

Balance of probabilities

Banking crisis deepens, raising risk level

February 27, 2009 – As the Bank of Canada prepares to lop another 50 basis points off its target overnight rate on Tuesday, the already-fragile global economy showed no signs of improvement and, in fact, displayed some increasing signs of distress. The world’s major stock indexes all plumbed new depths in February, testing last November’s lows and making as if to sink right through any support that might have been available at the lows last plumbed in October 2002.

But it was not to be, as investors lost their appetite for selling, at least for now, and thus avoided an all-out market panic, at least for now. That’s two “at least for now” qualifiers we inserted in that last sentence, and readers can be forgiven for wondering whether that may be one, or perhaps two, qualifiers too many.

Looking at the long-term chart for the S&P 500 Composite Index, we’re still tempted to reassert our original contention that this particular bear is finished. The market has plunged as much as it did when the dot-com bubble burst, but it has done so a lot faster. The credit crunch quickly morphed into a consumer-led recession – that’s the nastier kind – with the predictable nasty effect on business earnings, and of course, on earnings projections, which continue to be revised down, now with boring regularity.



But can we say for certain that the worst is now behind us? Truth is, nothing in this business is “for certain.” As investors, we work with a balance of probabilities. We read the tea leaves, consult the stars, pore over arcane financial statements and economic data,

frame our theses, make our decisions, and then hope for the best. Mostly it works as planned. Sometimes we see the freight train coming, and for a variety of reasons, are unable to do much about it.

Back in early 2007, for example, an inverted U.S. Treasury yield curve was signalling that there would be a recession within a year – a phenomenon that had occurred pretty much without fail since 1970. But which advisor, portfolio manager, or planner would, in March 2007, try to persuade clients in the middle of one of the great bull markets of history, to put all their money into T-bills? Some tried and failed. Some lost clients as a result of even suggesting such a move, because, of course, it was “different this time.” The “paradigm had shifted,” said the experts. Economic momentum had migrated to the “BRIC” nations (Brazil, Russian, India, and China). The days of American influence on the global economy were at an end.

Trouble is that the BRIC, and most other, nations still relied on the mighty US economy as a market for exports. And through the decade, that market had been voracious, a black hole for mountains of consumer goods. Fuelled by a seductive combination of low interest rates, easy credit, and innovative financial engineering that seemed the spread the inevitable risk far and wide through global markets, the good times seemed permanent.

But things aren't really ever “different.” The iron laws of economics cannot be ignored for long. Debtors must always settle up with creditors. Always. That settlement, if put off for too long, can be protracted and painful, as we have seen. Trillions of dollars worth of so-called toxic debts are being settled now, through the auspices of governments and central banks everywhere, as the burden of payment shifts inexorably to taxpayers everywhere around the world.

And the effects of that retrenchment are being felt most painfully in economies that are least able to cushion its effects. Economies like the BRIC nations, whose domestic growth, as strong as it was, still could not offset their reliance on export – largely to the US – as a major GDP driver.

In Eastern Europe, the situation is particularly grim, with as many as 16 emerging nations teetering on the edge of bankruptcy. As we pointed out last week, that spells big trouble for the entire European financial system, because many of Western Europe's largest banks are heavily exposed to the East. The International Monetary Fund, the World Bank, as well as two European institutions have already provided billions in loans in an effort to ward off a regional currency crisis. Western European governments have already implemented bailout and relief programs for their banks, similar to US efforts. But still the troubles come.

In Britain, Royal Bank of Scotland Plc reported the biggest financial loss in British history (US\$43 billion in 2008), and has been nationalized in all but name by the UK government. In the US, Citigroup Inc. got three new directors on its board, as the US government increased its ownership in the beleaguered bank to 36%. So-called stress tests of US banks with more than US\$100 billion in assets last week showed that a whole

lot more capital is needed to support losses under a sustained economic downturn this year. That put US financial stocks under their own stress test last week, as the sector led US stock markets to another loss on the week, the month, and the year to date.

The Dow Jones Industrial Average declined 4.1% on the week, and posted an 11.7% loss for February, for a 19.5% loss in the year to date. The S&P 500 Composite similarly dropped 4.5% on the week, 11% for the month, and 18.6% for the year to date.

The S&P/TSX Composite Index, on the other hand, last week provided the one bright spot in this otherwise gloomy picture. Canadian financials, with an assist from golds, and metals and mining, supported the TSX through the week, lifting it to a weekly gain of 2.1%. Friday, however, saw a 3% retreat in financials on news of creeping bank nationalization in the US. Toronto's benchmark index closed February with a monthly loss of 6.6%, leaving it 9.6% in the red for the year-to-date.

As we said earlier, we're tempted to reassert that markets have reached a bottom. We've stated in past comments that this process will be long and arduous, characterized by volatility and all sorts of anxiety. So far, it's holding true to form. The balance of probabilities is, we believe, still with us. But the continuing banking crisis in the US and abroad, and the very real possibility of an unfolding currency crisis in Europe, has raised the level of risk in our scenario considerably. ■

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