ahead.

By 1926, the U.S. had emerged as the money center of the world; it was the place where foreign nations came to borrow capital. As a result, foreign bonds were listed on the N.Y. exchange. As of January 1, 1926, there were 116 separate foreign bond issues listed, of which 65 nations were the makers. This was broken down as follows:

No. Nations	No. Bond Issues
2 Asiatic nations	(3)
3 Australasia	(7)
37 Europe	(59)
5 North America(U.S.excluded)	(17)
18 South/Central America	(30)

Many businessmen at that time adhered to the old philosophy of whatever goes up must come down. They believed that the stock market was overdone and they continued to look for pessimistic news to support their contention. Other subscribed to the underlying facts. They pointed out that at no time in history had credit been so cheap and the banking business so sound, and these two elements combined to form a



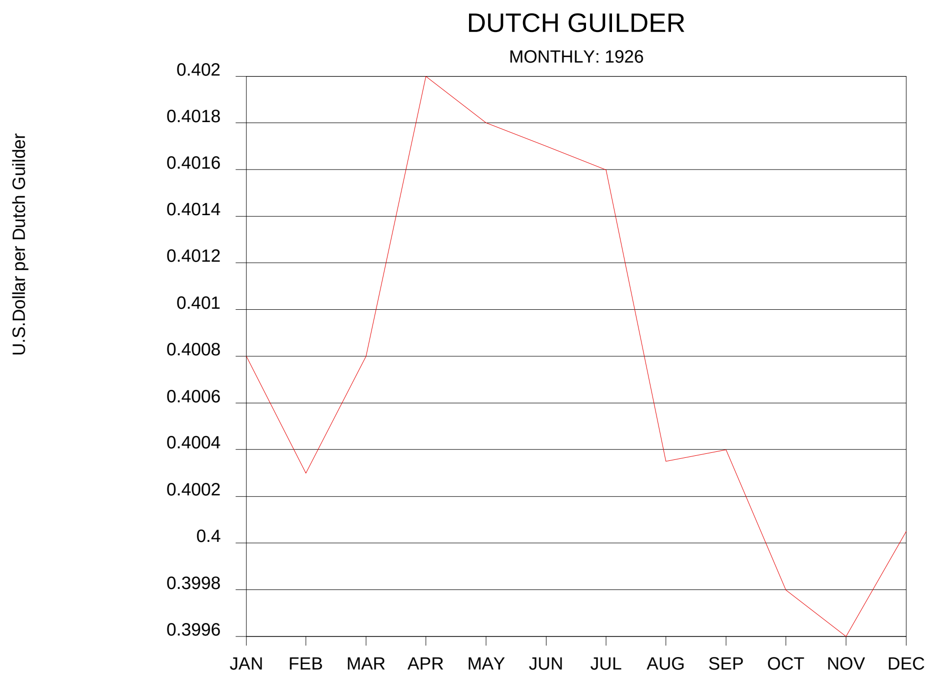
good, solid age of prosperity. These factors were true indeed. The U.S. was the world's banker in more ways than they knew. Everyone was floating their bonds on the N.Y. markets. Banking profits were quite impressive. All of the top ten banks had turned in record profits for 1925 precisely when credit and money were cheap.

Nonetheless, the market continued higher into January, reaching the 158 level on the Dow Industrial. February saw a new intra-day high testing the 163 level. But then the market began to break and February fell to close under 155. March continued to decline, as the normal correction after an 11-month bull cycle that culminated precisely during February.

Cyclically and technically, the market was due for a correction. All markets must correct even if only for one month after completing an 11-month bull cycle. Therefore, any bit of news would have been sufficient.

The news that came was Washington's rejection of a rail merger. The Van Sweringen brothers control led the New York, Chicago, St. Louis Rail road Co., The Pere Marquette, Erie, Chesapeake & Ohio, and the Hockling Valley railroads. They wanted to merge them to create what would have been one of the largest railroads in the U.S., saving the company $6 million in expenses. But Washington stated that the railroads were voted into a merger by the majority stock holders without consideration to the minority stockholders. Strangely enough, everyone was in favour of the merger. But Washington's denial of the application was excuse enough. Wall Street was in a state of shock and the main railroad stock of the group, known as the "Nickel Plate," fell 33 points the very next day. Had Coolidge broken his promise?

