

# The credit crisis fallout

Doug McTaggart

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- Global growth is expected to remain firm, or even pick up over the next few years
- Global inflation to remain firmly under control, not because central banks are doing a good job but because of the globalisation of the workforce and product markets
- The interest rate cycle will enter an up phase on the back of strong real growth
- Population growth into Queensland will pick up with the Sydney house market
- All the above is supportive of strong Qld growth and a strong construction sector with residential dwelling construction picking up
- But, there are risks....

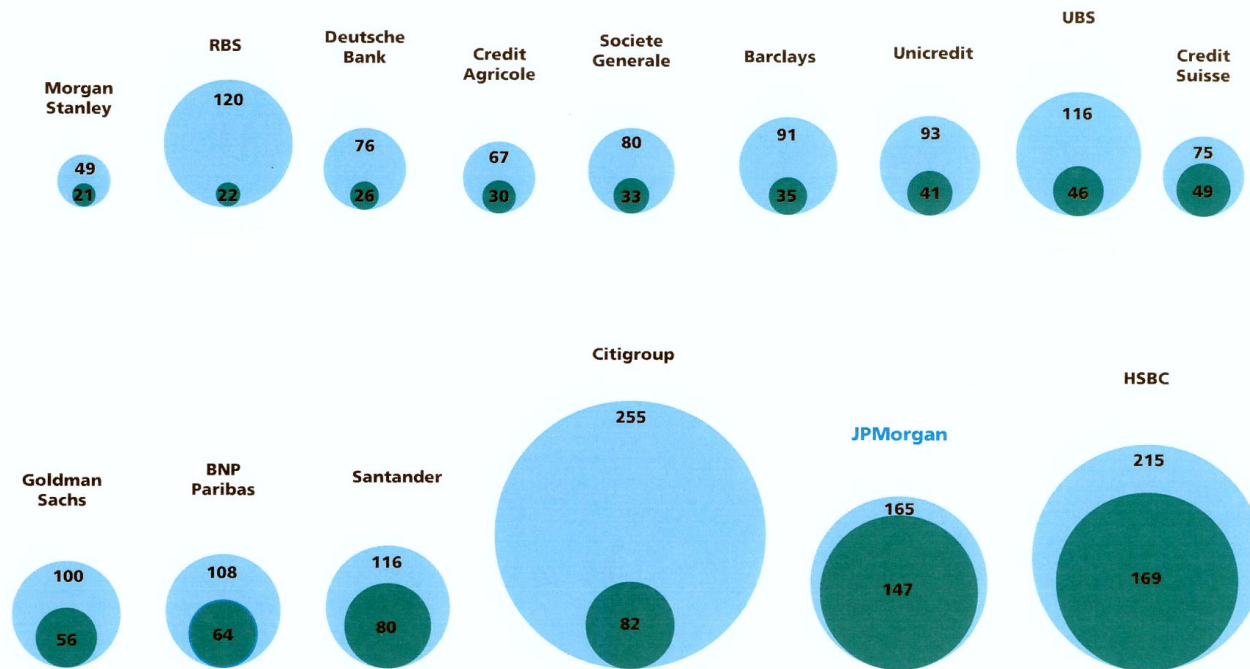
- Began with USD\$1.2 trillion in sub-prime debt out of USD\$50 trillion debt market
- Problem spread because of leverage
- Engulfed the entire global financial system
- End result is financial market contraction
  - Institutions getting smaller
  - 120,000 jobs gone on Wall St
  - Probably rising to 200,000 by year end

# Contraction of bank balance sheets



## Banks: Market Cap

- Market value as of October 20th 2008, \$bn
- Market value as of Q2'07, \$bn



Financial institutions are rapidly contracting in size

Source: Bloomberg, Oct 20 2008

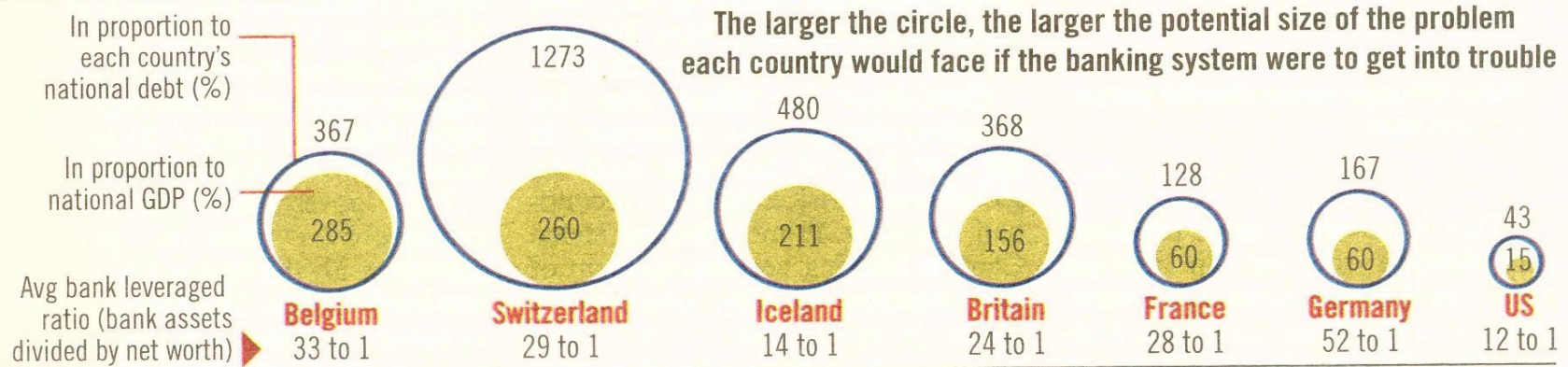
J.P.Morgan

While JPMorgan considers this information to be reliable, we cannot guarantee its accuracy or completeness

# Some will wear more pain

## Degrees of exposure

### Short-term bank liabilities



SOURCE: THE NEW YORK TIMES

Although some countries will wear a heavier burden than others. Interestingly, the problem started in the US but leverage ratios were much higher in Europe

- Crisis attributed to unfettered
  - Greed
  - Jealousy
  - Hubris
- Almost certainly true
- But what to do about it?

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  - Greed
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- Almost certainly true
  
- But what to do about it?
  
- After all, these are just **42.8%** of our human failings!

