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Global Credit Crisis: Past and Future Perspectives

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Key Take-Aways:

- *The current market sell-off has been agonizing for investors. But the markets do recover, often in stronger form, as they always have in the past.*
- *This crisis is most similar to the Savings & Loan crisis of the late 1980s/early 1990s and the Long-Term Capital Management/Russian Debt Default crisis of the late 1990s.*
- *This crisis is unique due to more globally connected markets, the use of highly leveraged, yet opaque financial products, and the expansion of non-traditional players acting as both lender and investor.*
- *We may be nearing an inflection point, making it critical that investors use discipline over emotion in managing their investment portfolios.*

A Repeat Performance-Sort Of

The sharp sell-off in stocks this week may have alarmed many investors, but keep in mind our economy and the US financial markets have been through periods of crisis before. While each time is uniquely painful, these periods are generally necessary to unwind excesses. And in every case, the markets and our economy have not only recovered, but tended to emerge stronger. The current crisis is reminiscent of the Savings and Loan (S&L) debacle of the late 80s and early 90s. At that time, S&Ls used deposits from savings accounts to fund mortgages. A large number of these institutions became insolvent when rising interest rates pushed their cost of deposit funding up while their mortgage loan assets were deflating on the backs of a sliding housing market. The insolvency of a large number of S&Ls ultimately caused the government to establish the Resolution Trust Corporation which became responsible for systematically taking on and working out the bad S&L assets. And an RTC-type solution is resurfacing today as a potentially effective way to deal with the current credit crisis.

While most like the S&L debacle, today's crisis also has similarities to another crisis in late 1998 caused by the failure of a large hedge fund called Long Term Capital Management. LTCM's meltdown was prompted by, among other things, the use of highly leveraged fixed-income and derivative instruments and Russia's default on its bonds. That crisis was similarly global in nature, not only causing the U.S stock market to fall nearly 20%, but also taking European markets down by some 35%.

Past Financial Crises: S&P 500 Performance

			Performance (from trough)	
Event	**Duration (months)**	**Peak-to-Trough Decline (S&P 500)**	**12-months after**	**18-months after**
1987 Stock Market Crash	4	-33.5%	22.8%	43.8%
Savings & Loans Crisis (1990-91)	3	-19.9%	29.1%	37.4%
LTCM Collapse (1998)	2	-19.3%	37.9%	40.8%
Avg. Past 11 Bear Markets (1945-2002)	13.0	-30.4%	30.0%	36.6%
Current Financial Crisis / Bear Market (2007-08)	11	-26.1%	--	--

Source: Bloomberg

What's Different Today?

Financial markets today are significantly more globally intertwined, in terms of both lending and investing. The proliferation of repackaged and leveraged products has resulted in greater complexity and far less transparency around the underlying collateral value and counterparty risk supporting these activities. Meanwhile, the pools of capital needed to support lending (via credit markets) and investing (via equity markets), and ultimately drive economic growth and value-creation, have diffused beyond the traditional U.S. banks and brokers to become more global and varied in nature. These players now include hedge funds, private equity companies, and sovereign wealth funds (SWFs), all of whom often play the roles of both lender and investor. Against that backdrop, the response to woes at Lehman, Merrill and AIG on the heels of a Fannie and Freddie bailout was an immediate and full blown freeze on any desire by market participants to provide capital to the system. This in turn reduced short-term dollar liquidity which further exacerbated the situation.

Wringing Risk Out of the System

We view the events of this past week as likely representing a key and perhaps near-final "deleveraging" of the current global financial system. Looking back, we have been through a period since the late 1990s of financial institutions taking on increasing amounts of risk, without, it would now appear, being adequately compensated or protected for that risk. And as this realization has become apparent throughout this credit crisis, the system's "risk-taking" appetite is being unwound. Recognizing the heightened global inter-dependencies of financial markets, Central Banks across the U.S., Europe, Canada, and Asia acted quickly, and in concert, to the growing crisis with a response that pumped $247 billion in U.S. dollar denominated liquidity into the system. While this move has seemingly calmed markets in the short-term, we think a longer-term solution will come in the form of increased government regulation of all types of capital providers in an effort to improve global financial system transparency.

Are We There Yet?

The big question on investors' minds is how low can financial markets go? The S&P 500 is down about 26% from its October 2007 high (a bear market is defined as a decline of 20% or more). Past bear markets (as shown in the previous table) have yielded average declines of about 30%. While painful, there are reasons to believe this may be an inflection point in terms of approaching a market bottom. We stand firm in our belief that this crisis will prove to be part of the bottom-forming process and that recovery is likely to take the shape of a "bumpy" U rather than a V. One key indicator we monitor is a sentiment gauge – the Chicago Board Options Exchange's VIX, or volatility, Index – which is showing negative sentiment levels approaching those seen around other significant turning point events, including the end of the 2002 bear market, the September 11, 2001 terrorist attacks, and the 1998 LTCM crisis. These crises have often coincided with periods of economic weakness and bear market troughs. And our data shows that 12-18 months after the trough of past bear markets, the S&P 500 is up 30-36% on average.

Now What?

We believe the best approach, even in turbulent times, is to take a long-term view and stick to discipline, not emotion, when making investment decisions. The stock market has a long-term upward bias, despite periods of extreme market turmoil. So now is a good time to take a fresh look at your portfolio to make sure it is aligned with your long-term goals. If you are re-evaluating your risk tolerance in the midst of this crisis, we would advise that the best way to manage risk in portfolios is through diversification. And use this global financial markets sell-off as an opportunity to build in additional strategic diversification by potentially adding asset classes that you may not currently have exposure to but which will likely provide improved risk-adjusted portfolio returns in the future.