2007, a year of records

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The second half of 2007 has witnessed a series of unprecedented events in the history of financial markets. The «dis-intermediation» model, which started in the mid 90´s and has been one of the main drivers of growth (via credit growth), has come to an abrupt stop. How did we get here, and what can we expect going forward?

Perhaps we could set the origin of the crisis in the bad lending practices that have taken place in the US mortgage market. The infamous NINJA loans («No income, No job or assets») are probably the best examples. These loans, churned out by mortgage brokers whose income was linked to the number and size of loans issued, were allocated amongst other debt into complex vehicles, sometimes without going through banks' balance sheets. These vehicles funded themselves by issuing so-called «alphabet soup paper» (CDO, CLO, RMBS, CMBS, ABCP…), thus creating what has been named the «shadow banking system»: a series of legal vehicles often domiciled off-shore, loosely regulated and out of the scope of central banks.

The rise in delinquencies in the subprime market has made investors in «alphabet paper» (among which were many money market funds) reassess the risk they were taking and wonder about the quality of the collateral behind these assets.

And then, the roller-coaster of big numbers started: ABCP issuance has dropped by USD300b; the CDO / CLO market completely froze; some money market funds where forced to cancel redemptions until they could liquidate their assets.

Others have paid in kind due to the impossibility of finding market prices for the assets they were holding (mainly structured credit). Some hedge funds have literally evaporated in a matter of weeks, banks' balance sheets have had to take back most of the assets held by the «shadow banks»; Central Banks have had to provide liquidity in unprecedented size (the ECB injected EUR349b in December). We have seen billions in writedowns by top financial institutions; and everybody has become suspect of holding bad assets.
The interbank money markets have been closed since August (another record!) despite big efforts by central banks to reopen them. Libor/eonia and libor/treasuries spreads have hit historical highs. We have seen a huge flight to quality and a 3 months treasury bills auction at a marginal yield of 1.50% with fed funds at 5.25%. This is totally unprecedented.
For investors, this is no longer a game of «return ON capital», it is more a matter of «return OF capital», thus leading to a widening of credit spreads all over the place: ITRAXX Crossover has widened by more than 200 bps; financial companies have suffered most in terms of spread widening, and we have seen a regulator in developed Europe taking over a mortgage bank and writing explicit guarantees on its deposits. We have also seen banks raising new equity to improve their solvency ratios, and, unsurprisingly, this money has come from petrodollars and Asia. What has been surprising (at least to me) is that equity market indices have behaved in a very respectful manner, although there are some financial stocks that have plunged by more that 40% while some utilities have risen by more than 25%.
When one contemplates the number, size and nature of events that financial markets have experienced in just five months, one can easily conjecture that 2008 will be difficult. Maybe a good way of looking at it would be to picture the western financial system as a boa constrictor who has just swallowed a donkey and is off to a long, heavy and painful digestion: the digestion of the huge amount of new assets that have just entered the balance sheets of financial institutions and which will undermine future credit growth and therefore future GDP growth. So, in my opinion, the question is not whether these events will spill over into the real economy, it is more a question of how big (or small) those spillovers will be.