- The full extent of our foibles:

- Lust
  - Gluttony
  - Greed
  - Sloth
  - Wrath
  - Envy
  - Pride
- } The Human Condition

# Seven deadly sins

- The full extent of our foibles:

- Lust
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$$\frac{\text{Greed} + \text{Envy} + \text{Pride}}{\text{Seven deadly sins}} = 42.8\%$$

# How do we protect us from ourselves?



- Laws to protect property rights
- Policy to create the “right” economic and social environment
- Regulations to protect the integrity of markets and to control self-interest

# How do we protect us from ourselves?



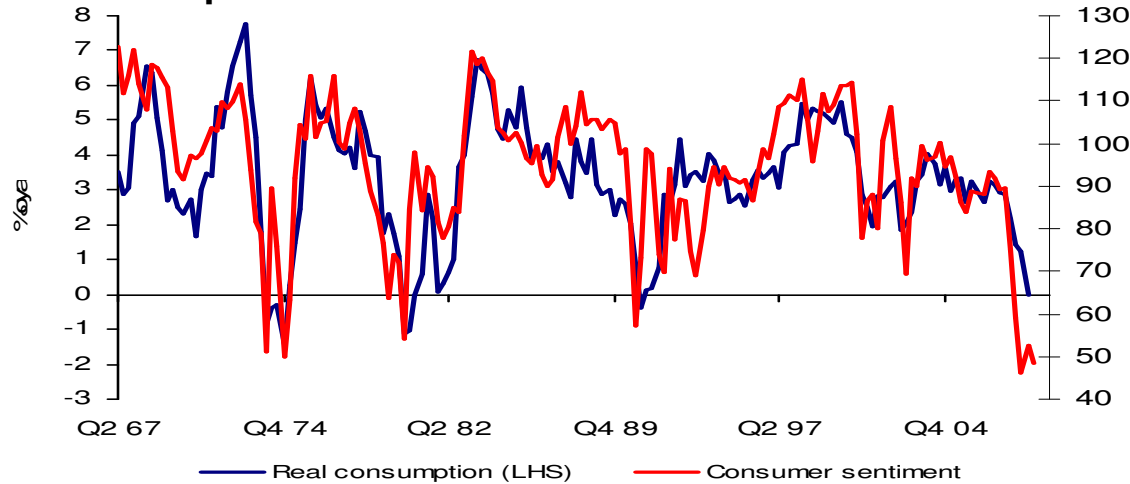
- Laws to protect property rights
- Policy to create the “right” economic and social environment
- Regulations to protect the integrity of markets and to control self-interest
- The global credit crisis was a failure of all the above!
- Systemic breakdown
  - Moral hazard
  - Regulatory failure
  - Greenspan

- ABS/MBS asset value write-down led to liquidity problems
- Liquidity problems led to asset pricing problems – distressed discounts
- Distressed discounts with mark-to-market led to solvency problems
  
- Enter policy-makers providing
  - liquidity to markets via central bank purchases
  - solvency via nationalisation
  
- Liquidity and solvency issues receding
- Focus is now on flow-on effects: **credit availability** and **confidence**

