The Great Unwinding Spreads Into 2009

"There. Now. I look up, I look down. There's nothin' to it." – Jimmy Stewart in *Vertigo*

The financial world has spent nearly all of its time since July 2007 in a reprise of Jimmy Stewart's scene wherein he tries to overcome his fear of heights in by stepping on increasingly higher chairs. We looked up in September-October 2007, again in February 2008 and April-May 2008 and one more time in August 2008. The looking-down episodes of August 2008, November 2007, and January, March, July and most horrifically September 2008 produced fainting episodes in many. The question of whether the world is headed into or can avoid a variation of the 1930s Great Depression moved off the fringes and into the mainstream of conversation.

By the time that month was over, the American financial landscape had completed the loss or transformation of Bear Stearns, Fannie Mae, Freddie Mac, Merrill Lynch, Lehman Brothers, AIG, Washington Mutual and Wachovia; both Morgan Stanley and Goldman Sachs transformed themselves into commercial banks during that month. The credit crisis extended into short-term debt markets: LIBOR jumped to a record-high spread over Treasury bills, commercial paper lending evaporated and even money-market mutual funds were so threatened the federal government moved to extend deposit insurance thereto.

Geologists for years have debated about gradualism versus catastrophism; the former would allow the Grand Canyon or the Straits of Gibraltar to be formed by long-running scouring actions, while the latter has these features being formed in spasms of nearly unimaginable violence. Most geologists and indeed most evolutionary biologists recognize a process called "punctuated equilibrium." Here a catastrophe occurs, such as an asteroid smashing into the Earth, changing the landscape in a most rude fashion and opening up millions of ecological niches. As the late biologist and essayist Stephen Jay Gould termed it, evolution is not so much the product of the survival of the fittest as it is the survival of the luckiest.

Here the fossil record is clear. Catastrophes wipe out the most intricate and ornate ecosystems, such as coral reefs and tropical rainforests first. If you are big and complex, you also are toast, possibly literally. If any of this sounds applicable to the exotic derivative chains and mortgage-related financial products that collapsed first and brought on the credit crunch or to the collapse of the Wall Street dinosaurs, it is quite by design.

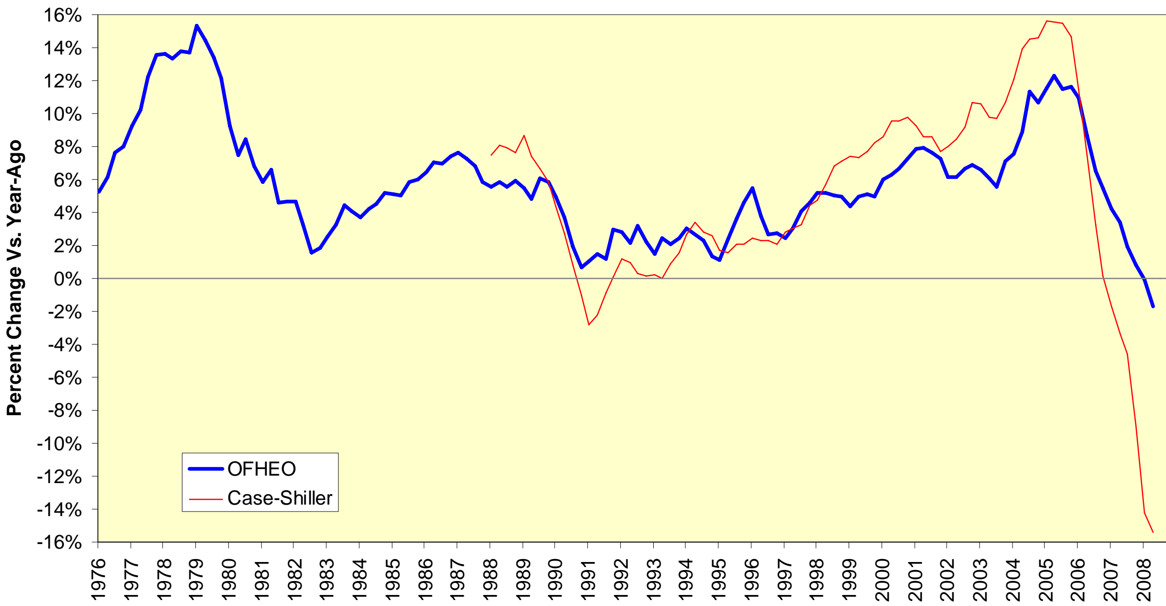
The Real Estate Asteroid

As a point of reference in case anything looks strangely obsolete or incomplete, this is being written in early October 2008, just after the passage of the Emergency Economic Stabilization Act of 2008, better known as the $700 billion "troubled assets relief program," coupled with another $100 billion or so of Congressional pork barrel spending snuck in at the last minute. That program was designed in large part to stabilize financial markets; its passage did nothing to stop a global financial market crash in the hours – yes, hours – and days after its passage.

If you are reading this, you did not get clobbered by the asteroid, and we do offer our congratulations. But you are living in a world dominated by the catastrophic deleveraging of what had been a credit bubble years in the making; no blame will be assigned as that bubble had many creators and enablers, and the exercise would simply be unproductive.

