

Credit crunch, panic and a reassessment of risk: what next?

The origins of the current troubles go back to the collapse of the tech bubble in 2000 and a prolonged period of low interest rates.

The sharp falls in share markets following the busting of the tech bubble caused investors to shun shares and look for defensive strategies. But investors were faced with a problem. Interest rates, which had been lowered to try and prevent any negative flow-on effects from the tech bubble, were too low to be of any real attraction. In other words, there was no perceived reward for being defensive.

A period of abnormally low interest rates created a vast pool of liquidity, which inflated house prices, resulted in lax credit and reduced investor sensitivity to risk. Investors, desperate for higher yields, turned to alternative products in the hope of higher returns. These included hedge funds and complicated higher yielding strategies such as collateralised debt obligations (CDOs).

The first signs of the recent problems came in the US mortgage market when the lowest quality borrowers (called the sub-prime market) began to default on their mortgage repayments. Markets initially assumed that any fallout would be contained and short-lived as overall market conditions were favourable. But as sub-prime delinquencies grew, markets came to realise that problems may be more far reaching than first thought. It is now estimated for example, that while sub-prime loans comprise approximately 15% of outstanding mortgage loans, they comprise perhaps 40% of all residential mortgage-backed securities issues in 2006 and two-thirds of issued CDOs. An additional issue is that leverage has been applied in many cases to increase the effective yield.

As markets became more stressed, and losses were highlighted, funds were forced to meet margin calls and investor withdrawals. These losses were magnified to the extent of any leverage present. The contagion risk stems, for example, from banks becoming nervous and electing to reduce their own perceived risk by say increasing their margin requirements.

Global share markets have also suffered an adverse reaction to the credit crunch but this can be explained by rising investor risk aversion and concern that the fallout from the credit crunch may derail what otherwise is a reasonably favourable global outlook.

What are the risks?

The risks are reasonably straight forward. They are that:

- The sub-prime mess leads to an indiscriminate rationing of credit
- The scale of the mess and potential liquidations are bigger than expected and

- The consumer is hit harder than expected as the price of credit rises, house prices fall, employment suffers and corporate investment declines – i.e there is a wider fall-out to overall economies

What do we know?

We know that sub-prime lending has all but evaporated and that delinquencies have risen. But investment grade spreads have not been similarly impacted. Broadly speaking corporate risk is low – over 95% of the S&P500 is investment grade and defaults are running at 15 year lows. Indeed, corporate performance has been very strong. While it is likely that corporate earnings will slow, it is also true that any slowdown will occur from elevated levels and that the quality of profits is high.

Overall, the global economy is in good shape. The consensus view is the world economy can likely cope with any US slowdown and that inflation is reasonably well behaved.

What about valuations?

Global shares remain attractively priced whether in absolute terms or relative to other asset classes such as bonds and in particular, hard assets such as commodities and real estate. It is also our belief that global shares are more attractive than NZ shares in valuation terms at present.

The global price earnings ratio is at a 15 year low and global profitability is at a 15 year high. It should also be noted that the global banking sector price earnings ratio is at a 15 year low, so a reasonable conclusion is that bad news has already been priced in.

What is the response?

At present, the risk is that fear and the unforeseen trumps fundamentals. The problem for investors is that the fundamentals suggest looking to buy, while rising risk aversion and risk control suggests considering selling.

The right course of action is most probably to stand back and continue to assess market conditions. Overall, the global economy is in fairly good shape and the pre-conditions for a sustained bear market do not appear to be in place, but there is a need to be vigilant for signs of contagion.