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A Year Later - What Has and What Has Not Changed

Only a year ago, following the bankruptcy of Lehman Brothers, the world appeared on the brink of a financial collapse that threatened to lead the real economy into a deflationary spiral. Today, the picture is very different. Global stock and bond markets have recovered very close to October, 2008, levels and the real economy, still reeling from the worst recession since World War II, is showing initial signs of improvement.

The events of the past year have had very different effects on the world of finance, the global economy, and Government budgets. This paper reviews what we believe to be the most striking changes that have occurred, including some that may be permanent.

I. The Past Year

The stress created by the collapse of financial confidence a year ago may be hard to remember. However, without the unprecedented actions taken by Governments worldwide, there is little doubt that we would be in a much different situation today.

Initially, stimulative monetary policy dominated the action. The US Federal Reserve offered guarantees not just to banks, but to money market funds, insurance companies and other financial intermediaries to stem the proverbial "run on the bank". In Europe, the Bank of England and the European Central Bank followed suit. At the same time, all central banks slashed short-term money rates to practically zero. These coordinated actions were a historic effort to avert a Depression.

Fiscal policies also became massively expansionary. In the US, our Federal deficit rose to over 10% of GDP, through both a fall in tax collections and enormous increases in stimulus expenditures. European nations took lesser steps to increase growth through government spending. In China, much of its fiscal surplus was spent on massive public infrastructure projects, thereby turning a brief but sharp economic downturn into an equally sharp recovery. As a controlled economy, the Chinese government was in the position of rapidly targeting its spending to geographies and industries deemed most desirable. In fact, recovery in Asia led the rest of the world. In contrast, the democracies of the more mature developed world have incurred huge deficits to stem the downturn, and are still experiencing little or no growth.

Financial markets around the globe are much higher than where they were last winter. Cash first moved into fixed income, where bond market spreads were extremely wide, offering investors attractive returns if they were willing to bet on the solvency of major banks and industrial companies. Negligible rates on money market funds made that choice easier. Although investors have been more cautious in moving funds to equities, still the S&P 500 has risen over 50% from its lows of early March, with many foreign markets registering even higher returns from their lows.

II. What Happens From Here

So far, there have not been any substantive measures enacted to address the structural weaknesses of the financial system, through improved transparency, more intelligent regulation, and appropriate capital standards. Instead, the focus appears to be on compensation reform. While the short-term orientation of incentives on Wall Street undoubtedly played a role in this crisis, our hope is that regulators and politicians will use this opportunity to initiate broader fundamental changes. Both here and abroad, accounting, regulatory, and capital standards should be modified in such ways to promote more ethically appropriate behavior and reduce overall systemic risk. Only with these profound changes can we reduce the risk of future boom and bust cycles.

The recession may be over, according to Fed chairman Bernanke, but any sustainable recovery faces the prospect of consumers and banks alike continuing to rebuild their balance sheets through greater saving and less lending, which will limit the chances for meaningful and sustainable growth. With 70% of the US economy tied to individual expenditures and with an estimated $1.5 trillion in remaining write-downs to be taken by banks globally, this could be a slow process.

There is currently enormous unused capacity in manufacturing plants as well as a large pool of the unemployed. Until we see increased demand translate into higher production levels and the elimination of excess capacity, it’s unlikely that there will be much inflation in the price of goods and services.

As economic growth slowly regains momentum the challenge for central banks will be to reduce monetary stimulus at a pace slow enough to maintain momentum but quickly enough to minimize inflation risk. In addition, fiscal deficits will have to be trimmed as recovery becomes apparent. To accomplish both tasks will require a delicate balance of both political and economic policy, with implications for the real economy that we will monitor.

III. Investment Implications

The stock market has rallied sharply over the past six months, with the expectation that the economy will continue to gain traction and that profits will be much higher a year from now. Recently, we have heard from many companies that their business has improved from the lows of last year and earlier this year, in terms of customer orders and inquiries. This trend needs to continue, and be encouraged by proper actions from central banks and Governments.

While there are reasons for optimism, risks to our current trajectory do exist. Serious economic and financial stress cannot be resolved without unprecedented actions, which themselves produce uncertainty. As long as the public retains confidence, we should start to see somewhat better economic growth. Then, growth prospects can be further improved through a combination of meaningful regulatory reforms and appropriate monetary and fiscal policies.