Viewpoint: Michael J. Panzner

Forecasting the Credit Crunch and Future Market Prospects

Biographies: Michael J. Panzner

Introduction

Michael J. Panzner is a 25-year veteran of the global stock, bond, and currency markets who has worked in New York and London for such leading companies as HSBC, Soros Funds, ABN Amro, Dresdner Bank, and J.P. Morgan Chase. He is the author of When Giants Fall: An Economic Roadmap for the End of the American Era (Wiley, 2009), Financial Armageddon: Protecting Your Future from Four Impending Catastrophes (Kaplan, 2007), and The New Laws of the Stock Market Jungle: An Insider's Guide to Successful Investing in a Changing World (FT Prentice Hall, 2004). He has also been a columnist at TheStreet.com's RealMoney paid-subscription service and a contributor to AOL's BloggingStocks.com. In addition, Mr. Panzner is a New York Institute of Finance faculty member specializing in Equities, Trading, Global Capital Markets, and Technical Analysis, and is a graduate of Columbia University.

What brought about the worst financial crisis since the Great Depression?

There are many reasons why we reached this point, but one, in particular, stands out: hubris. By the spring of 2007, for instance, the conventional wisdom on Wall Street was that the financial world had been totally transformed and the business cycle had been repealed. People were confident that reams of research and the lessons of history would prevent policymakers from repeating the mistakes of the past. Powerful technology and rapid innovation would ensure that risk was fully monitored and efficiently managed. Industry consolidation and the globalization of finance would allow any excessive or unwanted exposure to be offset. In sum, the "masters of the universe" thought they had it all figured out—which, of course, they didn't.

Was it just those who worked in the financial industry who felt this way?

Not really. Insiders and outsiders alike—including central bankers, regulators, and the political establishment—came to believe that markets and economies were virtually bullet-proof, no longer exposed as they once were to the fallout from exogenous shocks and endogenous eruptions. In a sense, the prevailing view was that with all the rules, strategies, and mechanisms that were in place, neither Wall Street nor Main Street would again find themselves taken by surprise, as they were during the Asian financial crisis of 1997–1998, the 1998 meltdown of hedge fund Long Term Capital Management, and on many other occasions before that.

How about the man on the street?

To be sure, confidence about existing conditions and the notion that the good times could carry on indefinitely was widespread. Although there were clear signs that something was amiss, many people drank the bullish Kool-Aid and warmed to the fantasy of a Goldilocks economy. They believed that society no longer had to be a slave to market and other natural forces. In today's sophisticated and globalized world, people were the masters of their own destiny, economic or otherwise. Not surprisingly, these perspectives spawned widespread complacency. Unhealthy imbalances were permitted to grow and fester. Prudence was seen as highly overrated. Planning for hard times took a back seat to riding the crest of the wave. In the end, of course, those notions proved dangerously misguided.

Are you suggesting that the failure to prepare for the worst ensured that it would happen?

To some extent, yes. In fact, throughout society, many of the mechanisms and backstops that people were counting on for protection in the event that things somehow went awry had unintended negative consequences. Instead of enhancing the resiliency of the system, the latticework of safety measures engendered a false sense of security, leading homeowners, investors, policymakers, business executives, and others to act naively or recklessly. Economists call this the moral hazard effect. Under these circumstances, everyone has an incentive to be on their worst behavior. In hindsight, it's clear that a lot of people took that message to heart.

So far, at least, the financial system seems to have suffered the most.

That's not too surprising, given that those who worked on Wall Street and in other financial centers made some of biggest miscalculations, at least in terms of the amounts they were playing around with. Among other things, many supposedly savvy operators failed to grasp that just because risks were being sliced, diced, repackaged, and shifted elsewhere, they weren't being eliminated. On the contrary, the new financial alchemy meant that all sorts of dangerously unfamiliar combinations were being created and that no one really had a solid handle on overall exposure. Moreover, with risk being shoved into every nook and cranny of the global financial system, it meant that few places on earth would be spared following a major shock to the system, like, for example, a bursting credit bubble.

Presumably, people are looking at things differently now?

There's no doubt that the events of the past few years are forcing a major rethink in certain quarters. Formerly free-spending Americans, for example, are beginning to cut back on purchases, slash borrowing, and boost the amount of money they have in savings. Yet not everyone grasps what is clearly a sea change. The fact that so many "strategists"—I use that term loosely—failed to see what was coming and were utterly surprised by the breadth and depth of the collapse hasn't stopped them from offering wrong-footed theories about what may happen next. Many are simply deluding themselves with short memories and wishful thinking. Indeed, ever since the "Great Unraveling" began, there has been no shortage of prognosticators claiming to see a light at the end of the tunnel.

Could it be that they were merely early and the storm will soon blow over?

Sure, but the odds are against it. With the world enmeshed in what is acknowledged to be the worst financial crisis since the Great Depression and, by all accounts, with most developed countries now entering the first synchronized slowdown since World War II, it's clear that what we've been experiencing is not a garden-variety cyclical event. Given that, a quick read of history, the kind that extends beyond the past decade or even the post-war era, suggests the outlook for the immediate years ahead is for more hardship and pain than we've seen already. Ironically, given how many ivory-tower theories have been discredited by events of the past few years, recent academic research would appear to confirm that outlook.

What are the details?

According to a December 2008 paper by Carmen M. Reinhart and Kenneth S. Rogoff, entitled *The Aftermath of Financial Crises*, episodes like the one that began in 2007 have traditionally been a bad omen.

