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The bears come out to play

The bears are coming out to play. There is more talk in the press and by market commentators of the risk of recessions in the US and other countries and, depending on what you are reading, threats of another global financial crisis (GFC) event due to surging debt, income inequality, political risk, market liquidity and valuations.

While recessions and financial shocks are inevitable, it is also the case that governments and regulators are more prepared for the next crisis. This should reduce the length and severity of future events. Many countries now have disaster recovery plans that should ensure a faster and more efficient response, regulatory gaps have been plugged, and the financial system itself is stronger.

It is also important to remember that investors with simple diversified portfolios sustained little permanent damage through the full GFC and recovery period provided they stuck to their plan, kept a long-term perspective and did not sell out after markets had fallen.

In contrast, those portfolios that suffered the most during the financial crisis were those caught in illiquid products – particularly more exotic structured products where underlying values were unclear and where there was no scope for early exit.

Recommendations

There is no doubt that market downturns and recessions will occur in the future, but this is not a reason to sell out of all equity positions. This is partly because of the opportunity losses from being wrong on the occurrence of a crisis, its timing or its severity, but also because equities demonstrated their resilience in the years around the GFC.

Instead, investors concerned about macro and market risks should review portfolios and ensure:

- Portfolios are diversified across a wide variety of assets and geographies.
- Portfolios contain some safe-haven assets such as bonds. Remember also that the Australian dollar tends to fall in times of stress, so holding unhedged international assets can mitigate losses.
- Most assets in the portfolios are liquid and, where they are illiquid, there is confidence in underlying values. Illiquidity and complexity are a dangerous combination.

Perhaps most importantly, investors should remember the timeframe over which they are investing – for the majority, this is many years or decades – and that although there will be periods of volatility along the way, they will not have a permanent impact on portfolios.

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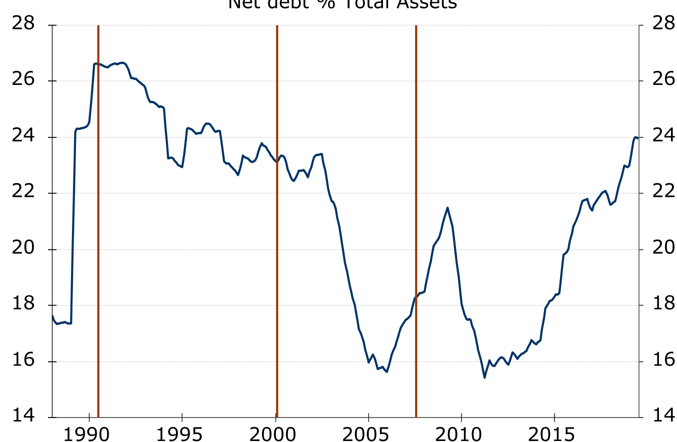
The bears are coming out to play. There is more talk in the press and by market commentators of the risk of recessions in the US and other countries and, depending on what you are reading, threats of another GFC event due to surging debt, income inequality, political risk, market liquidity and valuations. My purpose in this note is not to argue the merits of each of these risks in any great detail, but to consider the best way to ensure portfolios can be protected against any such "black swans".

What are the imbalances?

We begin with a summary of some of the major areas of concern and some brief comments on each. I will explore some in more detail in coming notes. Some of the issues that I do see as having some merit are:

- Rising US corporate debt

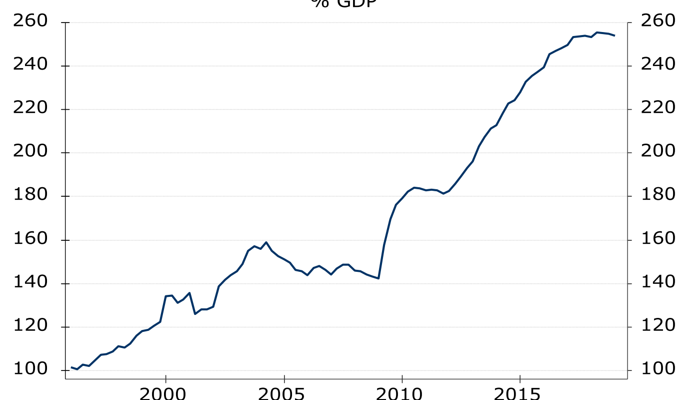
US corporate debt has surged since 2010 and is now above the level that preceded the 2001 and 2008 recessions. Higher leverage increases vulnerability to rising interest rates and any downturn in activity. One oddity in this debt build-up is that the proceeds have overwhelmingly been used to finance stock buybacks. While this means it has not been a particularly productive use of funds, it does mean that the money has not been recklessly used to create asset bubbles or cause overinvestment in machinery and equipment.