Growth vs. Inflation

Just look at the numbers set by economists. Apparently, between 46% and 53% of the US consumption during the past five and a half years has been financed by home equity withdrawals. So, in today's environment of difficult access to credit and falling US house prices, that part of consumption will have to be financed in a different manner.
I do not want to sound too negative, and, in spite of the fact that the chances of a US recession are higher today than ever in the last five years, there are parts of the US and world economy that look healthier than ever. Despite the worrying December print, the US job market is in much better shape than in the last recession, and thus in a better position to offset the housing slump. The corporate sector is financially healthy, with profits at or very close to record highs. In the rest of the world, economies are growing, and we ask ourselves if emerging economies can take the lead in a US slowdown. Although I do not believe in the decoupling of emerging market versus the US economy, the good shape of the former will help alleviate the impact of a US downturn (recession?) on the global GDP.
The most probable case scenario for the future is that we will face a series of quarters of sluggish growth (potentially seeing a mild recession in the US) until the donkey is digested, and when write-offs in financial institutions are completed and equity in the banking balance sheets is restored, most likely by petrodollars and Asian money.
Therefore, if 2008 is to deliver a downturn in growth in the US and rest of the world, the logical view is to think that Central Banks in the Western countries will tend to ease rates. But there is only one «little» caveat to this call: the last guest arriving to the Q4 party has been… inflation. November prints in US and Europe have been quite worrying, and it is not hard to imagine Mr. Bernanke and Mr. Trichet being highly concerned by the potential nightmare of stagflation.
Stagflation is undoubtedly the worst possible scenario for monetary policy makers. What would central bankers do? Would they raise rates (or leave them unchanged) to fight inflation while the economy melts down and unemployment rises? Or would they focus on growth, lowering rates at the risk of loosing credibility in their respective currencies and overshooting inflation? In my opinion, if they have to face such a decision they will go for growth, and there are several reasons to support this view.
In the first place, the inflation they are trying to fight is out of the scope of effectiveness of monetary policy. It basically arises from oil and food (note the differentials between core and general inflation). Secondly, despite the big changes that globalisation has brought to the world economy, I believe that the old mechanism «less activity = inflation contained» still works, and if we are to see stagflation episodes I do not think they will last long. Finally, corporate margins

are at or very close to record highs, and can partially absorb inflationary pressures.

So, if the call for slower growth for 2008 is correct, I think inflation should ease during the first two quarters, allowing central banks to deliver the much needed rates' ease (digestive pills for the boa constrictor).

2008, a shaky year of opportunities

And how will all this translate to the markets? Well, as said, a quite difficult environment for the first two or three quarters of 2008 should be expected. The king of all assets in that period will be those nobody wanted in the past five years: cash and volatility. In my opinion, it is very likely that we will be seeing some episodes of asset liquidation followed by risky asset rallies. But we should not be in a hurry to jump into those rallies, which should be short lived. The digestion of the donkey will be long.

In the government bond / interest rate space I would expect the FED to carry on lowering rates, as is already discounted. The forwards are quite consistent with the macro call set above, and together with the all time high of asset swaps, make me see no value in US government bonds at these levels. Only in the case that unemployment sharply deteriorates (with prints above 5.5%) I would think that Fed funds should be lower, and that would give a bid to US Treasuries. We must not forget that US Treasuries will most likely serve as a safe haven for investors during the risky assets sell-off, and thus shorting bonds can be a very risky position.

In Europe, despite the hawkish rhetoric, and given the ongoing stress in the money market and the level of EUR/USD, I would assign very little probability to the scenario of ECB hiking rates, and, on the contrary, find it easier to defend the possibility of the Council changing to an easing bias once (if) the inflationary pressures ease. Therefore, with short term euro government bonds with slight positive carry, there is a cheap option in playing the possibility of ECB ease by buying this part of the curve.

In relative value, I would favour trades that will benefit from higher risk premiums: curve steepeners, credit spread wideners, and, although it may sound inconsistent with the above, eventually asset swaps tighteners will be appealing since they are at record highs and correlate positive with lowering rates.

In the credit space, I would not buy during the first 2-3 quarters, since the higher funding costs for financials will spread to corporates during 2008. For investors who cannot wait, I would go to shorter maturities and higher quality. Big is good.

As for relative value, spreads of financials are pricing a much worse scenario than corporates, so buying senior financials (of BIG Institutions) vs. corporates is, in my opinion, a sound trade.

I find it very difficult to believe that the structured credit market will be reopen during 2008. If investors have learned a lesson from this turmoil, it is that we should deeply study the collateral behind «alphabet soup paper». There are very few investors with the capabilities to do this properly. So, my opinion is that the «dis-intermediation era» might be over, and that we will be seeing a «re-intermediation process» in the years to come. Investors will be more willing to buy bank debt and play on the same side as banks than to buy paper which funds the assets the banks have gotten rid of by placing them in «shadow banks».

The exposure to hedge funds should, in my opinion, overweight those managers with little beta to markets, which behave well in a high volatility environment, which are experts in relative value strategies, with an investment universe of very liquid assets and who do not rely on carry for performance.

Needless to say, it is in difficult conditions such as these that the best long term investment opportunities appear for the patient, rigorous and disciplined investor which is able to separate the good from the bad and the ugly.

Good luck in 2008!

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