As the Ides of March rolled around, the market continued to crash. It was written up as the worst panic since the Rich Man's Panic of 1901 and the dismal days of April and May 1920. Despite the new records on



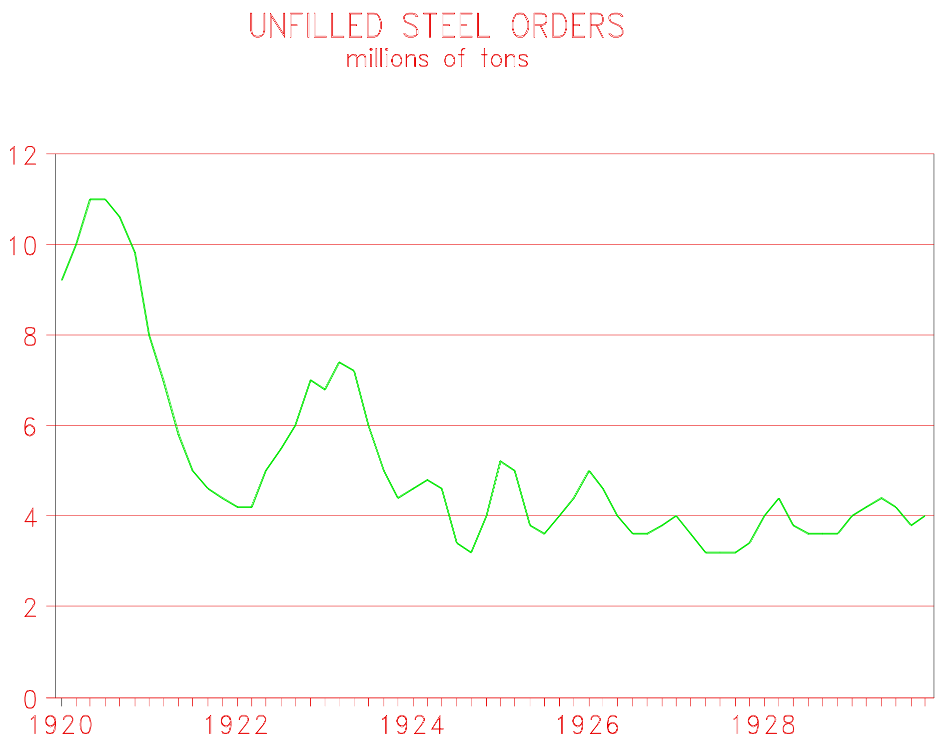
volume, which had been established on the way up during the fall of 1925, new records on the way down were established as volume reached 3.7 million shares for the day on March 3. The ticker was 52 minutes behind, which only fueled more panic. The banks rushed out to support their clients, yet during the whole affair business was not affected.

The broader market continued to decline into early April under heavy selling. Bad news seemed to pour out during March and April 1926. Although earnings were still up for 1925, many had been expecting even greater earnings for 1926, but now that seemed to be an incorrect assumption. Others pointed to rising business inventories and immediately proclaimed the end of the world was near. But steel production was still moving at 96% capacity. By the end of March, 125 issues had made new lows for the year.

Perhaps it was Senator Lenroot's polite threat to the Fed in late December 1925 that prompted an initial retreat from the scheme to artificially stimulate Europe through lowering U.S. interest rates. Whatever it was, the Fed raised the discount rate in January 1926 from 3.5% to 4%. The stock market did not interpret this hike in the discount rate to be bearish in January although it created some nervousness. The market continued to surge higher in February following the rate hike.

Again on the foreign exchange markets, the dollar dropped from a February high against everything except the French franc which continued to decline sharply into July 1926. Strangely enough the stock market had come to a halt along with the dollar.

Within the economy, several varied trends were taking place. Unfilled orders for U.S. steel had peaked at 5 million tons in December 1925. Although production itself remained high during the first quarter of 1926, it was merely catching up with the backlog of unfilled orders. That December 1925 high of 5 million tons would remain the peak until World War II.



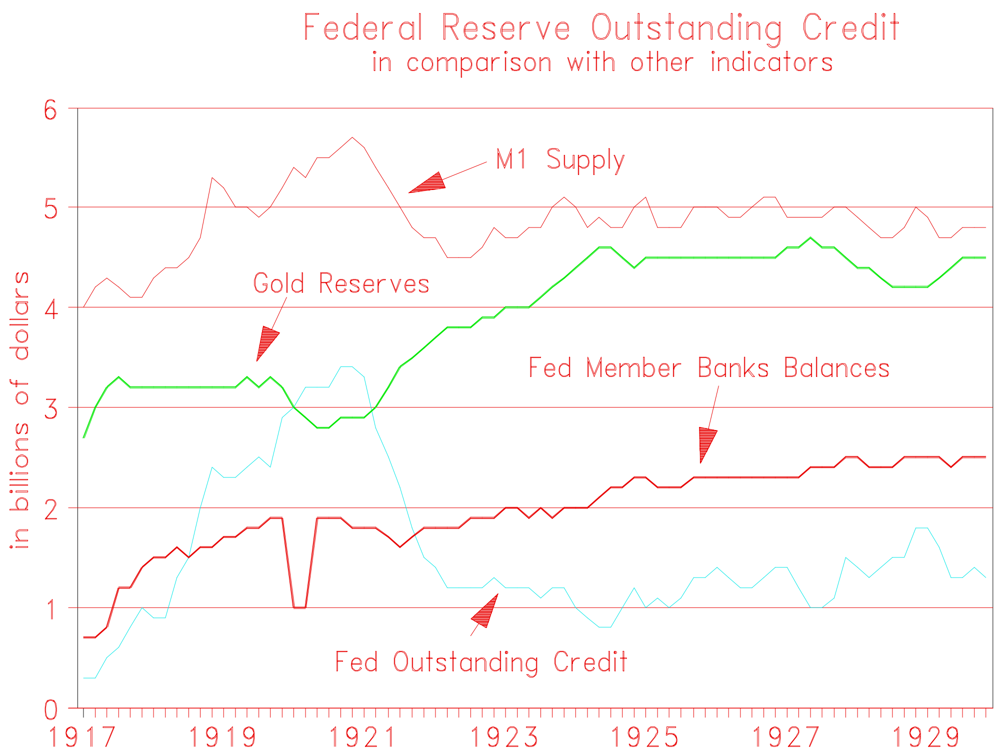
U.S. auto production, including trucks and taxicabs, had reached a temporary peak in January 1926 at nearly 440,000 units. This was the highest monthly production figure since the low of 50,000 units during January 1921.