- Rising Chinese debt

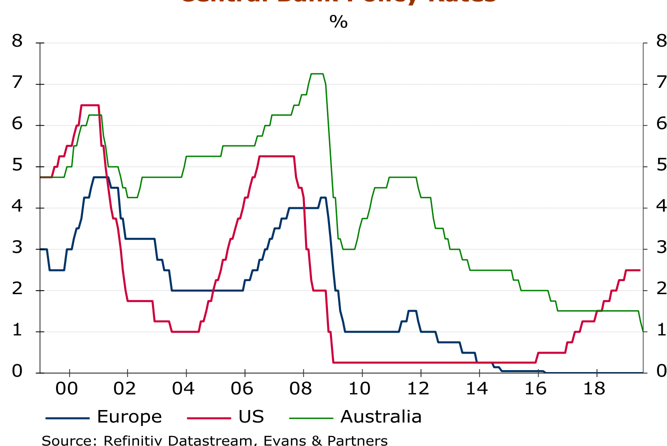
Chinese debt has surged over the past decade. The major part of the rise began with the significant stimulus introduced at the depths of the crisis which continued until financial reforms stemmed the increase in 2017. Another financial crisis in China would hardly be a surprise given the extent of this debt increase, opaque lending practices and bank balance sheets. But it is also important to bear a few things in mind, including:

- The timing and triggers for such an event are impossible to predict. It could be a decade away.
- China has already had a financial crisis in 1998, from which it recovered quickly. It used FX reserves to bail out banks at that time. FX reserves are still large and could be used again. The economy and financial sector are, of course, much larger now.
- Measuring debt against GDP is convenient but not all that meaningful (the chart below shows the current estimate at around 260% of GDP and around 300% if off-balance sheet local government debt is included). Debt relative to assets would be a better measure and productive assets have increased enormously over the same period. While there was certainly some wastage, many useful infrastructure assets have been built.
- The Chinese banking sector is not interconnected with the rest of the world and a small proportion of the debt is held by foreigners, so there is less risk of contagion.
- Bank balance sheets are reasonably healthy overall because household deposits are so large. Household debt is also still low.



- Central bank ammunition

Another common investor concern is that the ability of central banks to respond to a crisis is limited because interest rates are already near zero. As a result, there is less scope for central banks to prevent future downturns becoming recessions.



Whether there is truth to these concerns depends on the efficacy of "unconventional" policy mechanisms like quantitative easing in future periods of stress. Quantitative easing is best at dealing with crises that are born out of, or made worse by, market dislocation and illiquidity. The GFC was one such event, and the crisis would likely have been less severe if Lehman's was dealt with in a different way and if more liquidity was provided more quickly as it spread.

However, there will be some crises of a more economic than market nature where the stimulus from lower interest rates would make a greater difference. Central banks will need to rely on governments providing fiscal stimulus in these cases if there is financial scope and a willingness to do so. The good news here is that central banks and governments have worked on crisis recovery plans in the aftermath of the GFC, so responses would likely be earlier and more coordinated next time.

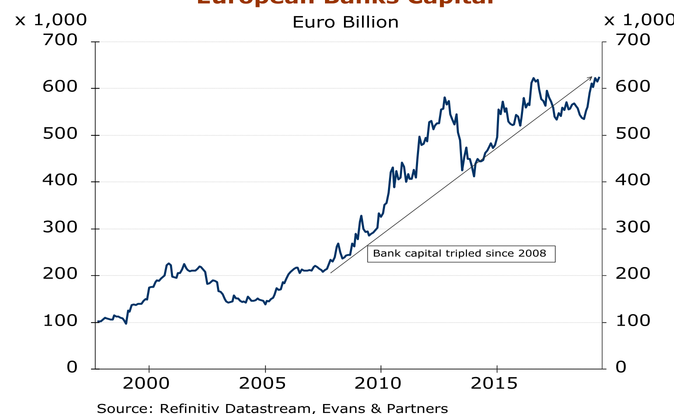
What are the improvements since the crisis?

While recessions and financial shocks are inevitable, it is also the case that following the near-death experience of the GFC, governments and regulators are more prepared for the next crisis.

This is the case on a number of fronts. As previously mentioned, central banks and governments now have disaster recovery plans that should ensure a faster and more efficient response. It is also the case that regulatory changes should ensure that similar financial crises are both less likely and will be less of a threat to the global financial system.

Firstly, regulatory gaps have been plugged. One of the contributors to the extent of the problems with the GFC was poor coordination of regulation across countries and across different types of financial companies. Another point is that regulation did not keep pace with the growth and risks associated with derivatives.