# The consumer goes on strike!



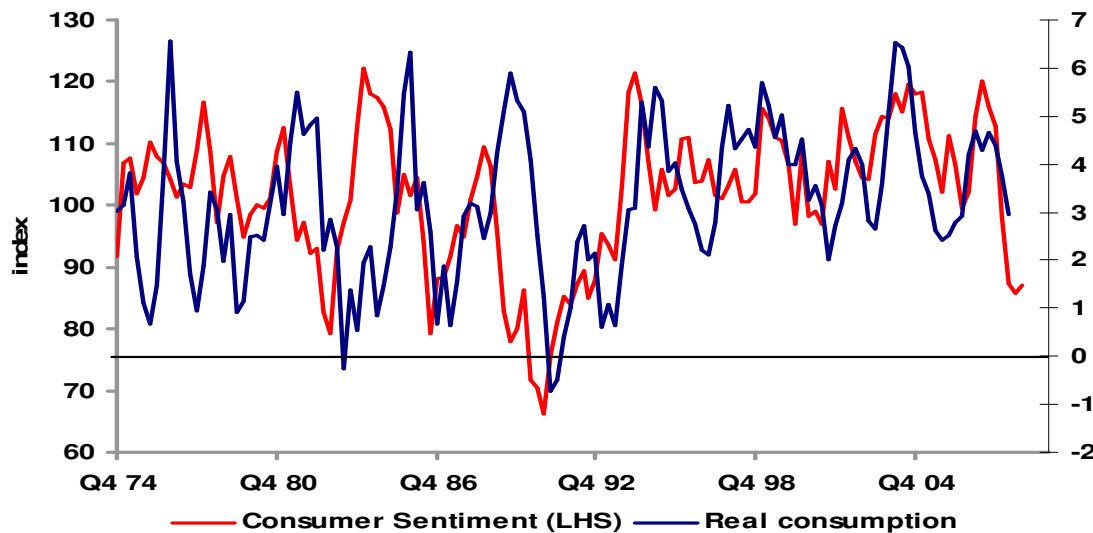
### US consumption and confidence



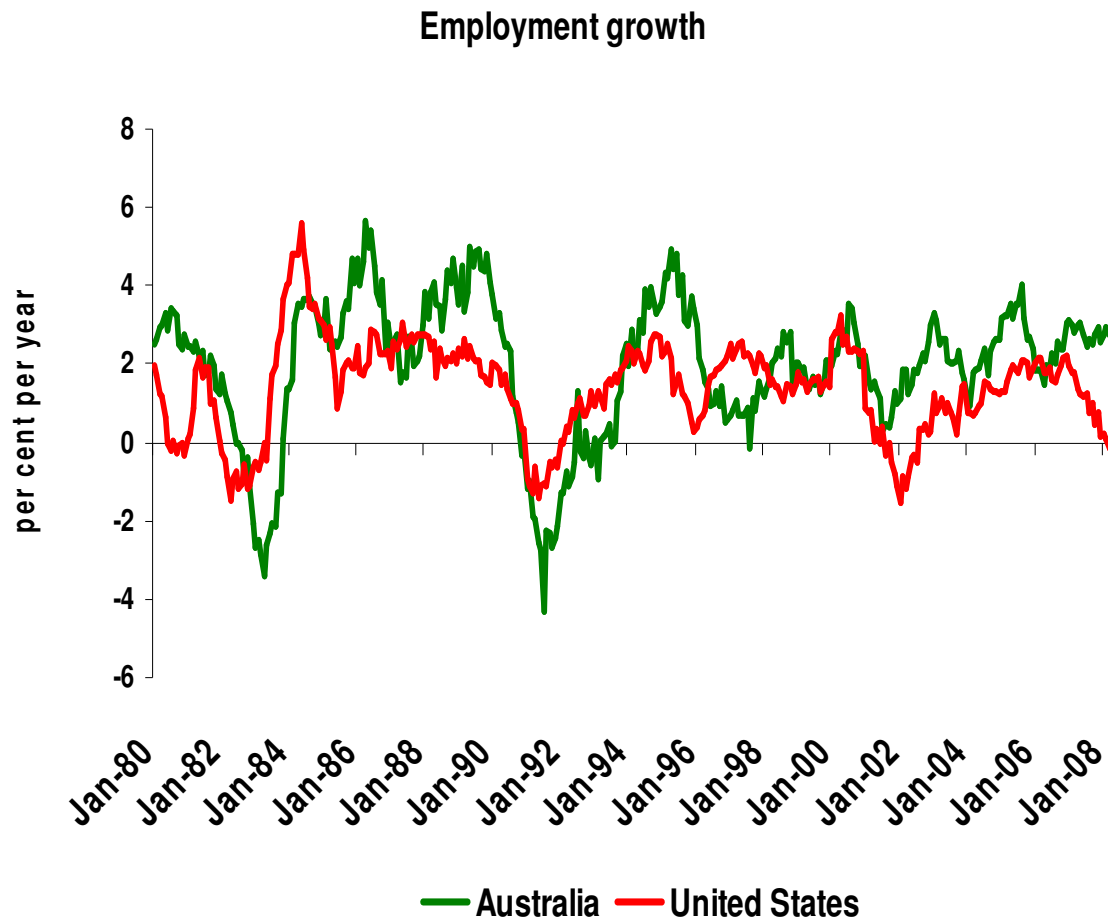
Consumer confidence has collapsed in both the US and Australia

Consumer confidence is a good predictor of future household spending

### Westpac-MI consumer confidence index



# Not driven by labour market outcomes



But it wasn't the collapse of labour markets that dragged down confidence

US labour market were weak while Australian labour markets remained strong

Yet consumers acted the same in both countries

- Implications: the paradox of thrift
  - Falling sales
  - Falling business confidence
  - Falling business investment
  - Rising unemployment
  - Recession

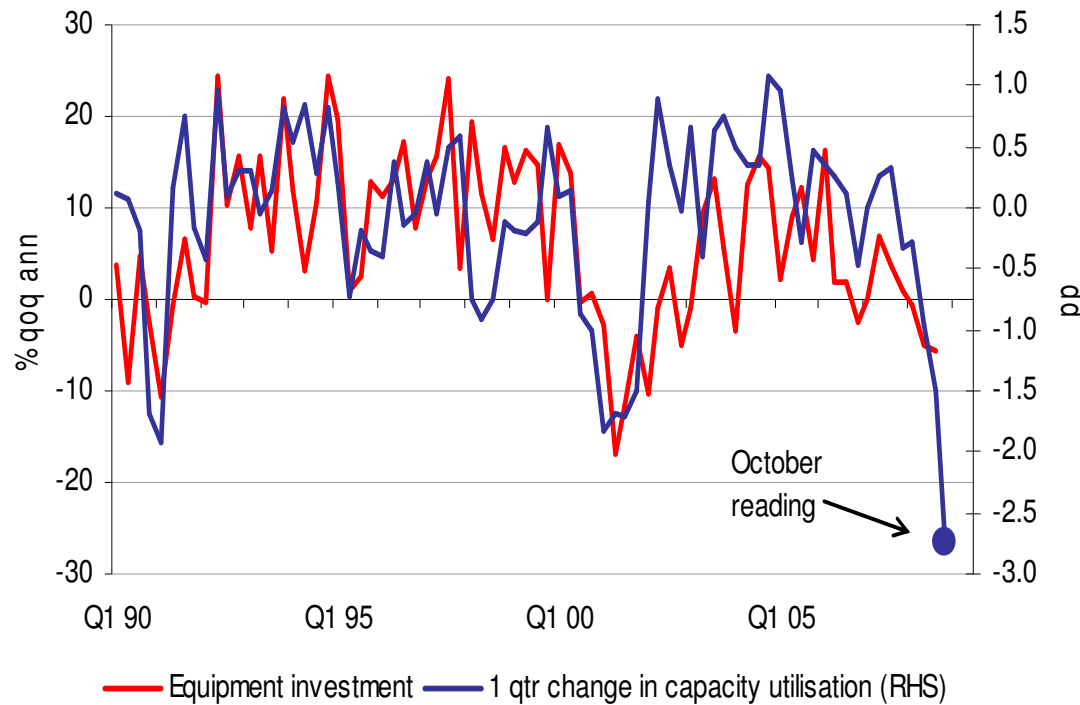
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- V-shaped, U-shaped, L-shaped?
- Depends on how long the stream of bad news lasts