On the banking scene, brokers' loans had reached a record high of $3.1 billion during January 1926. Total outstanding loans of reporting banks reached nearly $19.5 billion. In both cases, these were now above the corresponding record highs which had been established at the peak of speculation in 1919. Brokers' loans were then $1.5 billion and total loans of reporting banks stood at $16.5 billion.

The rate of change between brokers' loans and total loans clearly illustrated a growing sector of speculation. But as we will review in the years ahead, many corporations were shifting toward floating more stock rather than bonds. Had that not been the case, then total outstanding loans would have risen more dramatically to finance the wave of innovation and expansion which was underfoot during the Roaring 20s.

When we look at the money in circulation, reserve credit and bank balances in comparison to the gold stock and broker loans, a curious effect leaps out from the statistics. Note that total reserve credit peaked in 1920 at nearly $3.5 billion. Yet it peaked in December 1925 at $1.4 billion. Bank balances stood at record highs by January 1926, yet money in circulation remained well below its 1920 high. The expansion was not being financed by the Fed as much as from capital which was earned through the trade surplus as well as through the flight in capital to the U.S. from overseas.

The first quarter of 1926 was the only quarter during which the U.S. had moved from a trade surplus to a deficit. This deficit in trade came to a bottom with the stock market during March of 1926 and this never took place again, even through the end of 1932.



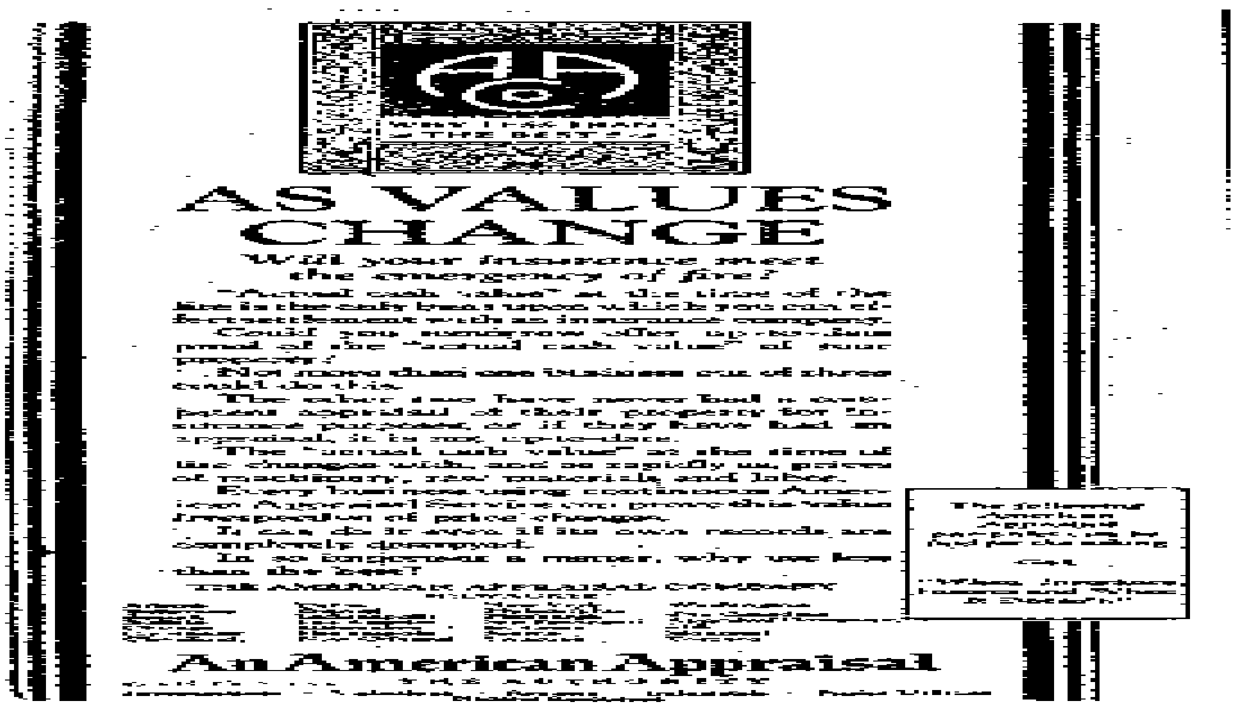
Virtually all commodities had peaked during 1925 and the first quarter in 1926 held only disaster for those markets. Silver had managed to rally back to 73 cents in late 1925. But 1926 saw a high form in January at 69 cents and a continued panic sell off brought the silver market under the low which had been established during 1921.

