"In the business world, the rearview mirror is always clearer than the windshield."

Warren Buffett

It has been five years since the collapse of Lehman Brothers and the unofficial beginning of the global financial crisis. While the Lehman bankruptcy occurred in September 2008, the record will show that the U.S. recession actually started in December 2007 and ended in the summer of 2009. Some indicators have returned to well above their pre-crisis peaks, while a number of others have lagged. In this piece we review the primary causes of the crisis and discuss the uneven recovery we have experienced to date.

The "Great" Recession

The major contributor to the recession of 2007-2009 was massive debt creation in the private sector, led by a bubble in housing prices, fueled by easy access to mortgage credit. Leverage in the financial system, inflating this bubble, grew to a point where most investment banks held $100 of debt for every $3 of equity. In 2008, home prices began to fall, credit tightened, liquidity in the financial system dried up, equity markets plunged and the meltdown was underway.

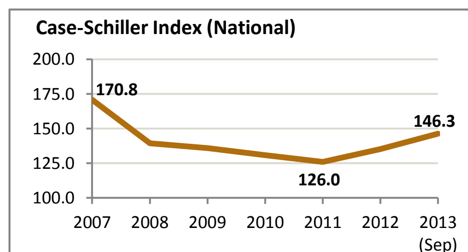
By the end of the first half of 2009, over 11 million jobs had been lost, GDP had declined precipitously, and tax revenues had fallen drastically. To rescue the economy, both the Federal government and the Federal Reserve embarked on unprecedented bailout and stimulus programs. This intervention was massive; looking back at it now, we can say that much of it was successful, as the Treasury's advances of funds to financial institutions and auto companies have been almost entirely repaid, in some instances with profits.

The "Not so Great" Recovery

The current recovery may be described as sluggish and inconsistent, but still a recovery. GDP growth of 1.8% over the last 12 months falls short of the 2.8% growth in 2007.

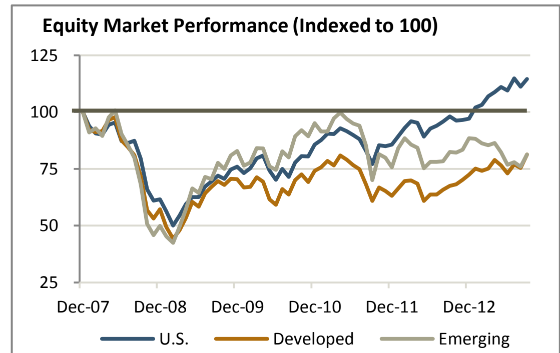
Interest Rates	YE 2007	Sep. 2013
1 Month T-Bills	2.5%	0.0%
10 Year Treasuries	4.0%	2.9%
30 Year Mortgages	6.1%	4.5%

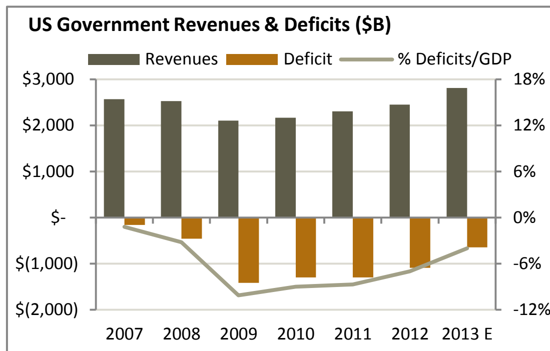
Confidence in financial markets was greatly assisted by the easy money, ultra-low interest rate policies of the Federal Reserve and other foreign central banks. Short-term and long-term rates are much lower than five years ago (*right table*). Mortgage rates fell from 6% to a much more affordable 4.5%. In sum, it has been a very profitable five years for bond investors, or those whose credit scores qualify for mortgages. At the same time, the balance sheets of most consumers are much stronger than five years ago, because of both mortgage refinancings at lower rates and actual reduction of debt.



Housing prices, which were decimated during the recession, have recovered to roughly 85% of their pre-crisis levels as shown in the chart to the left. This reflects very rapid gains in favored urban areas such as New York, Boston, Los Angeles or Miami. However, other areas of the country, such as Nevada, Arizona, Michigan, and parts of Florida are still well below 2007 peaks.

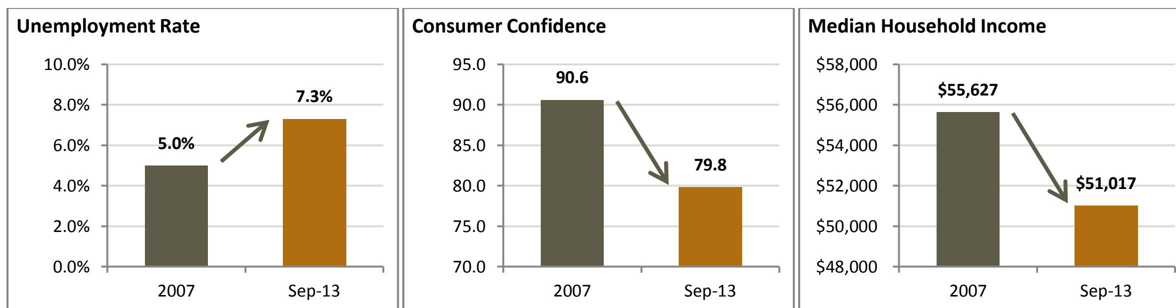
Corporate profits have done well, the dollar has risen against a number of currencies, and banks are far better capitalized. S&P earnings have been resilient, with profits 17% higher than at the end of 2007. Fueled by low interest rates and improved corporate profits, equity markets rebounded, with the U.S. stock market leading the way compared to both developed and emerging international markets. Despite the substantial market recovery, only the U.S. market is above its 2007 year end level and its rise of 16% is almost exactly in line with the gain in profits over that time period.





As consumer balance sheets improved so did corporations. Cash as a percentage of total assets on corporate balance sheets has hit all-time highs. The initial price of this adjustment, of course, was a large U.S. government deficit, as automatic stabilizers kicked in as unemployment rose and tax revenues collapsed when incomes and earnings fell in 2008-2010. Even here, however, there has been good improvement recently; primarily because of the effect of the tax hikes and sequester last year, the Government deficit this year will be a little less than 4% of GDP vs. 10% in 2009.

However, many economic measurements, particularly those related to the well-being of the average American, show that we still have a long way to go, before getting back to pre-crisis levels. Unemployment is still much higher than at the start of 2008, consumer confidence is lower, and median incomes (adjusted for inflation) are lower. We need policies to help boost employment levels and to restore GDP growth to the historic average of around 3% real.



We are still facing a sizeable Federal deficit, and the long-term problem of entitlement programs threatens to exacerbate the problem. It will take much more cooperation in Washington, from both political parties, to ensure that our recovery path is not derailed. Business balance sheets are healthy, but sufficient business confidence is required to make investments in capital equipment, research, and people. Should Washington set aside partisanship, and rise to these challenges, the footings for improved and sustained GDP growth are in place. Therefore, we are eagerly looking for signs of collaboration from which to further build an investment thesis that will continue to benefit our clients.