# US business investment to fall sharply



Capacity utilisation and investment

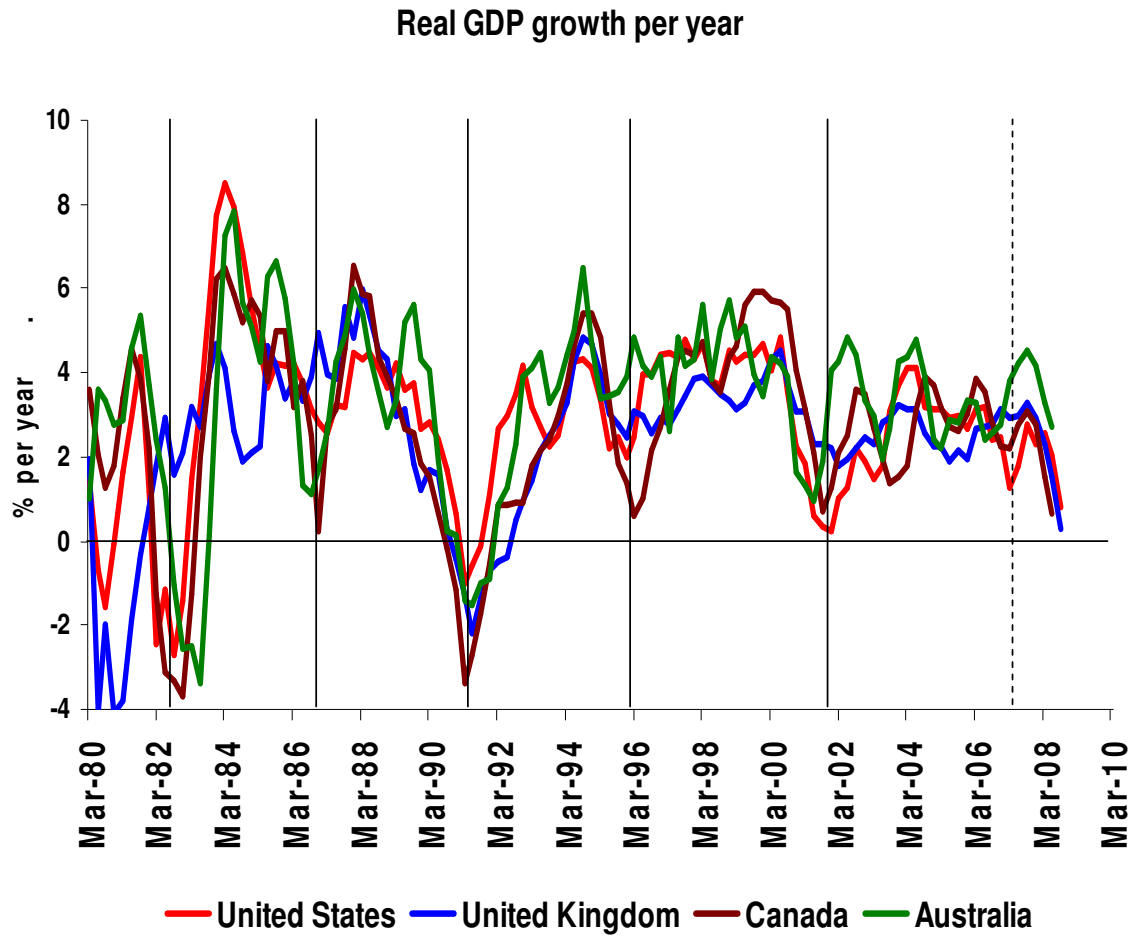


As sales fall, orders fall, capacity utilisation falls.

As capacity utilisation falls, business need for increased capacity collapses and business investment stops

Employment is highly correlated with business investment an industrial production

# The growth engine stutters



It looks like the global growth engine – the Anglo economies – is heading into recession

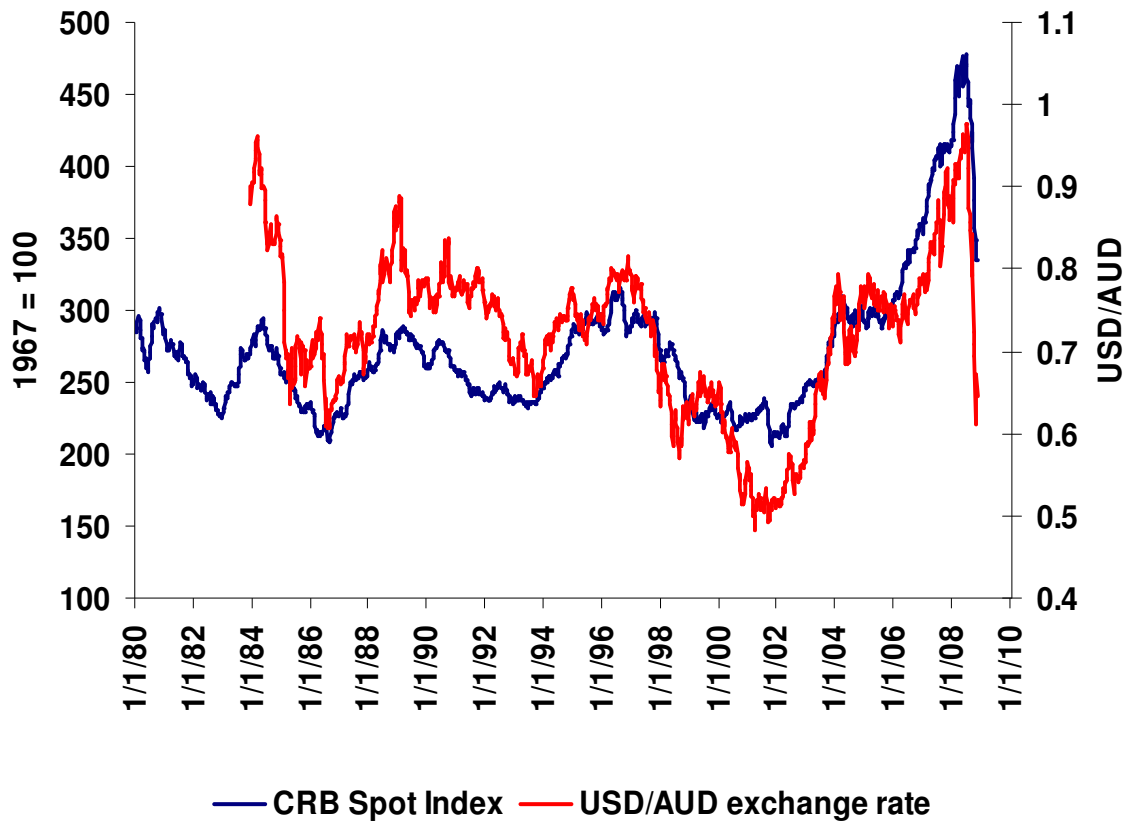
# What to more expect?

- Bad policy
  - Knee-jerk reactions
  - Example: recent Australian fiscal policy
- Bad regulation
  - More “Sarbanes-Oxley”?

# Help! – commodities to the rescue?



### Australian dollar and commodity indexes



Commodities face increasing supply, falling global demand and China specific problems