Around the globe, the stock markets did not respond in similar manners. In Japan, the peak came during February at about 110 on their index and this proved to be the final high. The Japanese market never exceeded its February 1926 high and continued steadily lower, eventually reaching bottom during July 1930 at 41.

In Italy, the stock market dropped into February and then rallied in March counter to the U.S. trend. Curiously enough, that March 1926 high was the final high for the Italian market which had reached 90 on their index. From there the market continued lower and a drastic low at the 60 level during June 1927. Further manipulation on the part of the central bankers in 1927 would aid this market in rebounding back to the 85 level during May 1928, but from there onward, the decline would eventually reach bottom at 39.9 during June 1932.

In Switzerland and Sweden, their stock markets rallied during the first quarter of 1926, pausing briefly when the U.S. market had supported, but their uptrends continued. Sweden witnessed a major high during 1927 while in Switzerland, the market reached its high during September 1928.

The British stock market declined throughout the first quarter of 1926, perhaps in response to the overvaluation of the pound. While the undervaluation policies of France were continuing to add a downward pressure on the franc, their market peaked briefly during February, declined into March, and then rose 30% in September 1926. The uptrend in France continued until the first quarter of 1928.



When looking at all the international aspects during the first quarter of 1926, one sees that this was the only quarter during which the trade surplus of the United States turned into a deficit and the dollar peaked during February. Therefore, the actions of the market during March seem to have taken place in conjunction with shifts in international trends, perhaps more so than with purely domestic influences.

During April 1926, the Fed at New York suddenly cut the discount rate back to 3.5%. Although there was no official comment, it seems that they perhaps took action due to the sudden swing from a trade surplus to a deficit. But during August of 1926, the Fed would raise the discount rate back to 4% where it would stand for one full year thereafter.

Government was still enjoying its power plays. The Ward Food Products Corp., a $2 billion operation, was forced to consent and surrender its corporate charter and to sever all relations that might suggest a monopoly. The anti-trust laws were being fixed more and more and this news was not looked upon very favourably by the stock market during the spring of 1926.

Taxation was also increasing. The latest invention was the gasoline tax. By 1926, all the states in the Union had imposed a tax on gasoline except New Jersey, Illinois, Massachusetts and New York. The revenues of the forty-four states which did collect the tax for 1925 added up to $146 million, which was up 83% over 1924, and up 450% over 1923 levels.

The stock market, after a swift and sharp kick in the pants, remained stagnant as stock prices hardly budged. Yet the steel and motor industries continued to rack up sales. Gillette bought two foreign companies in Germany and Austria to further push the Gillette safety razor. The N.Y. Fed suddenly lowered the discount rate from 4% to 3.5%. Call money rates fell to March 1925 levels, reaching 3%, and broker loans fell to 2.5%. Bond sales were brisk and new daily records were established while the stock market still licked its wounds.

Many had warned about massive business failures, but there were hardly any taking place, and in fact, failures were trending a bit lower than 1925 levels. By early May the New York Times reported: "In general the national industry has kept at a steady gait and seemingly will continue so. The stock market fluctuations did not truly reflect its condition."

The famous Otto H. Kahn was quoted during May 1926 and the words from such an important banker are still quite important today. He stated in May 1926:

"Episodes such as those which have marked the course of stock prices and so-called Wall Street sentiment...constitute a generally harmful nuisance. They also constitute a reflection on the steadfastness and sobriety of a portion of the community...The only circumstances under which, in a country with the resources, the resiliency and the basic elements of ours, a temporary descent into the cyclone cellar becomes warranted are - leaving aside grave foreign complications - either manifestations of stark and persistent over-production or over-trading, the advent of a major credit disturbance, or acute monetary stringency. None of these circumstances exists today or is even remotely likely to occur."

The commodities in general declined as well, though they did not stop in March but rather extended into April. Yet supplies in many sectors had dropped significantly from the previous years. During April 1925, for example, wheat was reported with visible stocks of some 50 million bushels, while in April 1926 the visible supplies had declined to 28 million. Nonetheless, most commodities from lead to rubber fell and established new lows for the year in April.

Despite the lowering of the discount rate from 4% to 3.5%, the stock market remained steady, showing little incentive to rally after the March blood bath. There was a marked flow of cash to Europe at this time through foreign loans. The French floated a huge loan and the proceeds were used in an effort to try to stabilize the French franc.

