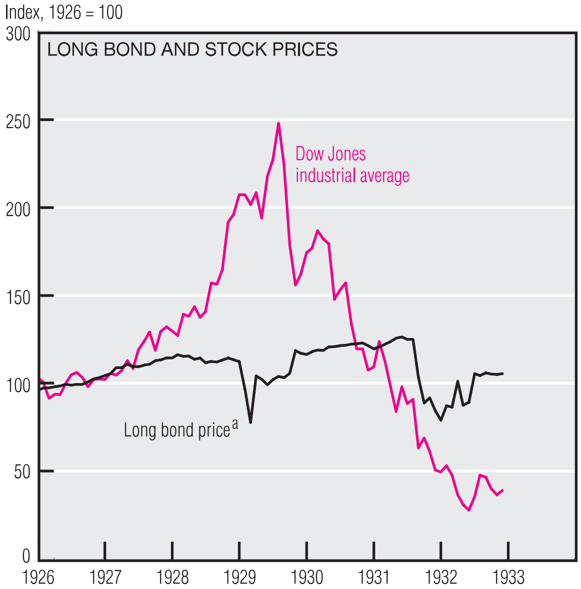
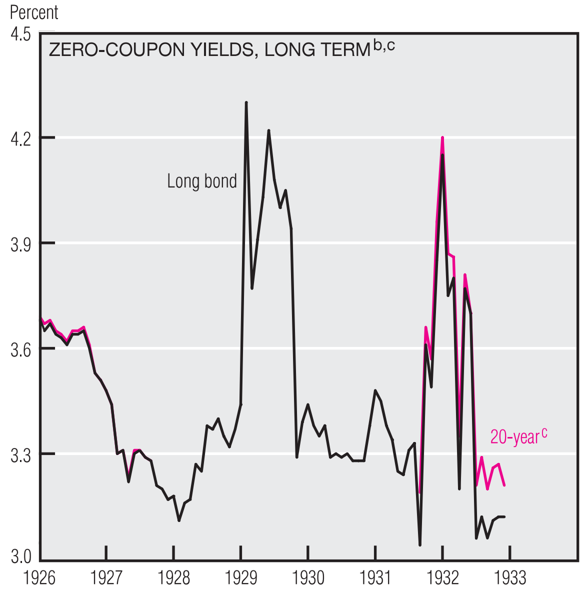
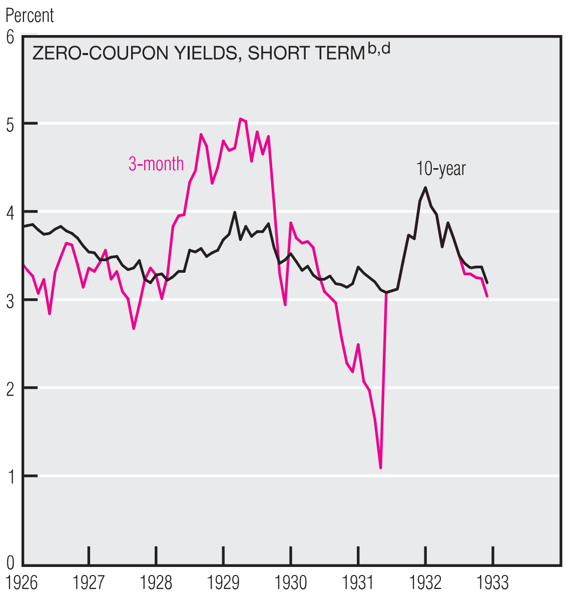
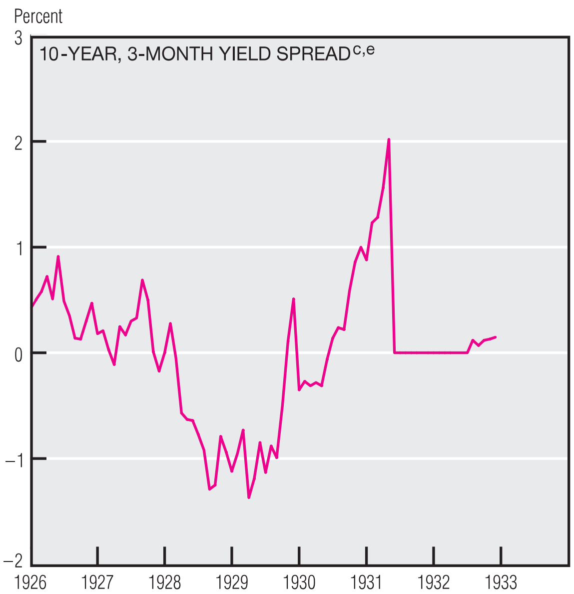
Interest Rates in the 1920s









a. Estimated price of zero-coupon (discount) long bond is partially tax-exempt.
b. Estimated spot rates of zero-coupon yields are partially tax-exempt.
c. Data for the 20-year zero-coupon yield are missing from October 1927 to August 1931 because of data limitations.
d. Estimated spot rates of the 10-year and 3-month zero-coupon instruments are set equal from June 1931 to July 1932 in the primary data source because of data limitations.
e. Estimated spot rates of the10-year zero coupon minus the estimated spot rate of the 3-month zero coupon. Both are partially tax-exempt.
SOURCES: Thomas S. Coleman, Lawrence Fisher, and Roger G. Ibbotson, *Historical U.S. Treasury Yield Curves*, 3d ed. Chicago, Ill.: Ibbotson Associates and Moody's Investors Service, 1993; and Phyllis S. Pierce, ed., *The Dow Jones Averages*, 1885–1990. Homewood, Ill.: Dow Jones & Company, 1991.

The prolonged bull market has renewed investors' curiosity about the 1920s, as many recall George Santayana's warning that those who cannot remember the past are condemned to repeat it. Much of the current attention focuses on factors underlying the stock market boom and the possibility of asset price inflation in equities; however, the bond market also provides some useful lessons.

The first notable point is the relative performance of the two markets. With the average for 1926 set as an index value of 100, bonds kept pace with stocks only until the middle of 1927. Throughout 1928 and 1929, bonds' performance was unspectacular, and they lost a third of their value in early 1929. This proved a blessing later, as bond prices stayed firm until late 1931 and then dropped much less precipitously than equity prices.

The flip side of bond prices is interest rates, and it is clear that 1929 was a year of high ones. Many people attribute this to speculators' intense demand for funds to invest in the booming stock market. Short rates increased more than long rates, creating a large—and sustained—inversion of the yield curve, a harbinger of the depth and duration of the coming depression. We should be cautious when we interpret this inversion, however, remembering that the strongly positive yield curve of 1931, traditionally a precursor of strong future growth, instead preceded far worse deterioration in the economy.