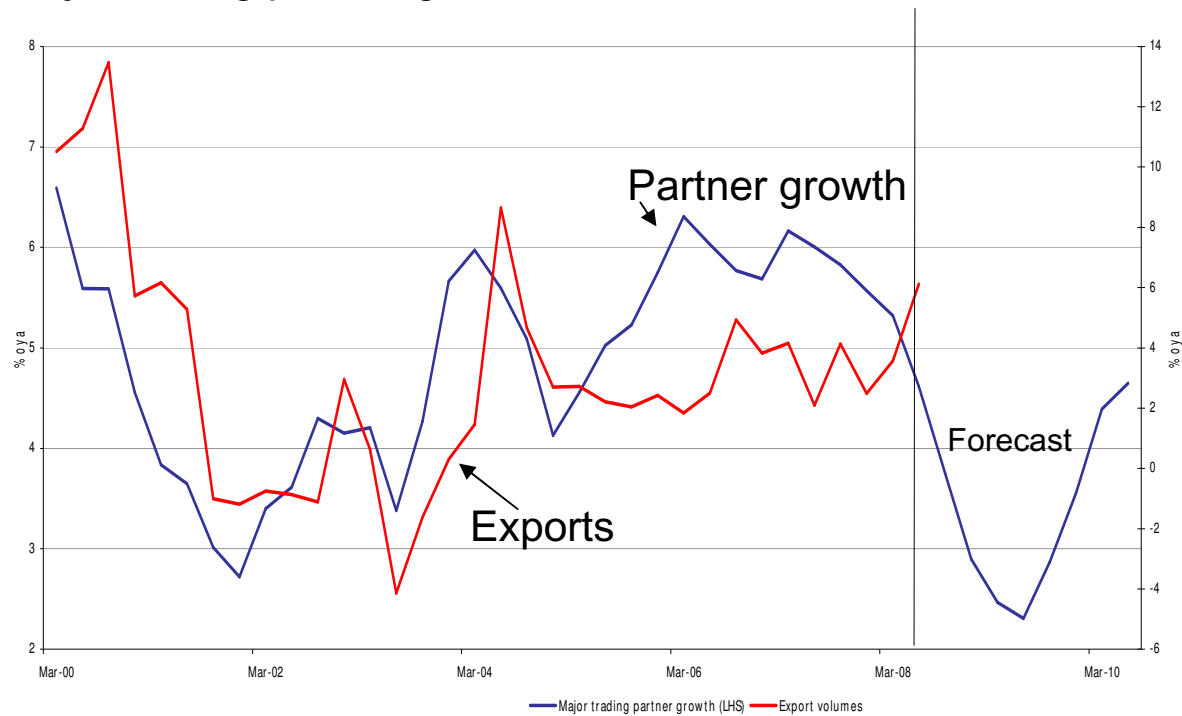
It is unlikely commodity prices will regain the previous highs for quite some time

This will sustain downward pressure on the exchange rate

# Our export markets won't help us



### Major trading partner growth



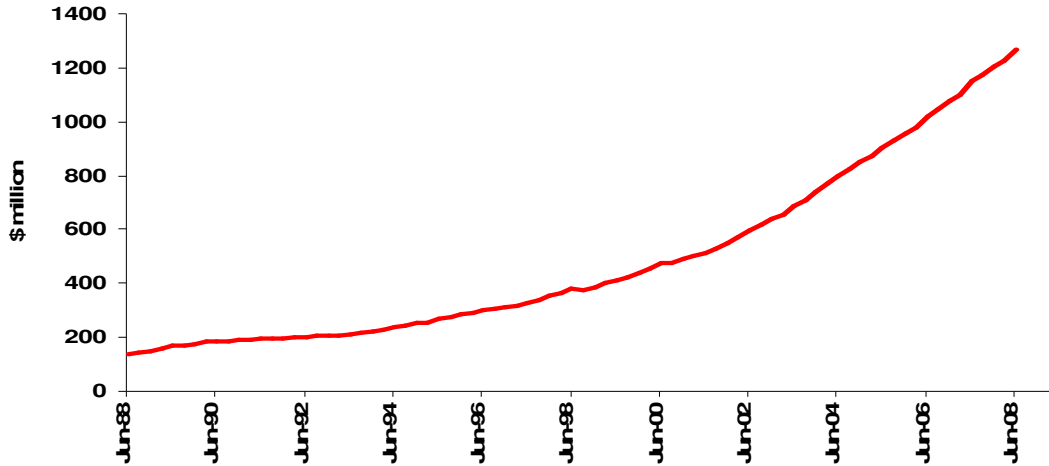
Given the global slump, Australia's export markets are likely to dry up in the near term

The weaker dollar will be of little short-term assistance

# Is all leverage bad?



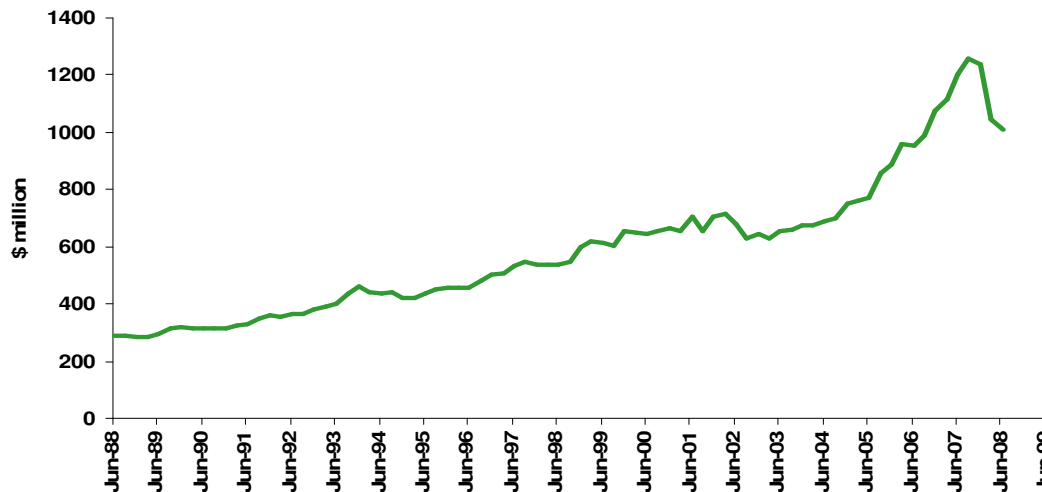
### Household liabilities



In the current environment, anything with leverage is bad!

Households have leverage, therefore they are bad!