In Britain, strikes still plagued the nation. Coal miners, who throughout history seem to have struck every time they have had a chance, went on another rampage. Many in the U.S. were looking for coal exports to pick up sharply as they had in previous years, exporting nearly four million tons of coal to Britain. But this time the Brits really got out of hand. The strikers tried to effect a naval blockade. The Royal Navy was called out with trained guns ready and ordered to blow the strikers out of the water if they did not give up the effort.

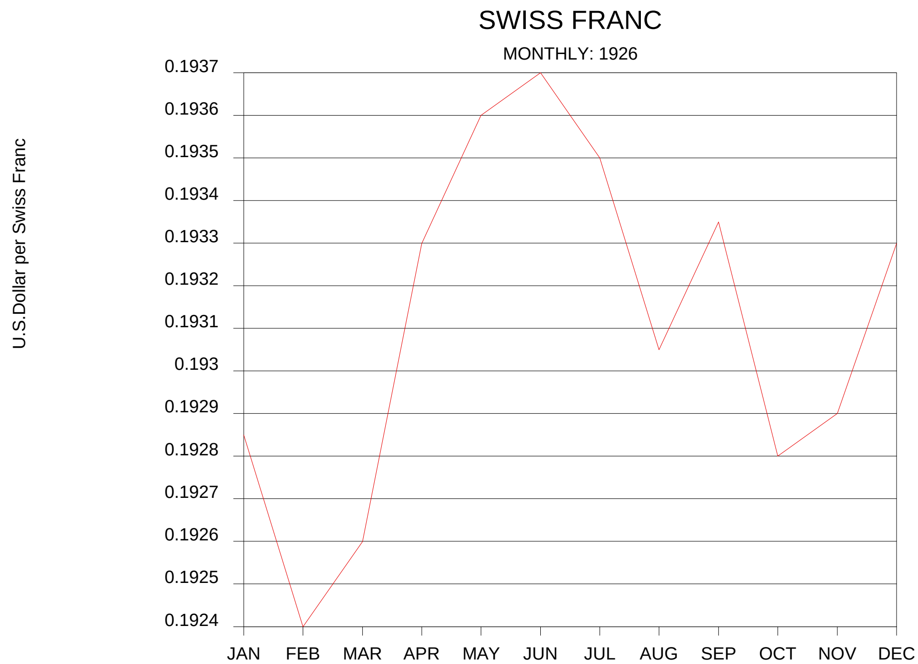
Europe's poor showing economically began to ring a few alarms. In May 1926, the U.S. bankers quietly withdrew a $100 million loan for Italy that had been headed up by J.P. Morgan & Co., syndicating the loan through 1,000 U.S. banks. After the bankers withdrew their support for the bond issue, it fell from 94.5 to 89 virtually overnight. This did not reflect an outright distrust of the numerous European bond issues but there was a concern about expanding these already substantial loans.

In Italy, the consumer price index was soaring. It had jumped to .34 in 1926 from .17 in 1919 (1980-100). Inflation had doubled during this time span. Exports had risen from 8.04 billion lira in 1921 to 18.54 in 1926. This was a peak in Italian exports which would never be reached again until

after World War II. Imports stood at 16.91 billion lira in 1921, rising to 25.88 in 1926. Exports had risen 130% while imports rose by 53%. Despite this improvement in foreign trade, the GNP had risen only moderately by comparison in constant lira terms of 18.8%. Inflation was rampant and far outpaced economic growth, drastically distorting the situation. From 1926 onward, the situation became worse.

In Germany, inflation seemed at last to be under control, registering merely 1% for 1926. Japan was already undergoing sharp deflationary pressures as their CPI dropped by nearly 8.6% during 1926. But in France, inflation was rising due to the drastic decline in the franc itself on world exchange markets. For the year 1926, inflation rose 17.6% over that of the previous year. But from 1921 levels, inflation was up sharply by 68.2%. British economic policy was still in overkill, forcing a deflationary period upon its population. Inflation had continued to decline as the pound rose in the face of declining commodities, further reducing their CPI from 1921 to 1926 by 17.7%. In the United States, inflation was almost non-existent. With 1980= 100 on the CPI, it stood at 21.7 in 1921 and by 1926 it remained at 21.5. Again this was largely aided by the relatively strong dollar against all other currencies except the pound and the decline in the overall commodity sector.

As June came on the scene, the stock market began to rally. Several banks had failed in Florida, which had experienced a tremendous real estate boom. In Boca Raton, Jesse Livermore, Thomas Coleman du Pont and a handful of others resigned from the directorate of architect Addison Mizer's 16,000 acre project, a deal worth approximately $40 million. People who had subscribed for lots owed $21 million and creditors pressed to force the project into bankruptcy. These events had a more positive effect on the stock market. The bad press that the Florida land boom had received made many skeptical about real estate investments and cash began to flow back toward the stock market once again. However, real estate related stocks continued to decline into July.



