BLACK MONDAY STOCK MARKET CRASH 1987: CAUSE AND IMPACT

[Case Study]

36 years ago, something almost unthinkable occurred in the global stock market: On October 19, 1987, the Dow Jones Industrial Average experienced a massive drop, losing nearly 22% in just one day. As the market started with the opening bell with the new week on Monday, the market dropped drastically, thus making it *“Black Monday”*

This market crash was so out of the ordinary that, statistically, it was considered a 22 standard deviation event, making it one of the rarest events after the 1929 Market Crash.

Now, how rare is that?

To put that in perspective, top economists at that time had crunched the numbers and concluded that even if the stock market had been operating since the dawn of time, the likelihood of witnessing such a steep decline in a single day would still have been astronomically low. It was so improbable that even if we repeated the entire universe's history a billion times over, a crash of that magnitude would still be considered 'unlikely'.

And yet, against all odds, it did happen.

What Was Black Monday?

Black Monday has a special significance in financial history. It refers to the dramatic and unexpected global stock market crash on October 19, 1987. Every stock market in the world opens a new trade on Monday, the first day of the week. Similarly, the market opened on Monday, October 19, triggering a massive fall due to several reasons.

Interestingly, the event is also known as Black Tuesday in countries like Australia and New Zealand due to time zone differences. That day, around 23 major global stock markets plummeted, sending shockwaves through the global financial system.

Markets were tumbling left and right. From Malaysia to Mexico and New Zealand, markets across the world saw 30 to 39% declines. Hong Kong, Australia, and Singapore were hit even harder, with their markets diving over 40%. Austria fared slightly better, with a relatively mild drop of 11.4%, but Hong Kong went with a burn of a 45.8% fall.

19 out of 23 major stock markets of the world were in the red, experiencing a drop of more than 20%.

The total damage?

A jaw-dropping estimated loss of nearly US$ 1.7 trillion occurred. The scale and suddenness of this crash were so severe that it had everyone on edge, fearing a potential rerun of the Great Depression of 1929. But what triggered the market fallout in 1987? Let's find out!

Causes of Black Monday in 1987

In 1987, when the stock market nosedived, there wasn't a single headline-grabbing event that weekend which could've caused such a frenzy. Instead, it was the culmination of various elements that collectively fueled an atmosphere of investor panic. Let’s unwrap the factors behind the panic selling.

- **Overdue Market Correction:**

A primary driver behind Black Monday was a robust bull market that had persisted since 1982. Over this period of 5 years, stock prices had not just risen but tripled, indicating an overdue need for a significant correction.

- **Emergence of Program Trading:**

Program trading removed human control by making automatic buy or sell orders based on stock prices. This often caused a loop: buying more when prices increased and selling more when they fell. During the 1980s, Wall Street firms were increasingly adopting computerised trading, creating a more volatile market at that time.

- **Role of Portfolio Insurance:**

Black Monday saw a method called portfolio insurance used to safeguard stock investments. It involved using computer programs to sell stock futures if prices fell to prevent big losses without selling the actual stocks. When prices dropped, these programs started selling stocks, causing a chain reaction of more sales of stocks. As the market kept falling, more sell orders were activated, and fewer people wanted to buy, worsening the situation.

- **Impact of Triple Witching:**

The Friday preceding Black Monday, October 16, witnessed the simultaneous expiration of stock options, stock index futures, and stock index options – an event known as "triple witching." This led to extraordinarily high volatility in the final trading hour on Friday, followed by significant sell-offs in after-hours trading.

- **Role of Mass Panic:**

Additionally, geopolitical tensions, such as the standoff between Kuwait and Iran threatening oil supplies, added to the investor unease. The media's role in amplifying these developments has also been scrutinised. While various theories attempt to decode the reasons behind the crash, a common consensus points towards mass panic as a critical factor in escalating the crisis.

Impact of Black Monday on Different Countries

The Black Monday crash on October 19, 1987, was a global stock market event that had varying impacts on different countries, reflecting their unique economic and monetary policies.

- **Hong Kong, Singapore, and Australia:**

These markets, which had been experiencing rapid growth and speculation, suffered heavy losses of more than 40%. The impact was aggravated by liquidity problems as foreign investors withdrew funds, creating a cascading effect on the market values.

- **Europe:**

European markets also faced significant downturns. For instance, the UK's FTSE 100 Index fell by 26.5%. This crash exposed vulnerabilities in the European Monetary System, particularly its attempt to maintain fixed exchange rates among member countries. France, Italy and other countries were forced to devalue their currencies to manage the market pressures.

- **Japan:**

The Japanese market was relatively less affected, with the Nikkei Dow Jones average dropping by 13.2%. Japan's strong domestic economy and stable currency buffered it against the worst of the crash. However, this event contributed to the formation of a speculative bubble in Japan's stock and real estate markets, which eventually burst in the early 1990s.

- **United States:**

The US market, despite experiencing the largest one-day percentage drop in the history of the Dow Jones Industrial Average (22.6%), recovered relatively quickly. The Federal Reserve's response, including lowering interest rates and providing market liquidity, was pivotal. This quick recovery helped the US economy continue its growth trajectory until the 1990-1991 recession.

- **New Zealand:**

New Zealand took a unique stance by refusing to loosen its monetary policy in response to the crash. This approach, aimed at combating inflation and maintaining a high exchange rate, led to more profound and long-lasting negative impacts on its financial markets and real economy, exacerbating the recession and increasing unemployment.

The aftermath of Black Monday was a wake-up call to the financial industry, leading to significant regulatory changes, including the introduction of circuit breakers and trading curbs in stock exchanges worldwide. These measures were designed to prevent excessive volatility and promote orderly market conditions.

