GRAYISSUE
LONG TERM COMMENTARY

17 October 2008
Issue no. 84

History suggests there will be light at the end of the tunnel

South Africa's banking system so far has survived the crisis in financial markets relatively unscathed. This is also the case in China and Japan. However in Europe and the US there is a serious problem. One of the most remarkable features of the current crisis is how its extent and scale has taken even extreme pessimists by surprise. We are experiencing the worst banking crisis since 1931-1933. Its immediate cause was poor mortgage lending in the US. The IMF now estimates total losses will reach US$1.4trn, of which about half will be in the banking sector.

Banks – much higher gearing than superficially apparent

Since August last year banks, mainly in Europe and the US, have made provisions of US$635bn for sub prime losses and have raised US$495bn of capital to bolster their impaired balance sheets. The negative impact of these losses has been aggravated because there was, in practice, a much higher level of gearing in the banking system than was superficially apparent. Banks boosted their returns on capital by shifting risk off their balance sheets. This business model has totally collapsed. Collectively the global banking system is too undercapitalised to provide the normal expansion in credit a growing economy requires. A freeze in lending is already adversely affecting the global economy. Since March 2008 lending by US banks has hardly grown. Central banks have acted to maintain liquidity within the system, but have been unable to restore the banking system's capital base to a level which would allow normal lending to resume.

Private investors' appetite for further bank capital is limited. Those who provided the US$495bn of new capital raised so far have experienced significant losses. There is only one source of capital left – the state. As a result, banks in Europe and the US are moving unavoidably into some form of public ownership. Some banks will survive unscathed. Many others will see their existing shareholders' interest in their business substantially diluted.

What will be considered 'normal' moving forward will be different to the recent past

It is difficult to predict the outcome of this saga. Certainly the experience of the 1930s is still sufficiently real in the collective memory to make a wholesale collapse of the financial system politically unacceptable. It is noteworthy that US Federal Reserve chairman Ben Bernanke's area of academic expertise is the financial crisis of the 1930s. Allowing Lehman Brothers to collapse is now generally recognised to have been a major error. Governments are going to stand behind the rest of the banking system until normality returns. However, what will be considered normal will be very different to the recent past.

As the dust settles and the banking crisis abates, the focus shifts to the outlook for the global economy. It seems probable that the credit crisis will push Europe and the US into recession. Growth in Asia will slow significantly, partly because of a contraction in world trade, but also because many developing economies also have developed unsustainable excesses which have to be worked out of the system. Investment will slow. A decline in world growth will erode commodity prices. Corporate profits are likely to decline significantly. Business conditions will be difficult.

We've been here before

It is not easy to make meaningful predictions about the economic outlook. However recent economic history does offer useful insights. Since the end of the 1960s there have been four major periods of economic contraction.

1974 – 1976: This period witnessed the first major global recession after the Second World War, mainly caused by a big rise in the oil price. The Dow declined 41% from 987 in October 1973 to 578 in December 1974 – similar to the recent decline of the Dow from its peak in September 2007. Another similarity with 1974 is that investors were lulled into complacency by a long period of financial stability. For about 20 years after 1950 Europe and the US experienced continuing growth. The idea of a serious recession was totally alien. More recently, there has been a sense that we are living in golden age. As in 1974, the shock to investors' psyche has been profound. Interestingly, in 1975 the markets bounced back rapidly. By June 1975 the Dow reached 880, up 52%. Business conditions, which peaked in the middle of 1973, declined for 20 months and then picked up strongly.

1980 – 1982: This recession was caused by a decision by central bankers, and in particular Paul Volker, chairman of the US Fed (1979 – 1987), to bring inflation under control by hiking interest rates. This is the only significant example of governments engineering a recession to eliminate inflation. In contrast, the Fed's policy under Alan Greenspan (1987 – 2006) was to sustain growth at all costs. Economic activity declined over a period of three years from mid 1979 to June 1982. After peaking in November 1980 the Dow fell to 783 in June 1982, down 22%. It then bounced 37% in six months.

1988 – 1991: After six years of strong growth the world economy stagnated for three years as it digested the consequences of the collapse of communism and the Japanese investment boom.

2000 – 2002: The 1997 – 1999 Asian financial crisis had adverse effects on emerging markets which did not start to recover until 2002. This was followed by the implosion of the dot.com bubble, which was one manifestation of a major slowdown caused by various economic factors. While the recession was comparatively mild, global economic activity stagnated for three years.

We may enter a period of economic stagnation as the world adjusts to the new banking realities. However, it is important to recognise that we have been here before. Our experience since 1970 suggests these problems take up to four years to resolve. Recessions are bad for share prices because they decimate earnings. However the market is forward looking. Typically the biggest stock market rallies occur immediately after share prices collapse into an economic downturn.

Commentary by Sandy McGregor, Allan Gray Limited