Philequity Corner (November 26, 2007)
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Will History Repeat Itself?

Mark Twain said, "History does not repeat itself, but it does rhyme." While trying to learn from past crises, we found out that the closest and most similar to today's subprime crisis is the U.S. Savings and Loans (S&L) meltdown in the 1990s. Both had its origins in financial market innovation gone awry, poor market regulation, and a failure of rating agencies to protect the average investor.

The U.S. Savings & Loans Crisis

Late in the administration of President Jimmy Carter, the balance sheets of savings and loans institutions (or thrifts) came under severe pressure from the high and volatile interest rates during the late 1970s and early 1980s. Congress then substantially loosened S&L lending standards and allowed them to diversify into riskier and hugely profitable commercial real estate lending. This was a departure from their original mission of providing savings and mortgages.

At the same time, federally backed deposit insurance at these institutions was raised from $40,000 to $100,000. Not only did this spark off a mad rush of funds into these thrifts, it also further encouraged the thrifts to increase risk taking.

Compounding the S&L crisis was the considerable loosening of regulatory standards. In particular, the thrifts were given the option whether they were to be state or federally regulated. This encouraged excessive S&L chartering by many states (notably California and Texas) which stood to earn from large fees by offering ever more lax supervisory regimes.

Two financial innovations played important roles. The first was the development in the 1980s of deposit brokerage. Deposit brokers earn commissions by finding the best certificate of deposit (CD) rates for their clients. Previously, banks and thrifts could only have five percent of their deposits be broker deposits. This limit was soon lifted, allowing even the small thrifts to attract large deposits by offering the highest rates. In order to make money on these expensive funds, these had to be lent on even higher rates, meaning taking even more risky investments.

Second, which made the system of deposit brokerage even more damaging, was the introduction of linked financing. In linked financing, a deposit broker would approach a thrift institution and say that they would steer a large amount of deposits to that thrift if the thrift would, in turn, loan money to certain people or to place the funds in certain investments. Junk bond king Michael Milken (who was later jailed for racketeering and securities fraud) packaged and brokered funds for several savings and loans on the condition that these institutions would invest in the junk bonds of his clients.

According to a 1999 review by the Federal Deposit Insurance Corporation (FDIC), 1,042 thrifts with total assets of over $500 billion failed during the 1986-1995 period. The total direct costs attributed to the crisis amounted to $150 billion. In today's costs, the S&L crisis would be of a similar magnitude to the current loss estimates of the subprime crisis.

Déjà vu?

Not only were the origins of the subprime crisis and the S&L meltdown similar, the market conditions today and in 1990 (the peak of the S&L crisis) also look the same. In both instances, oil prices spiked to new highs. There is also now a higher probability that the US will enter a recession, similar to the case when US plunged into a recession in 1990-1991.

Meanwhile, the impact to the stock market, especially to bank shares (in both cases), were devastating. As in the 1990s, when a majority of thrift banks closed shop, many banks, real estate investment trusts (REITs) and hedge funds now are suffering huge losses. Moreover, a number of mortgage lenders have already declared bankruptcies.

