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An introduction to investment

Case example 3 of 5: Shocks to the system

Here you can see some examples of sharp interruptions to the economic cycle, and why they occurred.

This case example is linked to the tutorial **Capital markets and economic cycles**.

The Pensions Regulator

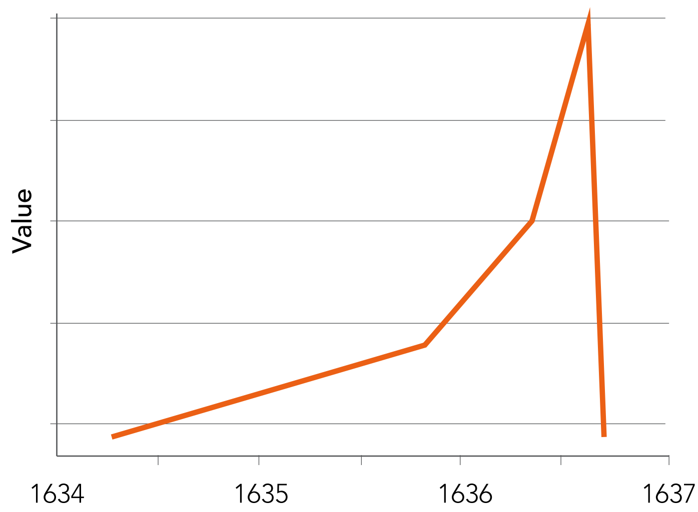
Three interruptions

As you know, economic cycles tend to run in seven to 10 year periods. However, history has shown that the predicted run of the cycle can sometimes be rudely interrupted. Three examples of this are:

- Tulip fever
- the South Sea Bubble
- Black Monday.

Tulip fever

This chart shows the consequences of a strange craze in Holland in the 1630s which brought many to ruin.



A single tulip bulb

In 1593 a man called Guestner bought a tulip bulb in Constantinople, and took it back to Holland. In a few years, tulip bulbs had become a status symbol, highly sought after by the rich and famous in Holland and Germany. To begin with, only connoisseurs bought them…

The fever grows

…but soon, speculators looking for quick profits started buying them too. Tulip exchanges, rather like stock exchanges, sprang up.

By 1630 everybody was buying tulip bulbs, hoping to make their fortune. There was no question of planting them. They were traded – for land, livestock, farms and savings.

Madness reigns

At one point it took all of these items to buy one tulip bulb:

- four tonnes of wheat and eight tonnes of rye
- one bed
- four oxen, eight pigs and 12 sheep
- one suit of clothes
- two casks of wine and four tuns of beer
- two tonnes of butter and 1,000lbs of cheese
- one silver drinking cup.

A cautionary tale

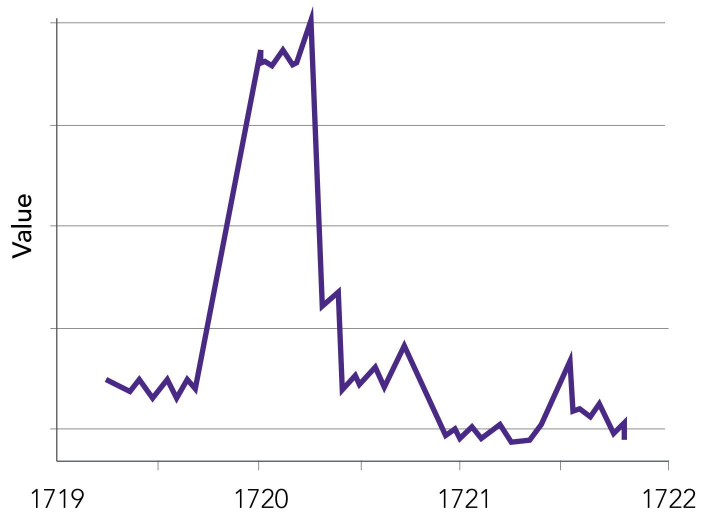
A man went into a bar and began to peel and eat an onion lying on the counter. But it wasn't an onion. It was the owner's tulip bulb. The man went to jail for many years.

All ends in tears

Some people sold their tulip bulbs, others harvested theirs and the supply grew. Soon tulip bulbs weren't rare any more. The market plummeted as people panicked. In just six weeks, the market crashed. Fortunes and lands were lost.

The South Sea Bubble

This chart shows the change of values in South Sea shares during one of the worst blips in the economic cycle ever.



Blowing the bubble

In 1711, after a war which left Britain in debt by £10 million, the government had a bright idea. It proposed a deal to the South Sea Company. The company would finance the debt in return for 6% interest. In addition, it would have exclusive trading rights in the South Seas – giving it access to the wealthy South American colonies.

The bubble forms

The South Sea Company issued stock to finance operations and gain investors. Trade in shares was brisk from the start, and so the company issued even more.

The company appeared to be successful. Attracted by its image, investors didn't care that the management team was inexperienced. They were greedy for South Sea shares, and the price went rocketing up.

The bubble gets bigger

The management team of the company started hyping the stock. They started rumours that they had full use of Latin American ports. (Actually, Spain only allowed three ships a year. But the speculators didn't know that.) Other companies tried to build on the boom. Among the things on offer were building floating mansions and distilling sunshine from vegetables. The speculators gobbled it up.

The bubble bursts

In 1718, war between Britain and Spain started again. The South Sea directors knew their company was not making any profit. So they sold their hugely overvalued shares. Investors noticed this and panicked. They frantically tried to sell their worthless shares and many fortunes were lost. The stock market crash had started and all other shares plummeted in value at the same time.