Impact of Black Monday on India

When Black Monday shook the world in 1987, India's experience differed greatly from other nations.

Interestingly, the Indian stock market, particularly the BSE Sensex, showed remarkable resilience during this period. Unlike the steep plummets seen elsewhere, the Sensex only dipped by about 2.5% on October 19, 1987.

What's more, it bounced back within just a week! This was largely because the Indian market was relatively underdeveloped at the time and was not yet open to foreign investors, which insulated it from the immediate shocks experienced globally.

Fun fact:*India was just three days away from one of its biggest festivals, Diwali, on October 22.*

However, Black Monday did have indirect effects on India:

- **Pressure on the Indian Rupee:**

The crash amplified the existing challenges for the Indian rupee, which was already grappling with a balance of payments crisis. The government found itself cornered into devaluing the currency by 18% in 1988 and had to seek assistance from the International Monetary Fund (IMF).

- **A Push for Reforms:**

The crash exposed several inefficiencies and vulnerabilities in the Indian financial system. It lacked essential aspects like proper regulation, transparency, and technological support. This situation served as a wake-up call, highlighting the urgent need for reforms and liberalisation in the Indian capital market.

- **Opening Up the Economy:**

Perhaps one of the most significant impacts of Black Monday on India was its influence on the government's decision-making. It played a role in the Indian government's historic move in 1991 to open up the economy and the stock market to foreign investment and competition. This was part of the New Economic Policy, which set the stage for a period of rapid growth and development for the Indian economy and its stock market in the years that followed.

What Happened After Black Monday?

After Black Monday, the Federal Reserve took swift action to stabilise the economy. They cut interest rates by 0.5%, aiming to make it easier for people and businesses to borrow money. This move was part of their strategy to boost spending and lending in the economy. Additionally, the Federal Reserve pumped billions of dollars into the economy through a process known as quantitative easing, which essentially means buying up financial assets to increase the money supply and encourage lending and investment.

To tackle the kind of rapid market decline seen on Black Monday, regulators also put new safeguards in place. One significant change was the introduction of 'circuit breakers' in major stock markets. These are like emergency brakes that automatically stop trading if prices start falling too fast.

These circuit breakers are set to kick in at different levels of market decline. In the U.S., for instance, if the S&P 500 index drops by 7% from the previous day's close, it triggers what's called a Level 1 halt, pausing trading for 15 minutes. A 13% drop activates a Level 2 halt, also stopping trading for 15 minutes. If the drop reaches 20%, it's a Level 3 situation, and trading halts for the rest of the day. The idea behind these measures is to prevent panic selling and give traders a moment to breathe and reassess, hopefully avoiding a market freefall.

Can Black Monday Happen Again?

The possibility of another event like Black Monday happening again is extremely rare.

Since the 1987 crash, financial markets have evolved significantly, becoming more regulated and efficient. One of the major changes implemented post-Black Monday is the introduction of "circuit breakers" in stock markets.

However, the financial markets have also become more complex. While safeguards like circuit breakers reduce the likelihood of a crash identical to Black Monday, they don't eliminate the possibility of major market downturns entirely. History shows us that significant market downturns have occurred multiple times since 1987, such as during the dot-com crash, the 2008 financial crisis and the COVID-19 freefall, although these were different in nature and scale.

The key takeaway for investors and financial advisors is to focus on how to react when significant market downturns occur. Emotions can heavily influence investment success, and selling out of fear can lock in losses. Effective planning and considering periods of below-average market returns are crucial. It's also important to stress test investment plans to see how they would perform during market downturns. Each market downturn in history, including Black Monday, has eventually seen a recovery where markets reached new highs.

So, can another Black Monday happen again? The answer is not straightforward. While exact repeats are less likely due to new regulations and mechanisms, the financial markets' inherent unpredictability means significant downturns can still occur, potentially triggered by unforeseen factors.

Key Takeaways for Investors From Black Monday

Market crashes underline the importance of understanding market dynamics, maintaining a long-term perspective, and having a robust investment strategy to navigate through periods of financial turbulence. The principles below are crucial in ensuring investors can withstand market fluctuations and achieve their long-term financial goals.

- **Market Crashes Are Temporary:**

History shows that markets tend to recover after a crash. For instance, the sharp declines in August 2015 and January 2016 were followed by strong recoveries, indicating the temporary nature of such downturns.

- **Importance of a Long-Term Strategy:**

A well-thought-out, long-term investment strategy can provide the confidence needed to stay the course during market volatility. Investors without a clear strategy might make decisions based on emotions, which can lead to unfavourable outcomes.

- **Market Crashes as Buying Opportunities:**

Savvy investors often view market crashes as opportunities to buy stocks or funds at lower prices. They prepare a 'shopping list' of attractive stocks to buy during these downturns.

- **Tuning Out the Noise:**

Over the long term, events like Black Monday become minor blips in the performance of a well-structured portfolio. It's beneficial for long-term investors to ignore short-term market noise and media sensationalism, focusing instead on their investment goals.

- **Other Instances of 'Black Monday':**

The term has been used to describe other market crashes, not just the one in 1987. For example, October 28, 1929, marked a significant market drop that contributed to the Great Depression. The term also applies to the August 24, 2015, flash crash due to economic concerns about China and, less commonly, to the market crash on March 9, 2020, driven by the uncertainty of the COVID-19 pandemic.

Market volatility is a natural phenomenon due tothe day-to-day workings of the economy. But such crashes teach a lot about the fundamentals of the stock market. Another such market crash happened again in the early 2000s. Read on to the next chapter and learn about the massive 76% fall in NASDAQ created by the infamous dotcom bubble.

Case Breakdown Podcast Reference:

https://youtu.be/o5DEJ7j4O2o