### Household financial net worth

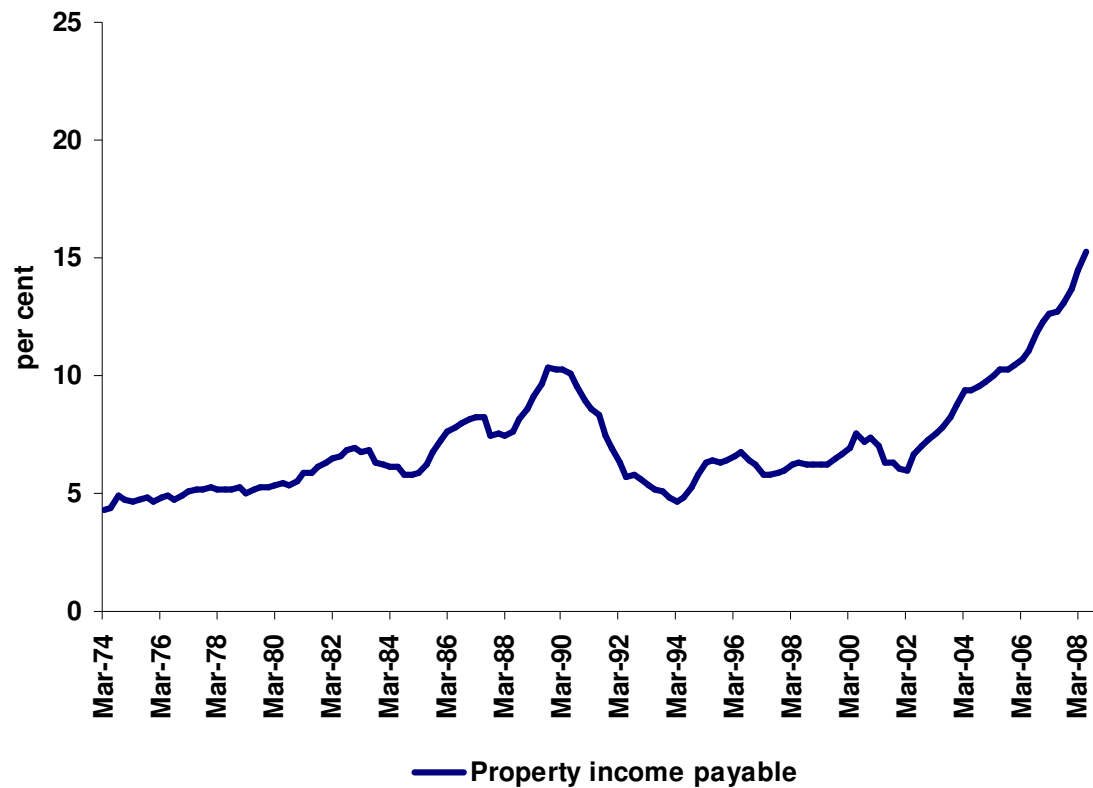


But, it looks like HH balance sheets are well managed, very solvent and liquid – though subject to mark-to-market volatility.

# Is all leverage bad?



property income receivable and payable as a share of gross disposable income

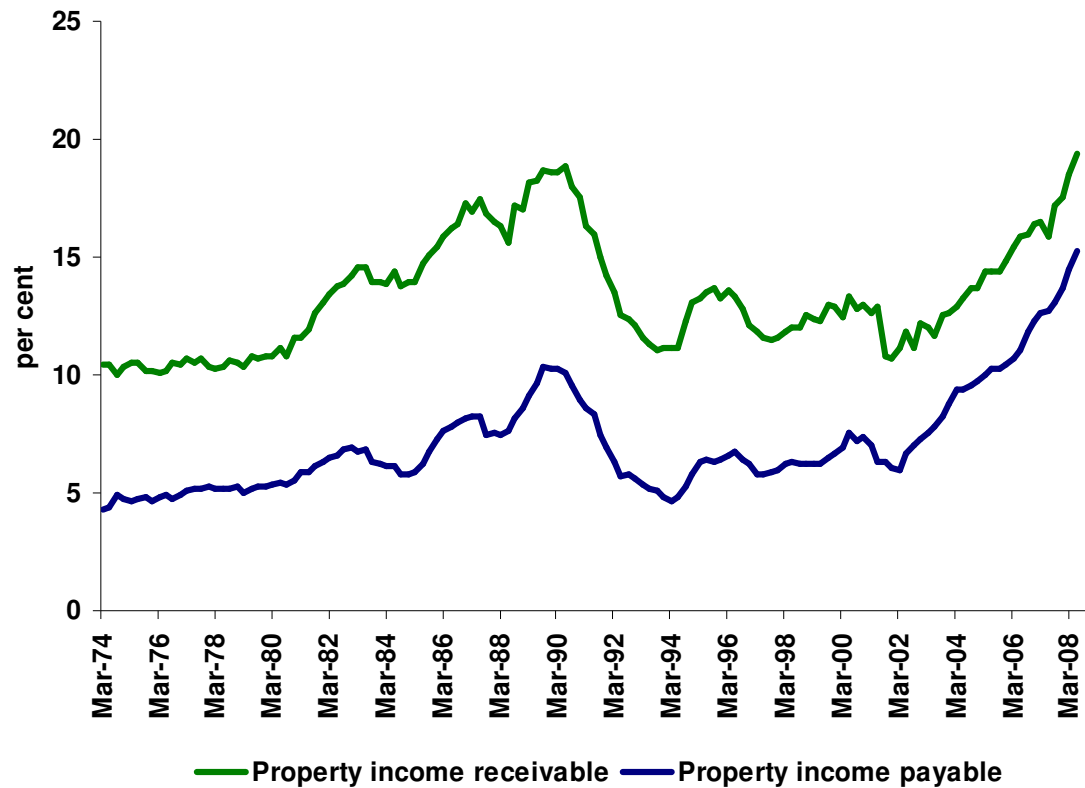


At first blush, HH P&Ls look under stress because outgoings on debt have risen a lot.

