The Great Recession 10 Years Later

WHAT IT MEANS LOOKING BACK, WHAT IT MEANS TODAY AND WHAT IT MEANS FOR THE FUTURE

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Fall 2018

Summary

Global economies have struggled to recover from the Great Recession of 2008 for most of the last ten years. Central Banks came to the rescue to provide stabilization and liquidity more quickly and effectively in the U.S. than elsewhere. Now monetary policies are moving back toward more normal operations, again more quickly in the U.S. Super accommodative monetary policies have provided a giant infusion of liquidity to world markets, with most financial asset prices now at or near record highs. The retreat from massive liquidity provision is likely to have a profound impact on market behavior in the years ahead. Risk/reward metrics that have historically guided investment strategies have been subverted by a world awash in cash. Our expectation is that more normal relationships between risk and reward will re-emerge in the years ahead as liquidity conditions normalize. We expect more normal risk/reward relationships will return to prominence as drivers of successful investment policies in the years ahead. Varying scenarios of normalization among the industrialized economies will likely drive disparities among currency valuations and asset class returns.

Lehman +10: Global Liquidity at a Crossroads

It's easy to sound hyperbolic and melodramatic in describing the unprecedented market cycle we've been navigating since 2008. Yes, the ten-year anniversary of the crash is upon us. The ghosts of Fannie Mae, Bear Stearns, Lehman Brothers and AIG still haunt us. We witnessed the surreal specter of Hank Paulson on bended knee begging Nancy Pelosi to support the TARP bill. Ben Bernanke opened the Fed's discount window to everybody and bought everything presented. The Fed invented quantitative easing, a euphemism for printing money to buy government bonds, to drive interest rates toward zero. Then the taper tantrum, the unwelcome early warning that monetary policy would have to return to normal, some day. The London Whale tempest tarnished J.P. Morgan's previously pristine reputation and dragged Jamie Dimon into the regulatory cross-hairs. Congress passed Dodd-Frank and the Volcker Rule, attempts to impose more cautious practices on the world's most dynamic financial system, notable for their silence on what was arguably the root cause of the meltdown: unregulated, unstandardized and under-reserved credit default swaps. There was widespread public resentment that Wall Street got bailed out and Main Street got hung out to dry. President Obama demanded a plan to break up Citibank, which Treasury Secretary Tim Geithner steadfastly ignored.

It all seems like it was so long ago and someone else's nightmare. The economic expansion that followed the crash, which is also approaching the decade mark, has been characterized by several unusual features that are hallmarks of an economy and society that suffered a near-death experience. Households eliminated an enormous quantity of debt, some by frugality and a lot by default. Economic growth was stuck in a rut and had difficulty accelerating beyond 2% for a long time following the financial crisis. Bank loan growth has been on snooze for a decade, far slower than a typical cycle. Labor force participation has been low and a major drag on growth for many complicated reasons, including the decimation of the housing industry, and that part of the financial services sector located in New York City. Wage and income growth have been historically sluggish, limiting consumer activity. History advises that recoveries from financial collapse are the most difficult and longest to stabilize, which sums up where we've been quite accurately.

Yet the stock market has rebounded dramatically from the depths of 2009 and achieved a rally of historic proportions: almost 19% compound growth since March 9, 2009—about twice the historical average return. More recently, the upward thrust has been supported by growth-oriented fiscal and regulatory policies from the Trump Administration. Tax reform has stimulated a strong acceleration in corporate profitability, although strong sales growth at a brisk 10% clip indicate solid underlying economic activity (S&P 500 year-to-year revenue growth through June 2018). Apart from better economic and corporate earnings performance in the last year or so, the defining characteristics of the long cycle since 2008 have been relatively modest earnings growth and the expansion of valuation multiples such as price/earnings ratios. Much of the Fed's capital invested in government bonds found its way to the next least risky investment, high-quality blue-chip stocks.

