SFA
Santa Fe Advisors

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Ten Years After

September 15th marked the 10 year anniversary of what many observers cite as the nadir of the 2008 global financial crisis: the date that investment bank Lehman Brothers filed for bankruptcy protection, the largest such filing in US history. While stocks would fall for another 6 months (the S&P 500 would ultimately drop 57%), the Lehman filing dealt a crushing blow to investor sentiment, and set off waves of panicked selling of assets perceived as risky…into markets with few buyers. Financial historians will debate for years whether policymakers exacerbated the crisis by not "bailing out" Lehman, as they did other large financial institutions during that period.

All financial crises tend to have commonalities: mispriced assets supported by excessive leverage, followed by a collapse in confidence and forced selling. All of these basic elements were present in the years preceding 2008. Factors specific to that period included:

*Regulatory policies intended to increase home ownership in the US resulted in taxpayer-subsidized capital flowing to high-risk borrowers, contributing to a housing price bubble and subsequent collapse.

*Excessive financial sector leverage, particularly at global investment banks which were heavily reliant on short-term funding. Rapid innovation in derivative financial products (which outpaced regulatory oversight) contributed significantly to systemic leverage. In many cases, perverse compensation systems encouraged excessive risk taking.

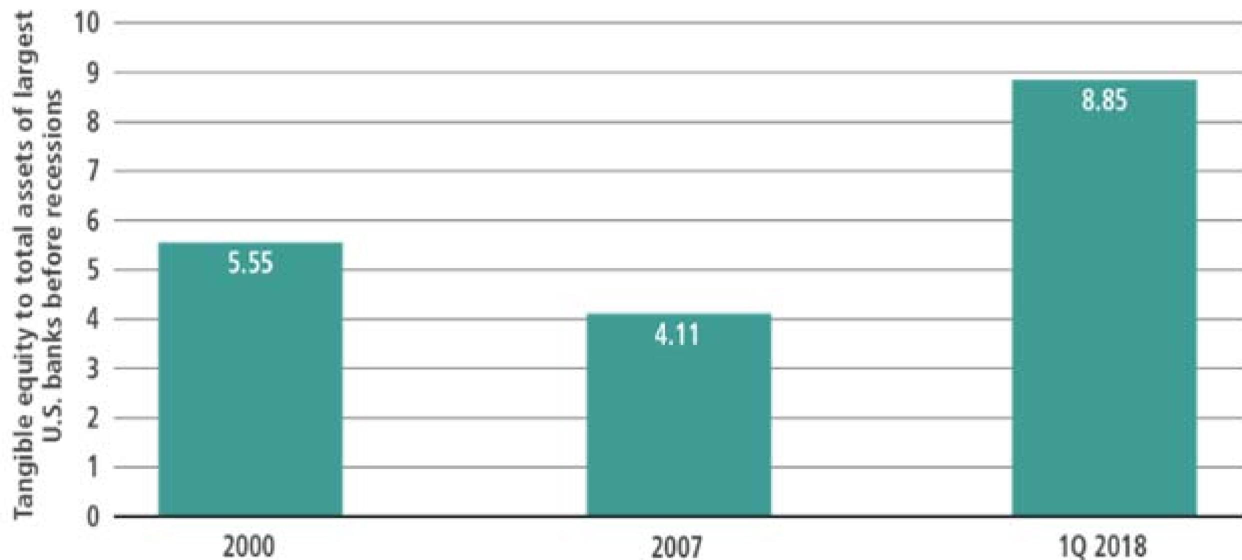
*Cyclical human behavior, which caused investors to take excessive risk in a low yield environment, compounded by flawed bond ratings by conflicted credit rating agencies and (arguably) overly accommodative Fed policy.

*Ill-advised international bank capital standards, which weakened banks by encouraging them to lend aggressively to fiscally profligate governments, particularly in Europe.

The crisis resulted in a dizzying sequence of events, including the failure or under-duress acquisition of several large US financial institutions (including Bear Stearns, Merrill Lynch, and Washington Mutual), and government intervention to prevent further failures. As the crisis spread globally, central banks responded by aggressively cutting short term interest rates, flooding the banking system with cheap money in an ultimately successful effort to avert a financial collapse. They also embarked on a (less obviously successful) exercise called Quantitative Easing (QE), which involved printing money to buy bonds, in an effort to spur economic activity by lowering long-term interest rates.

While collapse was avoided, it was not without cost. A generation of savers reliant on fixed income was hurt by artificially suppressed interest rates. In an echo of pre-crisis policies, QE has enabled governments to dramatically increase debt levels at subsidized rates that free markets would not permit. Additionally, cheap money increased the appeal of risky assets such as stocks and real estate, and may have fueled bubbles that could result in severe future market corrections. The end of the crisis ushered in a decade that has richly rewarded investors willing to take risk: since bottoming in early 2009, the S&P 500 has returned over 400%.

In many ways, the current environment is a much safer one for investors, particularly in the US. Whereas there have been several regulatory missteps (including heavy-handed policies that crimped post-crisis bank lending), the recapitalization of the US banking system has been quite successful. Graph 1 shows that US banks have far more capital than before the last two recessions; this lower leverage represents a significant buffer that should mitigate the next economic downturn, and make a severe crisis far less likely (though a significant market correction remains a distinct possibility).