# Households will save the day



property income receivable and payable as a share of gross disposable income

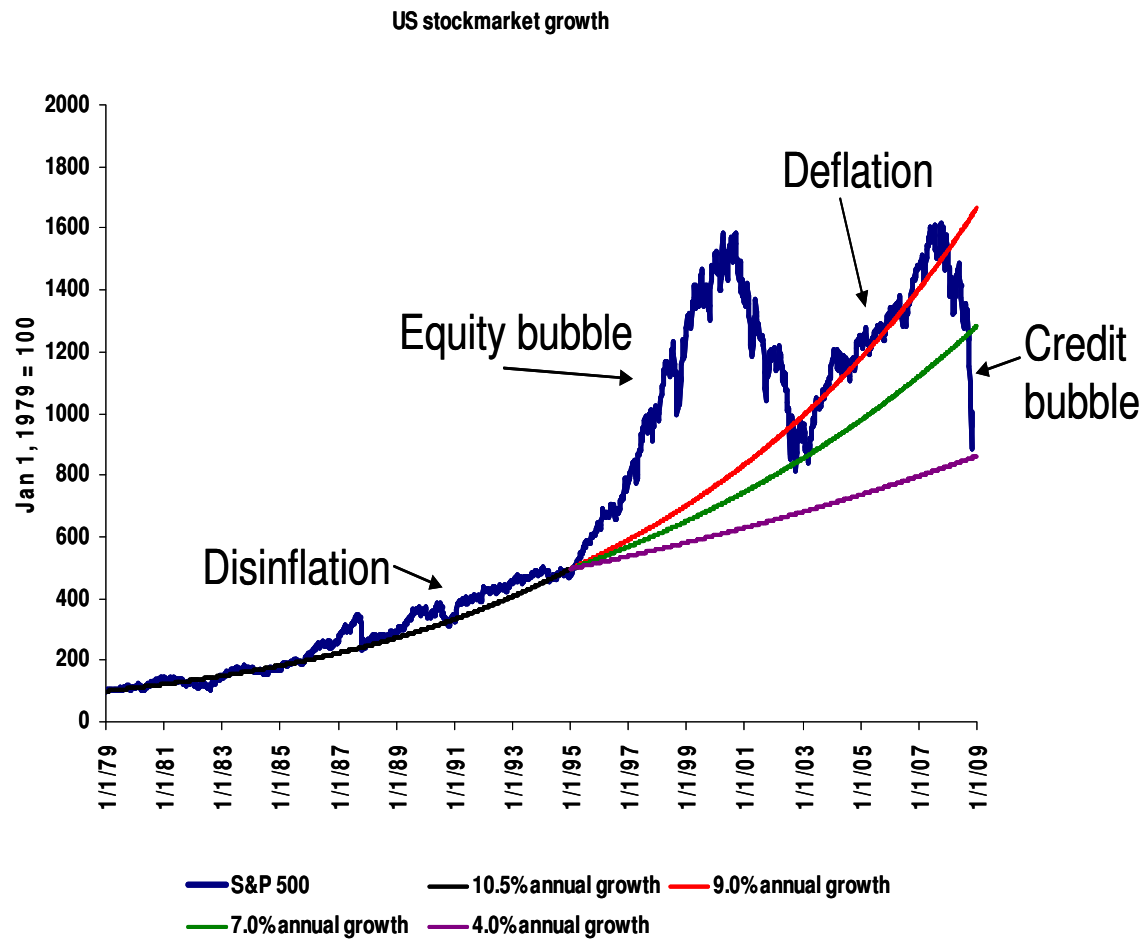


At first blush, HH P&Ls look under stress because outgoings on debt have risen a lot.

But to what end had most of the debt been put? – to purchase income producing assets

HHs are not as silly as “experts” claim

# Asset valuations: Cheap but who will buy?



Are markets currently fair value?

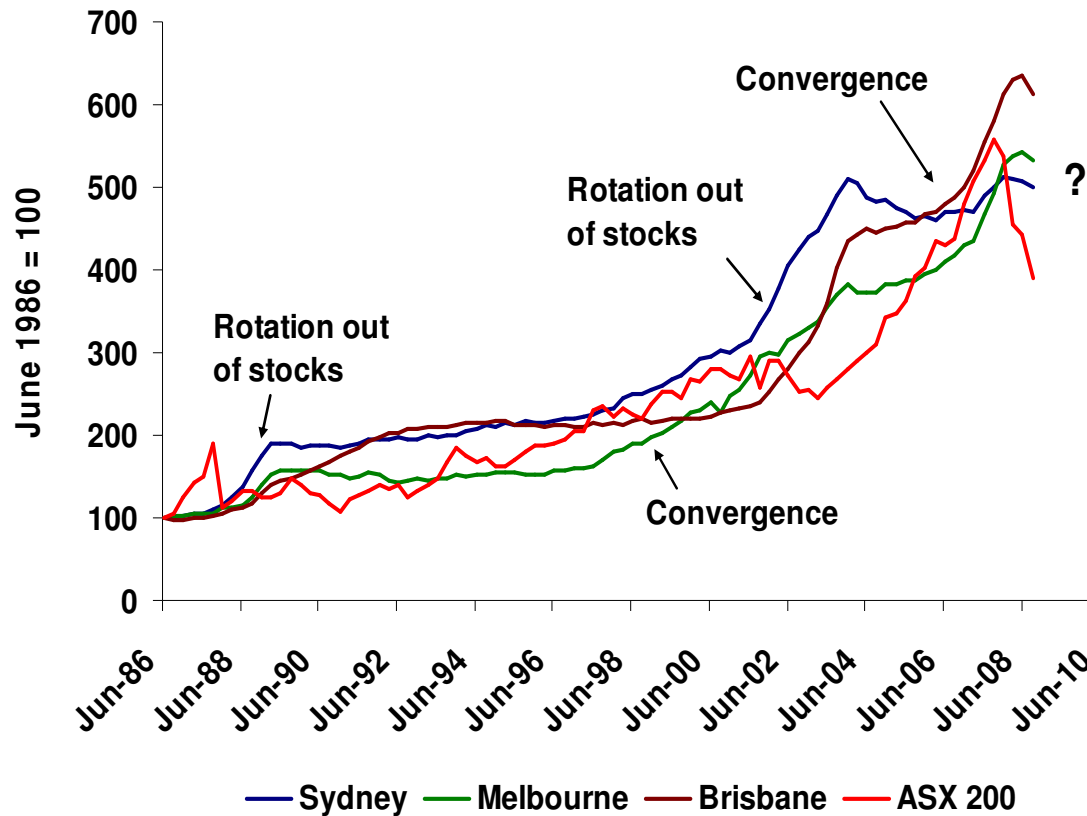
Hard to sustain the case that the US stock market has not seen real growth in US wealth since 1995.

However, markets are particularly focused on future earnings and are currently pricing in a doomsday scenario

# Are both houses and stocks expensive?



## House prices and the stock market



We typically observe prudent rotation by households between stocks and houses

At the moment we are seeing selling out of all non-cash assets – some distressed selling

When risk aversion falls again, which asset class will be the first to pick up?