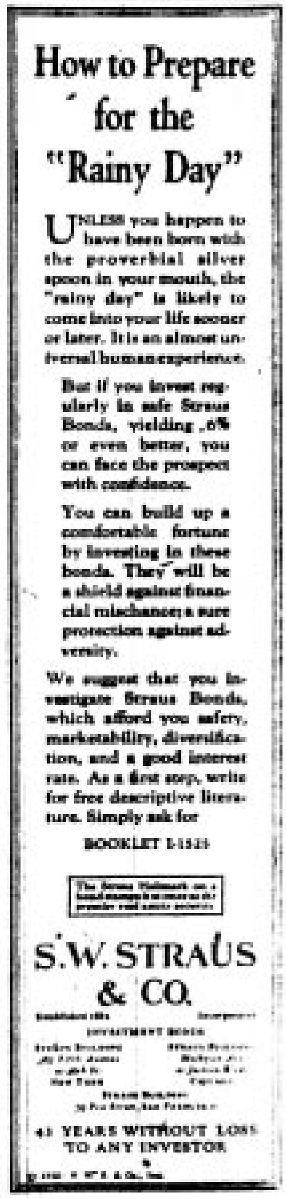
General Motors announced that it would spend $40 million, $10 million of which would be invested in a new venture that would prove to be a fantastic money maker for G.M. This new venture brought the establishment of G.M.'s Hertz Drivurself Corp. which would rent motors to the public. The news of the venture hit the streets and everyone was talking about how G.M. was going to make a fortune and at the same time become a major consumer of its own production. As the summer rally continued into August, the March low in GM. was 113 and the August high was 225.75.

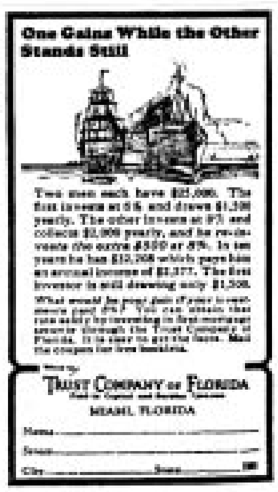
This summer rally was not just made up of G.M. Many other stocks did very well. Du Pont rallied from a spring low of 193 to 314; U.S. Steel from 117 to 156; and Hudson from 50 to 75. But Jesse Livermore was there. As a result, Time magazine, The New York Times and the Wall Street Journal all reported the rally skeptically and they doubted how much it truly reflected business conditions.

The truth of the matter was quite simple. Most companies were still showing prosperity with all-time record earnings. The velocity rate of money was up nearly 11% over 1925 levels. The money in circulation was $42.01 for every person living in the U.S. Yet steel production had backed off from the February high of 96% of capacity down to 71% capacity as unfilled orders declined.

The stock market came into a roaring high as G.M. declared an increase of 50% in dividends while the open market value of the stock had reached $1.8 billion. The Secretary of the Treasury also announced that there were 11,000 citizens who were worth more than a million and that 74 people had earned a total of $154 million in the previous year. Newspapers were filled with stories that caused many to dream about becoming millionaires.

The Dow Jones Industrials had been very choppy during the first halt of 1926. After rallying to a new record high during February, the March collapse was severe indeed,





posting a decline on the index of 17%. That panic in March was by no means the "normal" 5% correction that we hear talk of these days. The industrials had fallen from 163 to 135 and then during April they merely consolidated between 145 and 136. May posed an even narrower trading range between 144 and 137. June saw a rally from the 143.50 level up to 154 while July continued the trend, moving from 153.50 to 160.50. August then punched through to new highs for the year, reaching nearly 167, and the corrections that month all held above the July high of 160.50.

From the August 1926 high, the market began to drift sideways during early September, then suddenly dropped back to 156 during the final two weeks. October tried desperately to rally back over the 160 level but failed. Then suddenly the market went into another panic sell off, dropping back to 145.50 and barely closing October back above the 150 level. This time the market had corrected nearly 12.5% between the August high and the October low. Again, this was no mere 5% correction.