What is important to understand is just how much the credit crunch and its economic impact derive from the inflation and bursting of the residential real estate bubble. As housing prices are not particularly suitable for indexation given the role of a unique factor, location, in their determination, there is no one agreed-upon national measure of what housing prices have done over a given period. A comparison of the Office of Federal Housing Enterprise Oversight's House Price index and the Case-Shiller 20-city National Composite index is presented in Chart 1. The Case-Shiller indices, which underlie a group of futures contracts at the Chicago Mercantile Exchange, are based on a three-month rolling average of repeat sales over twenty metropolitan areas; the OFHEO index uses a national sample of repeat sales for single-family properties whose mortgages were purchased or securitized by Fannie Mae or Freddie Mac since January 1975.

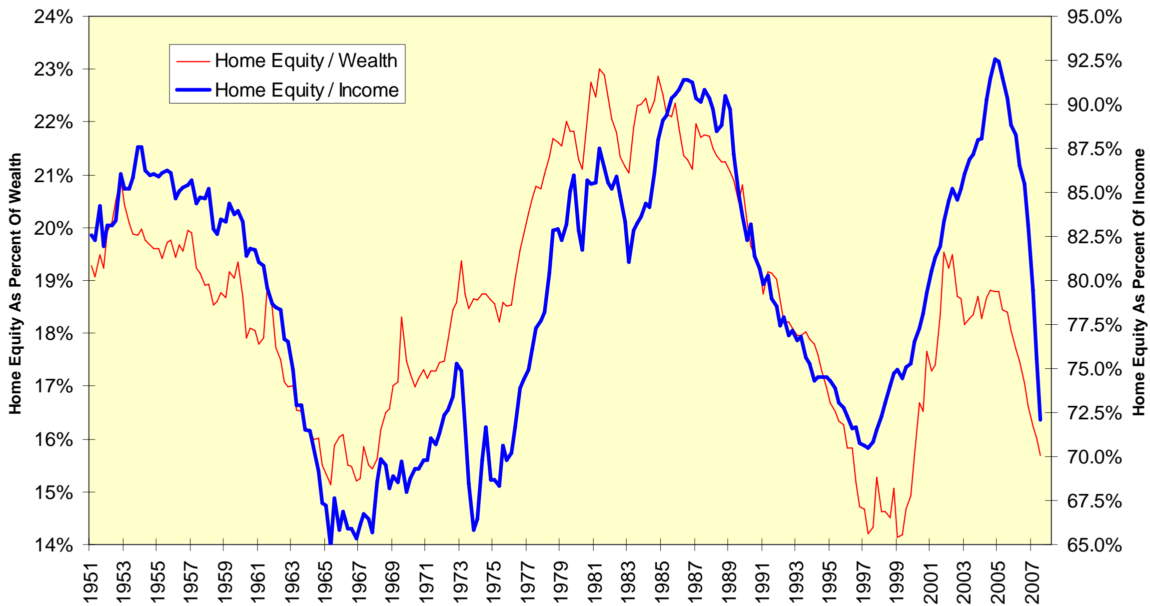
Chart 1: The Housing Price Decline



Even though housing prices peaked in the summer of 2006 and the first global market selloff related to the bubble occurred in February 2007, few people understood how the problem would reverberate through the financial system and the economy. It was considered at first to be a problem of sub-prime mortgages, those issued to borrowers whose credit was questionable. By the summer of 2007, the problem expanded to Alt-A mortgages often referred to as "liar loans" for their light documentation of borrowers' income, assets and employment status.

As more and more homeowners, both new buyers and existing homeowners borrowing against the equity in their homes stretched themselves (see "MEW And You," November 2007), the percentage of homeowners' equity declined sharply. The data in Chart 2, taken from the Federal Reserve's Flow of Funds reports, are current only through the second quarter of 2008. As home prices continued to fall after June 2008, it is safe to say the downtrends continued.

Chart 2: Homeowners Became More Leveraged



Loss Of Bank Capital

There is always an important distinction to be made between data and information in this business. We are awash with data, and it would be quite easy at this point to flood the remainder of this discussion with the most recent economic data and reports. Let it be sufficient to say the world had been tipping into recession since early 2008. Every indicator of importance, including employment, retail sales, industrial production and all financial market indicators have turned negative at the time of this writing and will continued their downward momentum into 2009.

The recessionary trend in 2008 was masked somewhat in the U.S. by the effects of the federal income tax rebates to qualified individuals and by strong exports in the first and second quarters. Both of those effects disappeared in the third quarter. The stimulus payments merely borrowed future consumption and placed it in the second quarter; export growth was an artifact of an overly weak dollar and strong demand from overseas markets destined to disappear. The destruction of household wealth in real estate and in financial assets underway by mid-2008 showed up in increased demand for savings as opposed to consumption and investment. Just as John Maynard Keynes noted in the 1930s, this demand to for cash balances as opposed to investment and consumption leads to the classic outcome of a negative sum game: Each player's attempts to maximize his or her welfare leads to a loss of welfare for the group as a whole. Keynes also noted low interest rates were an ineffective policy tool in such a "liquidity trap" environment as the excess cash simply would be hoarded.