"Broadly speaking, financial crises are protracted affairs. More often than not, the aftermath of severe financial crises share three characteristics. First, asset market collapses are deep and prolonged. Real housing price declines average 35% stretched out over six years, while equity price collapses average 55% over a downturn of about three and a half years. Second, the aftermath of banking crises is associated with profound declines in output and employment. The unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts on average over four years. Output falls (from peak

to trough) an average of over 9%, although the duration of the downturn, averaging roughly two years, is considerably shorter than for unemployment. Third, the real value of government debt tends to explode, rising an average of 86% in the major post-World War II episodes."

That's worrying, to be sure, but some would say that the past is not destiny. Are there other reasons to be pessimistic?

Sure, plenty. First, there are myriad imbalances that still need to be resolved in one way or another. In the United States, for example, even though a bursting housing bubble has brought prices in some areas back into line with incomes and rents, overall values are still high relative to secular trends, based on data derived from studies by Yale University professor Robert J. Shiller, author of *Irrational Exuberance*. As of the second quarter of 2008, for example, the benchmark S&P Case-Shiller Real Home Price Index was still more than 40% above its long-term median. As prices continue their inevitable reversion to the mean—and, more likely, given the pattern of past boom–bust cycles, overshoot—the fallout from the negative wealth effect alone will cast a powerful and persistent pall over the economy for quite a while.

What else?

Let's start with debt. Even though the upheavals of the past few years have forced banks and other intermediaries to cut back on lending, the amount of obligations outstanding is still staggering. At the end of 2008, for instance, total US credit market debt was more than three-and-a-half times as large as gross domestic product (GDP), or 15% higher than the prior record set during the Great Depression. One way or another, whether because of widespread defaults or frantic efforts to reduce leverage, those borrowings represent a substantial drag on future growth prospects. In addition, there are untenable cross-border imbalances that can only be rectified through economic pain, or bone-jarring upheaval. One example includes the United States' long-running current account deficit, which, at nearly 5% of GDP, reflects a propensity towards over-consuming and over-borrowing that cannot be sustained.

These are serious concerns, but won't America bear the brunt of the damage?

The United States accounts for a quarter of global GDP, so America's problem is, by definition, everybody's problem. More recent developments regarding global trade and capital flows, for example, have proved that. The once popular notion that the rest of the world could somehow "decouple" from the United States was laughable, given how dependent other nations were on the spending power of the American consumer. No doubt that formula will change as developing nations like China eventually shift their focus away from export markets towards domestic consumption. However, this adjustment will take time. Otherwise, in terms of the imbalances that exist outside the United States, you only have to look at how property prices are deflating throughout Europe, Asia, and South America to realize that others had their share of excesses and bad behavior.

What else makes you think that the risks are to the downside as far as markets and economies are concerned?

Two factors, in particular. First, the global system for intermediating credit has become seriously impaired. Not only is the securitization model, which has been a key driver of growth-enhancing liquidity, on its last legs—as evidenced by the dramatic collapse in issuance of and trading volumes in asset-backed and other derivative securities—but banks around the world have clearly demonstrated that they are neither willing nor able to do what they supposedly know best: make loans. The vast majority of financial institutions are capital constrained, and in many cases, literally or effectively insolvent. Despite all the bailouts and rescue efforts, including government-sponsored lines of credit, taxpayer-funded equity injections, and the loosening of regulatory and accounting constraints, there are few signs that the money is benefiting the real economy.

But isn’t it just a matter of time before that happens?

I wouldn’t want to rule that out, but as of now, the facts suggest it will be a long time before we go back to anything resembling “normal.” Among other things, some of the efforts being made now to fix things are actually causing more damage. Again, we are seeing the unintended consequences of government actions. For example, by stepping in as the intermediaries of last resort, the Federal Reserve and other central banks have effectively discouraged financial institutions from working together to repair the damage caused to the interbank lending market as a result of worries over counterparty risk. In addition, many banks seem unduly focused on getting their fair share of the bailout pie, instead of reworking anachronistic business models and making the painful adjustments they need to survive beyond the current crisis.

You noted that there was another factor that makes you pessimistic?

As I see it, there has clearly been a secular shift in attitudes towards risk and risk-taking. Anecdotal and other evidence suggest that individuals and businesses are not only increasingly concerned with digging themselves out from under the obligations they took on during the go-go days, but they are also rethinking how they want to travel the road ahead. Instead of pie-in-the-sky forecasts, companies are insisting on realistic assessments. Cushions and allowances that once seemed adequate are being expanded to take account of heightened economic uncertainty, counterparty risk, and market volatility. People are thinking less about returns and more about what they must do to preserve capital. All of this indicates that there will be little in the way of excess liquidity flowing through the economy, which further undermines the prospects for recovery.

Is there anything else?

Although I can think of many other problems looming on the horizon, one that is probably not on too many radar screens stems from a nascent but ultimately seismic shift in the global order. Up until now, the world has benefited tremendously from the United States’ role as the consumer and policeman of last resort. With the fallout from the credit crunch and subsequent economic unraveling calling the first role into question, and the quagmires in the Middle East, among other things, casting doubt on the second, it may be no time at all before other countries and regions lose faith in US and Western sponsored systems, mechanisms, and institutions. With that, we can expect to see serious disruptions of capital and trade flows. These schisms will inhibit and, increasingly, reverse efforts to expand economic and financial integration, which will have a negative effect on credit, liquidity, and growth.

More Info

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- Zero Hedge: zerohedge.blogspot.com

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