It's pretty clear that the bold financial triage put in place late in 2008 and early in 2009 by the Fed and Treasury successfully averted an economic debacle that might well have entailed a decade-long recession. The rapid response provided critical liquidity to collapsing markets and was instrumental in jump-starting the recovery. However, subsequent rounds of the experimental monetary policy known as quantitative easing from 2011 to 2014, designed to spur economic activity by creating a massive wealth effect, were largely unsuccessful in fostering the kind of rapid improvement in economic activity and job opportunities that typically emerge in a recovery cycle. In fact, the tactic greatly exacerbated a major headwind to healthy growth, income inequality, with the benefits bestowed largely and unevenly upon the existing wealthy. The economic ecosystem we cherish is one that encourages thrift, hard work and innovation, upward economic mobility and opportunity for betterment for all. A constantly replenishing and vibrant middle class has been the secret sauce that has made the U.S. economy extraordinary since our nation's founding. Quantitative easing was a retardant to upward income mobility, the absence of which has demonstrably strained our political comity. It can be argued that saving the financial system from collapse was an enormous benefit to society as a whole, but it is also true that there were costs that were not evenly shared. This is a continuing economic impairment that has evaded solution. The moral of the story is that the Fed did everything it could to stabilize the financial markets because few other policy levers were operating effectively. It was policy-on-the-fly, more than a little desperate, initially at least; it was messy, things got broken and the costs were considered necessary.

The Fed terminated quantitative easing by late 2014 and first raised the Fed Funds rate 25 basis points (bp) from essentially zero a year later. Since December 2015 additional increases have raised the short-term policy rate to 1.90%, roughly in line with inflation, as measured by the Fed's preferred inflation measure: the core personal consumption expenditure deflator (ex. food and energy). The markets expect the Fed to raise the Funds rate another 25 bp in September and possibly again in December. The Fed is guiding the markets to expect more increases next year, and if the global economy cooperates and hangs together, prospects are good that the Fed Funds rate will approach 3% next year. If inflation trends remain more or less constant, or more precisely, if inflation expectations remain anchored around 2%; the real, inflation-adjusted Funds rate would approach 1%. Historically, a 1% real Fed Funds rate is non-threatening to economic stability. In the last cycle, notorious for excessive use of mortgage credit, it took a 3% real Funds rate to destabilize home prices and begin the implosion of the grossly undercapitalized sub-prime mortgage market. A 1% real Funds rate would constitute a significant achievement for the Fed in its quest for the normalization of monetary policy, marking a return to an environment in which money has value and the costs of borrowing it reflect the inherent risks of the proposed usage. The Fed's demonstration of fidelity to the concept of sound money stands out among our global trading partners and is reflected in the 20% appreciation in the Dollar relative to the Euro since 2014.

The U.S. economy is tolerating rising short-term interest rates fairly well, but it remains to be seen if the same will be true in Europe and Japan, both of which continue to struggle to escape the undertow of persistently low inflation. Both the Eurozone and Japan continue to see only 1% inflation trends, despite massive quantitative easing in recent years and a modicum of economic improvement. Roughly 50% of government bonds in Europe and Japan have yielded negative interest rates since 2016. Both the European Central Bank (ECB) and the Bank of Japan (BOJ) have lately attempted to get in sync with the Fed's normalization regime and guided markets to expect that their quantitative easing policies will eventually end. However, German bund yields are still negative out to seven-year maturities, warranting some skepticism about how much monetary tightening the Eurozone and Japanese economies can tolerate.

The magnitude of quantitative easing that has occurred since 2008 is stunning to consider as displayed by Chart 1. Prior to the crash, central banks of the three main industrial economic zones, the Fed, ECB and BOJ, carried asset portfolios amounting to $4.2 trillion among them. At the peak earlier this year, the combined assets total topped out at $15 trillion, a 3.6× increase in less than 10 years. The Fed moved to the sidelines in 2015, but by mid-year, the ECB and BOJ doubled down on bond buying, both increasing their asset portfolios by $2 trillion per year in 2016 and 2017. It's not a coincidence that global interest rates went negative, credit risk premiums collapsed and the U.S. equity market roared up 50% in the period.