Similarities between the S&L & the subprime crises

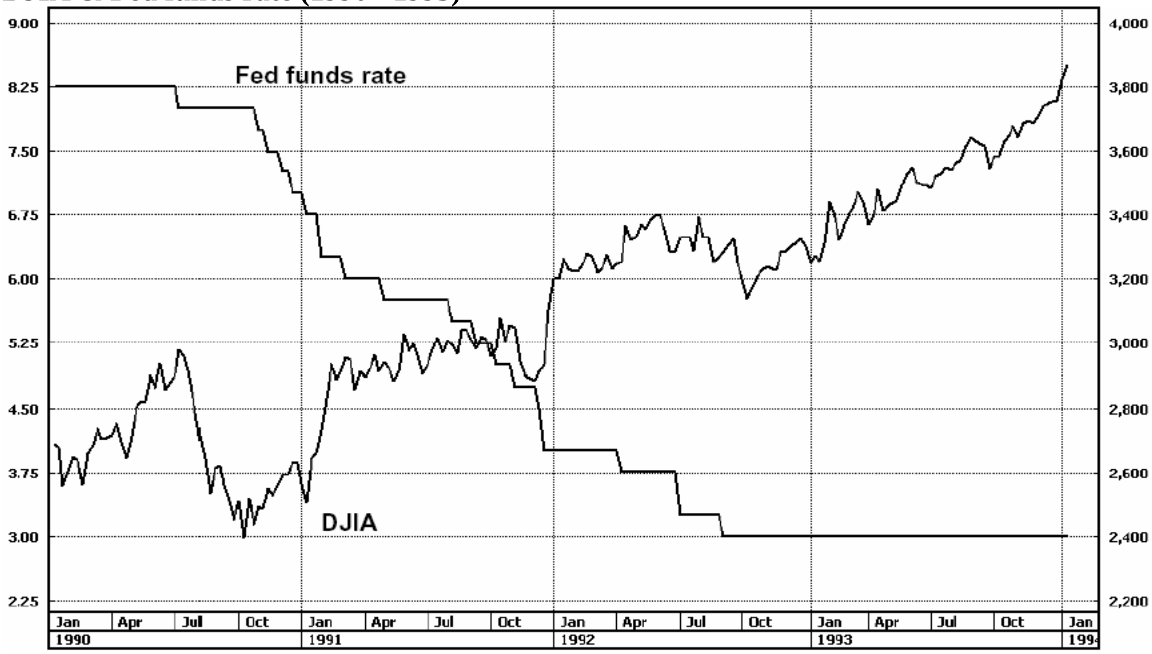
	1990	2007
1	Savings & Loans Crisis	Subprime mortgage crisis
2	US entering a recession	US expected to enter a recession
3	Oil spike from $15 (Jun 1990) to $40 (Oct 1990) as Iraq invades Kuwait	Oil spike from $50 (Jan 2007) to almost $100 (Nov 2007) due to a confluence of factors
4	Bull run in emerging markets started in mid-1980s	Bull run in emerging markets started in 2003
5	US bank stocks lost 40-50% in value	US bank stocks lost 40-50% in value
6	DJIA lost as much as 25% before bottoming out	DJIA has so far lost 12%
7	Bottom in share prices coincided with the start of the Fed rate cuts	Fed cut precipitated a big rally but the market is now retesting the August lows
8	P/E was 15 in US and 18 in emerging markets The rally from 1990s were triggered by expansion in multiples.	P/E levels are similar

Source: Wealth Securities Research

Actions to manage the crisis

The US Fed was successful in preventing a financial market collapse in the 1990s. It aggressively lowered the fed funds rate starting October 1990 from 8 percent down to 3 percent by September 1992. Prior to the cut in October 1990, the Dow Jones Industrial Average (DJIA) had fallen by more than 25 percent in a span of 3 months. The DJIA, however, recovered instantly after the October 1990 fed cut.

DJIA & Fed funds rate (1990 - 1993)



Source: Technistock

In today's case, the Fed has not been as swift in stabilizing the financial markets. Some are already saying that the US is already in a bear market, citing a popular market timing system called the Dow Theory. Technically, we still think it is unclear. Although the market is holding at support levels, it may still go down. Nobody will know for sure how long it will take and where the bottom of the market will be. However, we are sure that the Fed will continue to cut rates until a recession is averted or until the US gets out of a recession (if it indeed pushes through). As in the early 1990s (see chart above), the stock market should start its recovery as soon as the market realizes that the Fed will be successful in putting off the recession.

Concerted central bank effort may be needed

With the possibility of a US recession threatening global growth, it is not farfetched to expect simultaneous cuts by central banks in order to thwart a global slowdown. Already, a rate cut is looming in the U.K. after the Bank of England downgraded its 2008 growth forecasts. Similarly, rate cut expectations in Canada have been rising since the strong Canadian dollar is now beginning to squeeze domestic activity as well as exports. There is also an increasing chance of an eventual ECB rate cut as risks to European growth remain on the downside and the euro continues to appreciate sharply against the US dollar.

If these cuts happen, we may finally see a rally in the badly beaten down US dollar. Furthermore, the problem of hyperinflation in oil and commodities (due to the falling greenback) will now be solved. And with a more stable US dollar, a rally in US equities markets should follow suit, followed by a recovery in other equities markets.

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