The Journal of Portfolio Management

What Caused the Mess?

Peter L. Bernstein

Hysteresis is a word from physics that means a retardation of an effect when the forces acting upon the body are changed. Whoever invented the word and studied the process ignored its power over human beings through changing times. Hysteresis is at work all around us; for example, during the changing seasons of the year. When summer yields to autumn and temperatures begin to drop, lots of people still walk around without overcoats as though summer were still with us. The opposite occurs when winter yields to springtime and temperatures begin to warm up, but the overcoats are still in evidence for a while. These are homely examples of "a retardation of an effect when the forces upon the body are changed."

Great capital market waves and economic regimes are also subject to hysteresis, which helps explain the supermess that has afflicted the world economy. For example, memories of the Great Depression deeply influenced the conservatism of both economic policy and capital market behavior long after World War II was only a memory. Consider my own career. My father's untimely death in 1951 led me to become an investment counselor. At that time only two members of my college class were in Wall Street—and both of them were, like me, sons of Wall Street fathers (one classmate was J. P. Morgan III). How many people reading this essay can match that?

By the early 1960s, however, the hold of hysteresis on the system broke down. All the old codgers from Depression days had died off or retired, and a new generation with no nightmare memories began to swarm into Wall Street. The old 1929 high had finally been surpassed in November 1954. In 1958, bond yields rose above dividend yields for the first time in history. From the end of 1959 to the end of 1969, real GDP rose at an annual rate of 4.3% a year with CPI at only 2.5%. No wonder P/Es soared to an average of 18X in that decade compared with only 12X in the preceding 10 years.

Then "a retardation of an effect when the forces acting upon the body are changed" became a powerful force in this environment. Who saw cause for concern when inflation from the end of 1966 to the end of 1969 averaged 3.5% and was up to 5.9% in December 1969? Memories of the recent combination of delights blinded investors—and Federal Reserve chairmen—to the pernicious and ultimately fatal consequences of refusing to choke off inflation at birth rather than waiting until it was almost totally out of control. It took another 10 years, to the onset of Paul Volcker's single-minded attack on the price level in 1979-1980, before anyone confronted the magnitude of the hurricane of inflation the authorities had allowed to develop. But then hysteresis took over in the other direction. Treasury bonds remained in double digits until the final months of 1985, even though inflation by that time was running around 3.5%.

Hysteresis lies at the heart of the financial crisis now gripping the global economy. By 1990, memories of the Great Inflation had faded and those few investors who had the most vivid memories of that era were old fogeys, unable to understand the new world of disinflation, maestros at the Fed, and globalization. We passed through the savings-and-loan crisis, the Asian monetary crisis, the Long-Term Capital Management crisis, and the Russian government debt default without any lingering consequences. Those scary events were just blips on a smooth sea. Globalization, Goldilocks, and the Maestro promised an eternity of low risk that justified taking high risks and leveraging up all along the line, from securitized subprimes to CDOs in the zillions.

There are those who argue the Fed was the villain of the piece by creating too much liquidity. Liquidity may have been a necessary condition for the wild disregard of risk that overtook the system, but liquidity was not a sufficient condition. The consequences would have been much milder without the power of hysteresis that preserved the glittering memories of the years from 1982 to 2002, or thereabouts. Thus, hysteresis—"a retardation of an effect when the forces acting upon a body are changed"—was the sufficient condition for the greed and vast underestimation of risk whose consequences haunt us at this very moment.