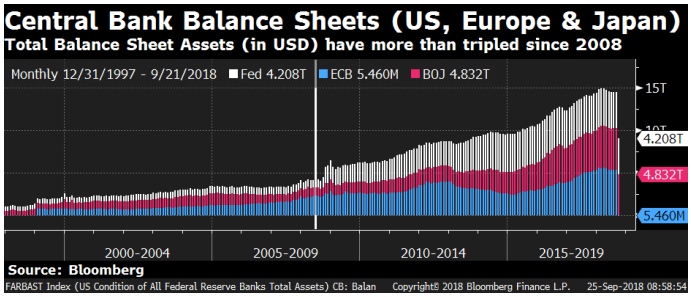

Chart 1

The Fed embarked on a much-heralded and gradual reversal last fall, accelerating this year and projected to reach $1 trillion in cumulative asset portfolio shrinkage by year-end 2019. The Fed accomplishes balance sheet shrinkage by not reinvesting proceeds of maturing Treasury bonds, requiring those bonds to be refinanced in the public markets. Combined with growing federal budget deficits, this extraordinary financing pressure is foundational to our bias to expect a rising interest rate environment in the U.S. for the foreseeable future. The ECB has been gradually tapering its bond-buying program, running at a mere $15 billion clip per month this fall. The BOJ continues to buy bonds at a substantial rate but the important point is that Fed balance sheet shrinkage is offsetting the combined purchasing in Europe and Japan, and in total the global liquidity balance has peaked.

The Era of Quantitative Easing Is Ending

The global economy is on the cusp of a sea change in liquidity conditions over the next several years that will drive profound implications for interest rates, asset valuations and portfolio allocations. The rate of change is uncertain and will be largely dependent in the near-term on the ECB's ability to mimic the Fed's normalization policies, raising short-term interest rates and shrinking its balance sheet. The ECB is likely to at least move modestly toward raising the policy rate next year, which should be supportive of the Euro and give global interest rates some lift. However, as expressed above and in the context of relatively sluggish Eurozone economic conditions, the possibility exists that the ECB may not be able to disengage from free money policies as quickly as planned or as the markets expect. We are monitoring these developments closely as we expect them to be among the significant drivers of investment policies next year. A healthy global economy is the likely outcome from European monetary policies that can successfully navigate back to normal, as the alternative is a dark picture laden with deflationary risks that are difficult to predict. Hope is not a strategy, and we will continue to closely assess monetary transitions abroad.

Markets have repeatedly rewarded policies and good governance, which promotes growth, opportunity and effective capital allocation. At the core of that virtuous dynamic is the integrity of money that reflects value, opportunity cost and risk. Most metrics of market valuation are mean reverting; they can vary from long-term trends over or under for long stretches but typically revert to mean in a cyclical time frame. The exception is currency valuation. Our observation is that countries which maintain policies that support the soundness of their currency have historically represented long-term stores of value and safe harbors in unstable markets. If we learned nothing else from the crash of 2008, we certainly learned that the Dollar was the desired safe haven when the chips were down, even with near-zero interest rates on Treasury bonds. The U.S. Dollar is well-positioned to continue to serve its historical role as the world's piggy bank.

The transition to normal monetary policies around the globe is not likely to be smooth, satisfying or subtle. It is likely that similar drama as occurred during and after the crash will replay in some kind of reverse fashion. Things will get broken. The disturbance in the Italian bond market and the collapse of the Turkish Lira are indications that liquidity is already scarce and discriminating in some markets. We remain focused on the reality that markets are clearing mechanisms for risk seekers. A return to normal means that rational analysis of risk and reward will be cornerstones of successful investment policies in the years ahead.

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