As Karl Marx noted, "Hegel remarks somewhere that all great, world-historical facts and personages occur, as it were, twice. He has forgotten to add: The first time as tragedy, the second as farce."

The macroeconomic trends in place were accelerated by the shrinking financial system. Once again, the data lag behind their observable manifestations. By early October 2008, a tabulation kept current by *Bloomberg* had direct banking system losses in excess of $585 billion plus another $80 billion from non-bank/brokerage sources of $80 billion. These totals do not count the losses suffered by Fannie Mae and Freddie Mac, hedge funds, private equity players, pensions and endowments and insurance firms. Those totals push the recognized losses in the financial system north of $800 billion. Estimates of the ultimate losses to be suffered vary, but numbers of $1.2-1.3 trillion seem likely.

The financial system was able to raise about $435 billion in new capital, leaving it $365 billion smaller. If we use a very conservative banking leverage ratio of 10:1 – and 14:1 may be more appropriate considering how the financial system had been operating – this $365 billion translates into $3.65 trillion in lost financial leverage. And that is a conservative estimate; the losses to come after October 2008, the actual leverage employed and the risk aversion engendered by the credit crunch surely will reduce financial leverage by more than $5 trillion against an annualized GDP of $14.3 trillion at the end of the second quarter of 2008.

Policy Responses

Even though we should try to avoid the blame game, we should point out how policy decisions can compound the catastrophic returns earned by many of those who invested in failing entities such as Bear Stearns and make the task of raising new financial system capital much more difficult. First, common shareholders in entities such as Fannie Mae and Freddie Mac understood from Day One they were at risk. Preferred shareholders, including many smaller banks that held those shares as part of their capital base, never thought they were at risk of complete loss or loss of their dividends, and yet that is what happened during the September nationalization. Second, the shotgun marriages arranged by the Federal Deposit Insurance Corporation of banks such as Washington Mutual not yet in insolvency signaled investors any capital in financial institutions was at risk to complete loss. Third, the ban on short-selling of a large list of stocks by the Securities and Exchange Commission disrupted equity trading mightily; we must not the worst declines in the stock markets occurred during this ban, and no one should be surprised. Blatant market manipulation seldom works as intended. Finally, the ad hoc nature of many of the government responses increased uncertainty dramatically at the very time when the market needed more certainty.

Overall, though, the extraordinary efforts by the Federal Reserve, ad hoc or otherwise, to inject reserves into the banking system and to lend directly to corporations for the first time since the Great Depression may have avoided an even worse implosion of the banking system. Whether it changes the final course of events or just the timing of those events remains to be seen, and may not be known for years.

What we can state unequivocally is the events of September-October 2008 constituted nothing less than a revolution, albeit one led by the existing government in an absent-minded fashion. The U.S. and indeed much of the world will be operating with an effectively nationalized financial system, one where decisions are made by politics as well as economics, for years to come. The days of exotic financial engineering, 30:1 leverage ratios and huge paydays are in the rearview mirror. Get used to it.

Effects On Markets
Where will all of this take us in trading in the year ahead? The answers are given with a massive grain of salt and in no particular order.

First, the disarray in financial markets produced by the bankruptcy of Lehman Brothers and the near-collapse of AIG emphasize the need for exchange-traded and centrally cleared credit default swaps. The world cannot afford the information vacuum in this crucial arena linking corporate bonds and stocks (see "Stocks Float On A Sea Of Bonds," December 2005).

Second, the inevitable slowdown in industrial demand should keep a lid on commodity costs. Much of the 2003-2008 rally in commodities was driven by rising Asian demand, and if global consumers are less wealthy, these primary producers will be hurt as well. Moreover, as commodity prices fall, producers have a tendency to sell at prices below the marginal cost of production in an attempt to cover their fixed costs.

Third, the enormous extensions of credit by the U.S. other governments will lower the quality of sovereign debt. Once asset sales are completed and the reality of recession sets in, the world will be faced with a huge pool of reserves looking for a home. The inflation, paradoxically, might show up in equity prices as shares of future profits may look like a better store of value than either real assets or government debt. Of course, all bets are off if the gloomiest economic forecasts come to fruition.

Fourth, the stresses in Europe pose a real threat to the stability of the euro. Milton Friedman mused the common currency might not survive Europe's first real recession, but let's hope it does. The costs of its collapse would be unimaginable.

Fifth, the revolution will continue politically within the U.S. Even though this is being written before the November elections, it seems clear the country is in shock over what it regards as a systemic failure. The average investor has made no money in U.S. stocks for a decade and feels as if everything he was told and then did served him poorly. The temptation to swing toward greater government intervention in the economy and greater control over financial risks will be high. Historically, this does not end well, but revolutions are messy processes. The New Deal consensus lasted well into the 1980s. For that matter, all world history since 1914 has been little more than a footnote to the start of World War I.

The years to come will witness a psychological struggle between those who accept this newer, poorer reality and deal with it and those who remain in denial and hope they somehow will be transported back to a better place and time. The former group will be much better off in all senses of the term and will be positioned to ride the inevitable recovery higher.