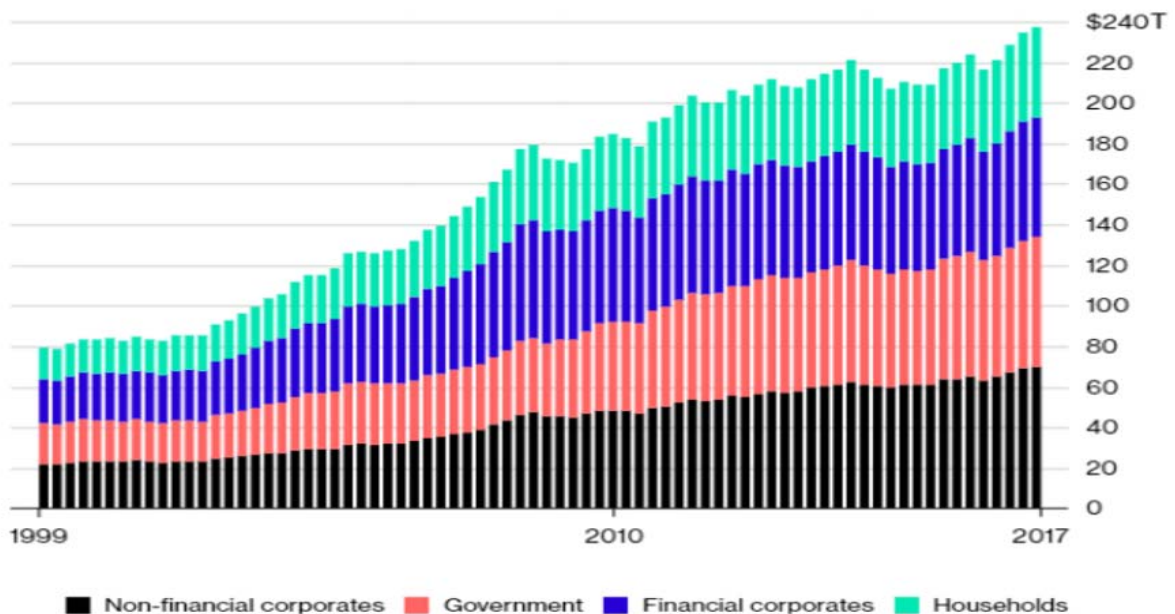
Source: PIMCO

The US is enjoying a powerful acceleration in economic growth, with strong job gains and corporate profit increases, and multi-year highs in consumer and business confidence, prompting Fed Chairman Powell to recently comment that the US economic outlook is "remarkably positive." While there are signs of late-cycle excesses in credit markets and real estate prices have stalled in a few pricier cities, there are few signs of an imminent recession - noteworthy since the US stock market rarely drops significantly during an economic expansion.

While global growth has decelerated in recent months, the expansion remains very broad based, and the IMF expects a record low number of countries to be in recession in 2018. Graph 2 shows that over 97% of world economies are experiencing expansionary conditions, as measured by composite (manufacturing and services) purchasing manager surveys.

Source: Haver, World Bank, GSAM

Against these positives are several obvious market risks, one of which is elevated US stock valuations. The S&P 500 currently trades at a 21x the previous 12 months' earnings, which is about 25% above the long-term average. Higher stock valuations mean higher risk, particularly as rising rates make bonds an increasingly attractive option. Another is rising global debt, which now exceeds pre-crisis levels, even adjusted for economic growth. Graph 3 shows aggregate debt, and demonstrates that leverage has shifted from the financial and household sectors to government and non-financial corporations.



Source: Deutsche Bank, Neuberger Berman

Another risk is the potential for a protracted global trade conflict. However, as we pointed out in our April commentary (Risk Cuts Two Ways – 4/17/18), most issues involve both upside and downside investment risks. When sentiment regarding trade risk became overwhelmingly negative in the spring, actual risk began to skew to the upside in the form of either fears not materializing, or the potential for better trade deals. The recently agreed NAFTA replacement (USMCA) represents the former; and a potential trade breakthrough with China would represent the latter. During the second and third quarters, US stocks returned over 11%, highlighting the importance of sticking with an appropriate investment strategy, while ignoring daily headlines.

As always, the greatest risks tend to be those that are not apparent, as those are the risks that are not reflected in current market prices. Indeed, 10 years after the Lehman failure, the last chapter on the 2008 financial crisis has yet to be written: we have yet to see whether central banks can successfully "normalize" these easy money policies, withdrawing the enormous monetary stimulus without triggering excessive volatility.

We are maintaining portfolio risk close to our neutral targets. We have a modest underweight position in stocks, with holdings skewed toward Emerging Market equities, which this year have dramatically underperformed the US and are now attractively priced. We also have an overweight position in floating rate debt, which should benefit if interest rates continue to rise. I will largely refrain from making tortuous analogies to legendary guitarist Alvin Lee, whose band inspired the note's title (*central bankers would love to change the world, but don't know what to do?*), in lieu of recommending watching one of the band's videos at high volume. Sadly, Mr. Lee passed 5 years after.

Thank you for your trust and confidence, and please contact a SFA team member with any questions

David E. Marion, CFA
Partner
(505)501-6201
dmarion@santafeadvisorsllc.com

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