Secondly, the financial system itself is stronger. For example, the amount of capital supporting European banks has trebled since 2008, and similar trends have occurred in the US and Australia.



Bringing together the improvement in financial regulation, the stronger financial systems and the greater planning for dealing with a crisis, my view is that the chance of another GFC-style event are relatively small in the foreseeable future. Economic recessions are inevitable – and probably overdue in a number of countries – but recessions do not mean financial crises. The GFC should be seen as an exceptional event due to confluence of systemic failures and not something that is likely to occur regularly.

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It is also important to bear in mind that, as awful as the GFC period was to live through, most portfolios sustained little permanent damage when the full crisis and recovery period is taken into account. Those investors that had a long-term perspective, held their nerve and maintained positioning through the down swing recovered their losses within a few years.

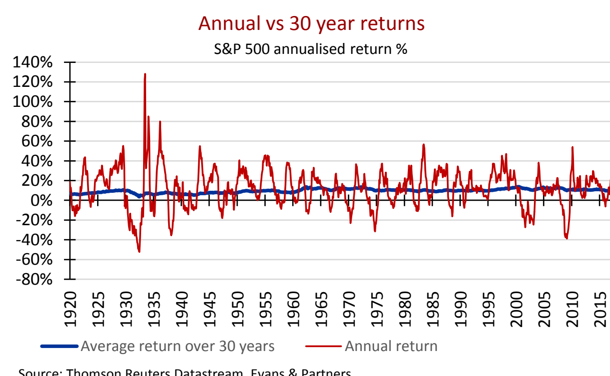
This was particularly the case for those who held diversified equity portfolios. The S&P 500 recouped losses on a total return basis within 19 months. For long-term investors, particularly for those with strong US exposure, the GFC now appears a blip when looking at ten-year rolling returns. Those who held diversified portfolios including bonds benefitted from a 10% increase in bond portfolios in the six months after the Lehman collapse.

In contrast, those portfolios that suffered the most during the financial crisis were those caught in illiquid products – particularly more exotic structured products where underlying values were unclear and where there was no scope for early exit.

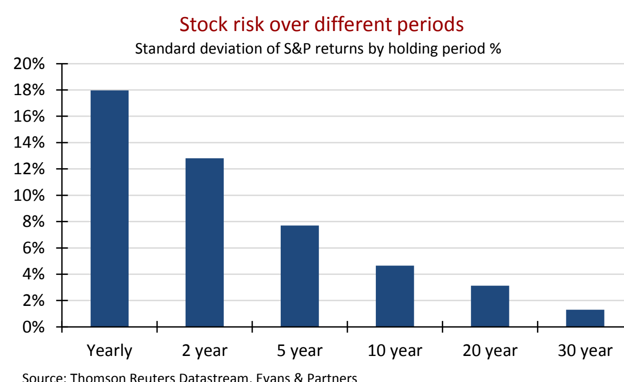
Liquidity, simplicity and diversification

The preceding analysis highlights the importance of liquidity, simplicity and diversification in ensuring portfolios are prepared for the next recession or market crisis. It also highlights that the wholesale selling of your equity portfolio is not necessarily the right way to prepare for a crisis.

It is also important to bear in mind your investing timeframe. There are a myriad of issues that may dominate headlines and create short-term market volatility, but which will have no lasting impact on markets – even such issues as the US-China trade war and Brexit that are pervasive at the time of writing are likely to end up fading from view and leave few permanent effects. The result is that there is much less variation in long-term than short-term returns. The chart below compares one-year and thirty-year annualised returns to demonstrate this point. The one-year returns show significant variability, but much of this disappears over longer-term horizons.



The chart below demonstrates this more formally by looking at the annualised standard deviation of equities over different holding periods. An investor with a one-year time horizon has typically seen annual volatility of 18%, while an investor looking only at rolling 30-year time horizons has seen annual volatility of less than 2%.



When we consider that most investors have a timeframe closer to 30 years than one, investors should not get overly carried away in being concerned about short-term movements in markets.

Recommendation

It's easy to get caught up in the negative stories around debt accumulation, political risk and potential recessions. And there is no doubt that market downturns and recessions will occur in the future.

The question, though, is what investors should do about it. Let's start with what I think they should **not** do:

- Sell out of all equity positions. This is partly because of the opportunity losses from being wrong on the occurrence of a crisis, its timing or its severity, but also because equities demonstrated their resilience in the full period around the GFC.
- Chase yield into more exotic and structured products. Liquidity and simplicity should be more highly valued in these circumstances.

Instead, investors concerned about macro and market risks should review portfolios and ensure:

- Portfolios are diversified across a wide variety of assets and geographies.
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