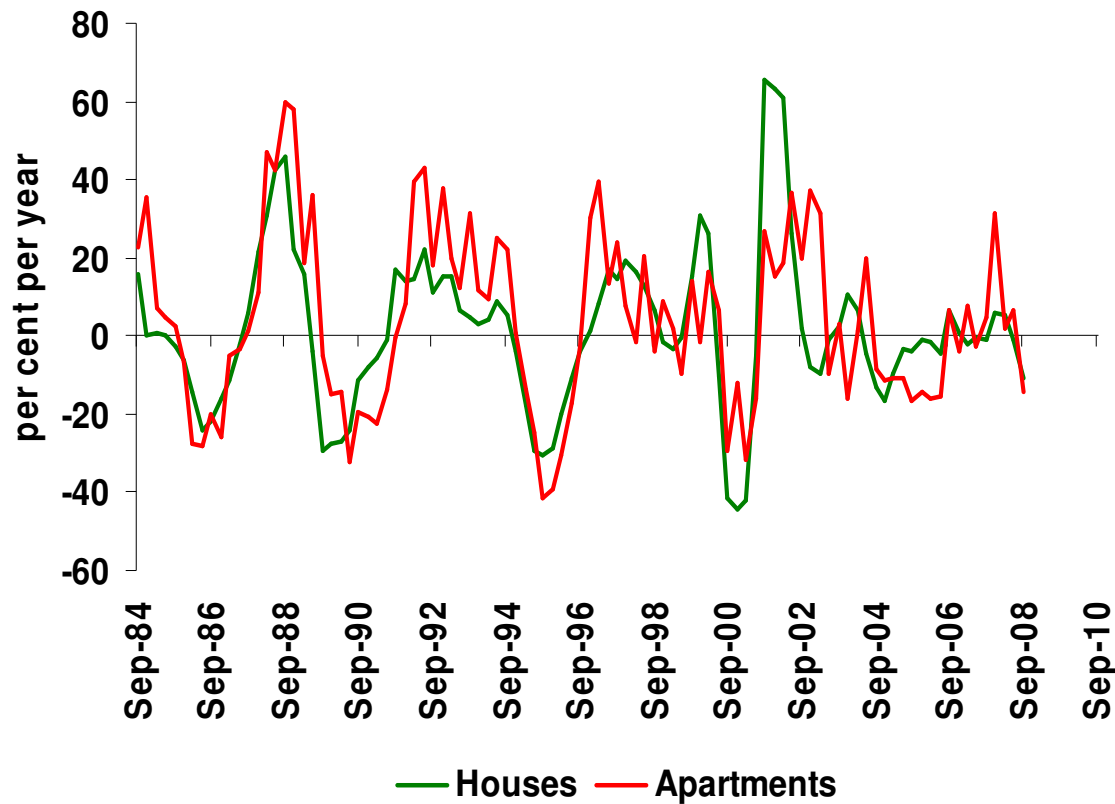
Stocks because they are cheap?

Houses because stocks are volatile?

# Residential construction still weak



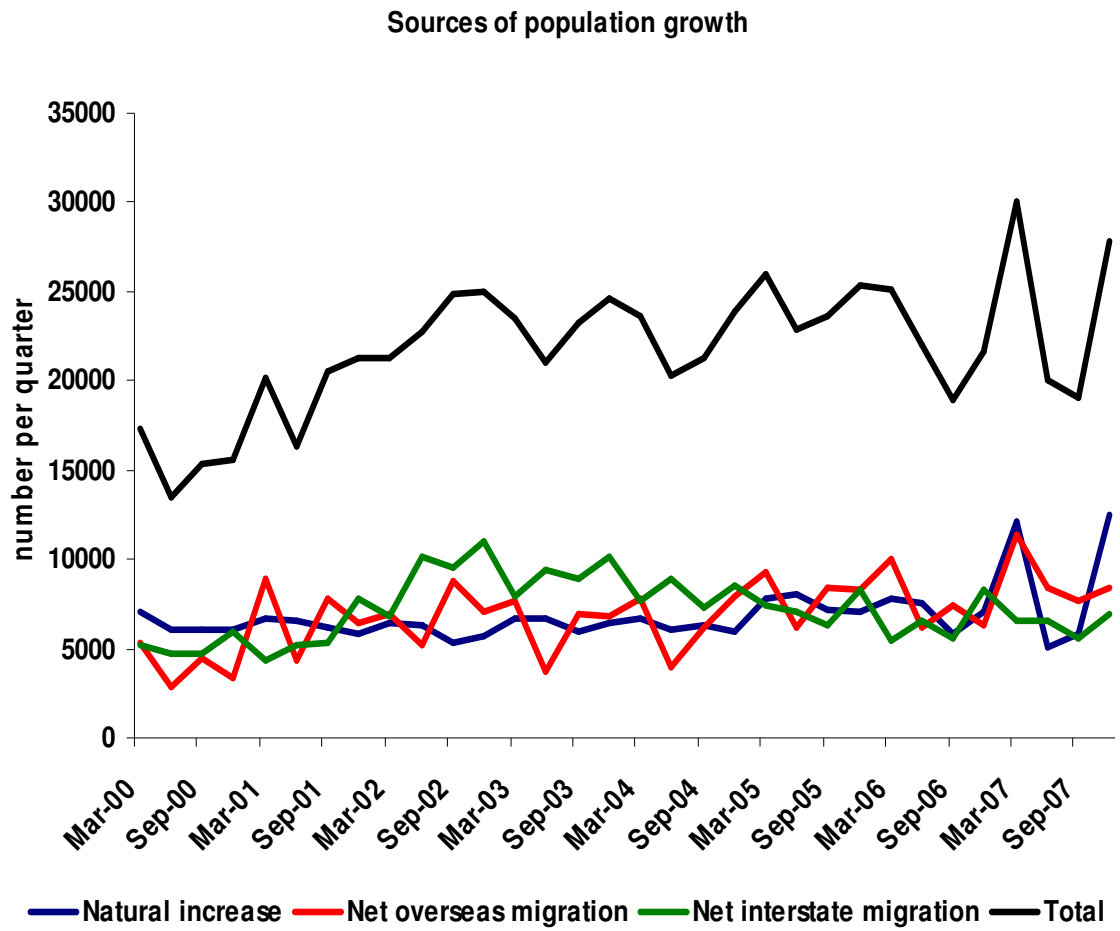
### Growth in approvals



Unlike the US, Australia does not have an excess supply of housing

It is hard to see a sustained fall in prices

# Queensland population growth is strong



Population growth is very strong. While net interstate migration is easing on the back of a softer Sydney house market, international migration is expected to continue to increase as 31,000 new skilled migrants will be allowed in next year

What is needed is a bigger baby bonus!

# What about inflation?



- Excess liquidity was the root cause of the problem
- *Excess* liquidity led to illiquidity problems which led to insolvency problems which led to a global credit crunch
- More liquidity is being used to solve the problem!
- Solutions: credit withdrawal or inflation
- However, the current deflationary shock has diverted attention

- Anglo consumers have gone on strike – withholding spending by choice
- Falling commodity prices, leading to falling AUD
  - Restoring global competitiveness, but who will buy
- In Australia, contraction of mining sector, housing sector, retail spending to continue
- An Anglo recession very likely
  - V-shaped, U-shaped, L-shaped?
  - Consensus is for U-shaped – back to trend growth after 2010
- Australia more robust – consensus not forecasting recession but hard to see how we could avoid one
- Inflation is a latent problem

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