The aftermath

The British government avoided a banking crisis because of its international standing. The issuing of shares was outlawed to prevent any future bubbles. This law was in effect until 1825. Some historians maintain that, after the South Sea Bubble, the economy took 100 years to recover. The South Sea management, meanwhile, had fled to other countries with their vast fortunes.

Black Monday

The stock market crash of 1987 is often remembered as one of the biggest economic disasters of modern times. But was it? This chart shows changing share values between 1986 and 1988.

How did it start?

In the summer of 1982, an extremely powerful bull market started (equity prices rising, buyers more predominant than sellers). Over the next five years, the atmosphere in the commercial world was frantic, illustrated by the fact that companies scrambled to raise capital to buy each other out.

Companies of little value sold bonds with high interest rates (often described as junk bonds). The money raised by doing this could be used to buy another company.

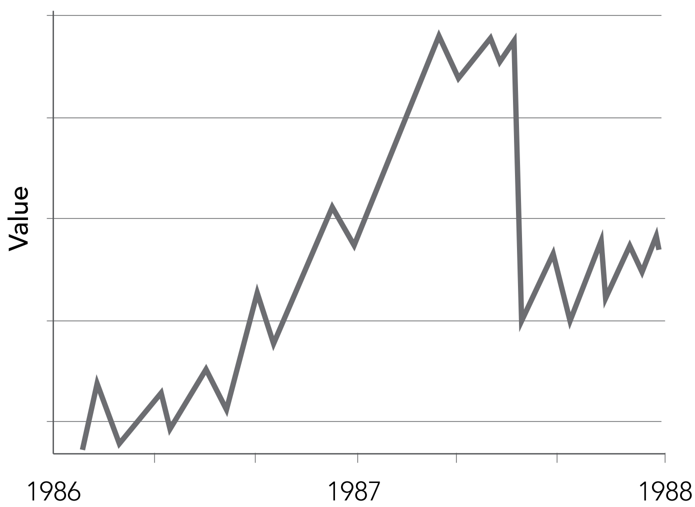
Why did it crash?

The reasons are complex, but basically, the stock market became unstable. People tried to sell their shares and the market couldn't handle so many orders at once. What was more, the new computer systems had not been tested against these circumstances and could not cope with the level of activity.

Whatever the reason, most people couldn't sell because there weren't any buyers left.

A blip, not a fall

If you look at the chart of the 1987 crash, you'll notice something interesting.



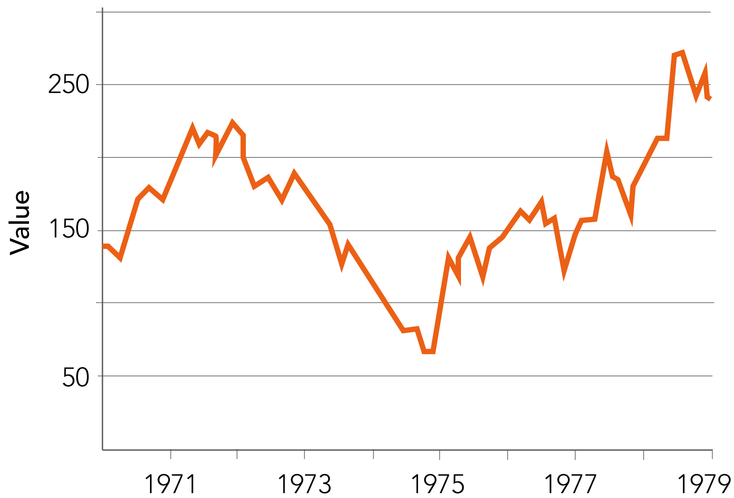
By the end of the year, the market had recovered to the level it had been in January the same year. Black Monday was a bad day for many individuals, but the market as a whole survived quite well.

The 1970s slump

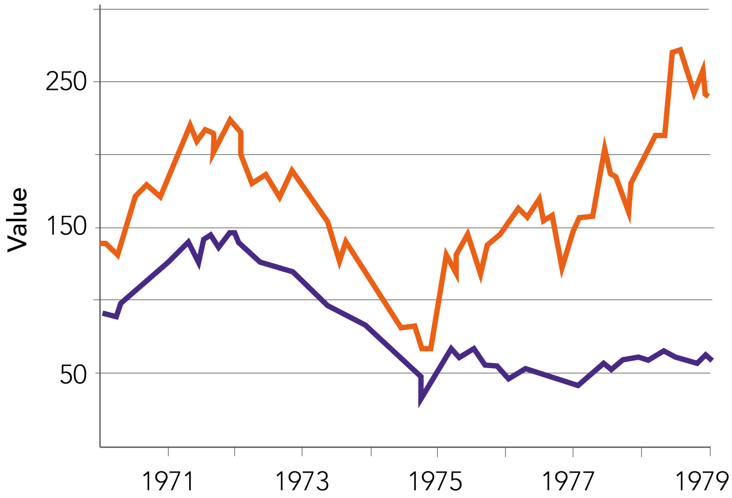
In the 1970s there was a slump in share prices. This one, unlike those in the previous examples, was not related to speculation fever. Also, unlike the previous examples, it illustrates the risks investors run with inflation and the importance of taking inflation into account.

Unlike the previous examples, it was not caused by speculation fever. It was the result of, among other things, rising oil prices and soaring inflation.

If we create a line graph to show the share prices between the years 1970 to 1979, we would see that there was a dip around 1975 and then the market recovered. But the recovery was not as strong as that line suggests.



This bottom line now shows the top line adjusted for inflation, which peaked in 1978 at 25% per annum. In real terms share prices did not get back to the 1972 value until the mid 1980s.



Compare this to 1987 when, despite Black Monday, the market at the end of the year was pretty much where it had been at the beginning.

You have now reached the end of this case example.

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