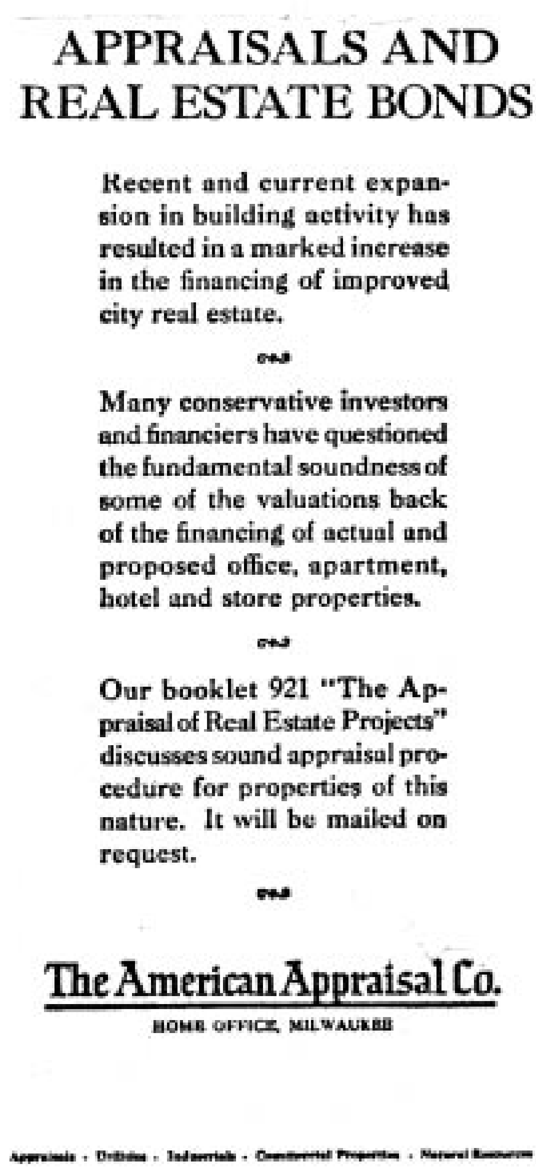
In the October 25 edition of Time magazine, the commentary on the market was as follows:

"The prices of stocks which began jiggling up and down a fortnight ago, bobbed more violently last week. There was a definite downward trend. One 'combined average' of prices estimated the general drop on the New York Stock Exchange at 2.93 points, the lowest since the 3.89 drop March 26, when many speculators were wrong. Bond prices rose in usual antithesis to stock drops. No underlying cause is yet discernible for this situation, especially since 250 leading U.S. corporations earned in aggregate $568,000,000 during the first half of this year. This, according to the American Bankers Association Journal, is 21% more than the $470,000,000 of last year's first half."

Here we find that Time magazine reflected a very important relationship which everyone accepted in those days. Note that Time clearly stated that the bonds moved up as the stocks moved down. This, they added, was a normal situation. This once again is strikingly different from how most people now view the bond market in relation to stocks. Back then, people would run into the bonds for shelter whenever the stocks became questionable. When stocks were very bullish, bonds would decline as capital left the bond market in favour of the stock market. This is a play which we strongly believe will be seen once again following 1985.

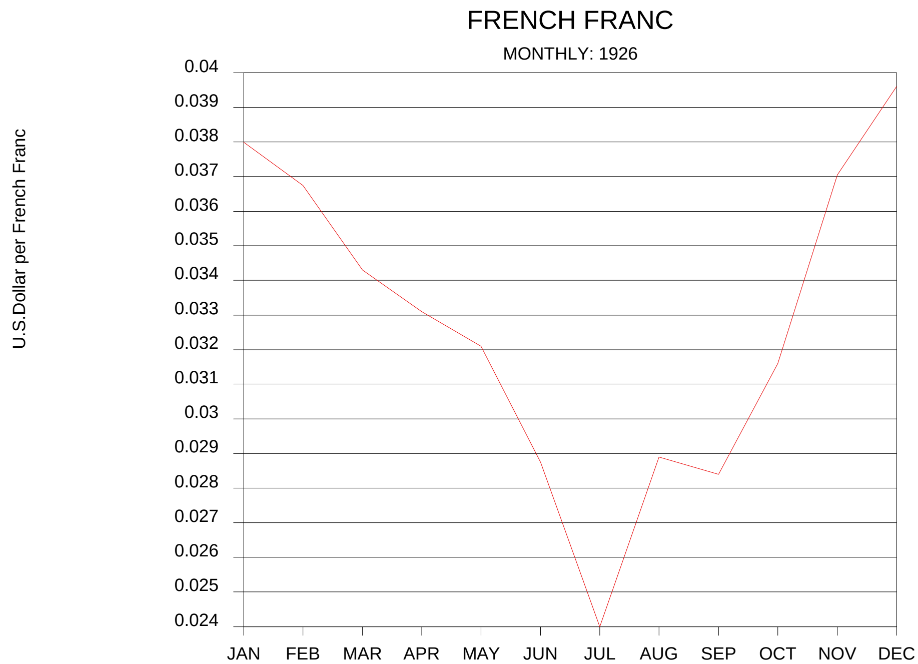
The amount of foreign debt floating upon the U.S. markets was quite large by this time. Some $11 billion dollars of debt were outstanding by the fall of 1926. Before the war, the trend in foreign investments had been for U.S. investors to place funds principally in Canada, Mexico or Cuba. But during the postwar years, Europe became the largest single debtor to the U.S. During 1913 there were only 11 foreign bond issues listed on the New York Stock Exchange. Now that number had grown to 145 issues. Some "frontier" bond issues in what is now Washington State were defaulted upon during 1926. But this by and large was overlooked by the bond investing public. Yet money continued to be cheap and abundant.

It is also important to note Time magazine's comment on earnings. They pointed out that corporate earnings were rising and underlying economic indicators were apparently indicating prosperity, yet the stock market corrected violently by 12.5% moving into October.



Unfilled orders for steel were beginning to rise from their June low. Auto production had rallied back, sharply peaking in August but not failing under 350,000 units going into October. This was contrary to normal seasonal conditions, which had produced a greater rise in production during that period in 1925 and 1924. This was the only excuse that the bears could find to talk about.

The French franc had dropped from its January 1925 high of 5.4 cents to 2.5 cents in July 1926. The dollar began to decline sharply against the franc between July and October 1926, dropping nearly 32% as the

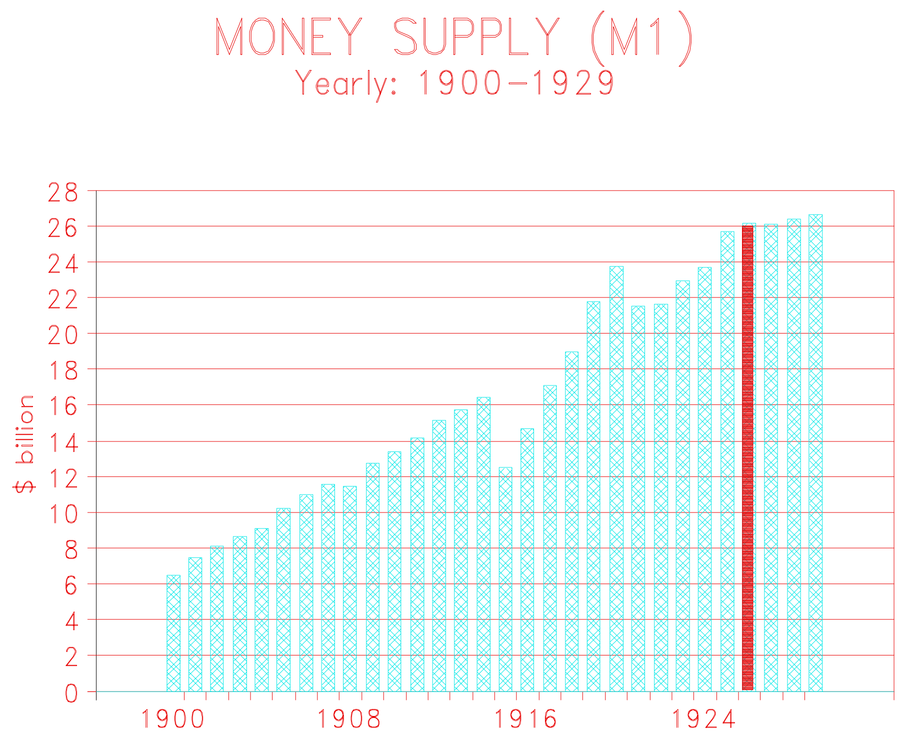


franc rallied. The Swiss franc remained steady as did the Dutch guilder but the pound actually began to decline during the fourth quarter of 1926.

Time magazine reported once again in their December 13 issue on the state of business affairs: "Investment bankers know that there is hoarded U.S. money yearning to buy safe securities, and corporations who need to borrow are learning this situation also. Borrowers are willing to pay less interest while investors are willing to accept less. Thus last week Standard Oil of New Jersey through J.P. Morgan & Co. offered $120,000,000 of debenture bonds at 5%. Morgan's merely opened their books and snapped them shut, for $500,000,000 in subscriptions tumbled in. Immediately, Standard Oil of New York offered $50,000,000 debenture bonds at 4.5% interest. Dillion Read & Co. bought them all up knowing that the bonds had a swift sale. Standard Oil of Now Jersey's yearly interest on this item will be $6,000,000. Had its bonds been sold at the 4.5% of its sister company's it would have saved $600,000 yearly in interest."

Many of the odd and unusual theories that I have developed in economics are based upon the study of events and how relationships come and go. One of those important rules concerns the creation of money. Most of the actual money created is done so in the private sector, whether it's on a gold standard or paper standard. The actual money supply was increasing during this period but the velocity in the turnover of money was rising on an average of 11% annually during this seven year period. Money was in effect creating money. The stock market value had doubled and this in effect doubled a portion of the money supply as well. People could borrow on the new higher values of those stocks and then take the borrowed funds and reinvest once again.

From the point of which we began looking at the stock market in 1921 until the end of 1926, the Dow Industrials had tripled in price. The economy was still expanding and innovation was high. Money remained



cheap despite the fact that the stock market had tripled. Foreign investment in the U.S. economy still ranked very high.

1926 had brought with it the beginning of Greyhound, G.M.'s introduction of Hertz and Pontiac, and Chrysler's launching of the Imperial. America moved more toward luxury cars, yet the Model-T was still a big seller for only $350. Broadway musicals were the rage, and this was a year of vast expansion and a rise in American pride. Although the summer rally had been blamed on good old Jesse Livermore, the bull market would still prove that it wasn't finished just yet.