September 2018 marked the 10th anniversary of the collapse of Lehman Brothers and the onset of the Global Financial Crisis (“GFC”). A decade hence we decided to take a look back at the key causes of the financial crisis, examine what has changed in both the market and the broader economy, and then give our thoughts on what issues were addressed, and what problems we believe remain unresolved.

Any event that was as broad and deep as the GFC was naturally the result of many factors, but any post-mortem of the causes center on two primary issues: the housing bubble in the U.S. and leverage in the global financial (particularly the banking) system. In the decade prior to 2008 low interest rates, increasingly lax lending standards, and the assumption that U.S. housing prices would not decline in harmony led to a rapid increase in housing prices and mortgage debt. From the late 1990s to the peak of the housing bubble in 2006 home prices appreciated more than twice as fast as rents for close to a decade. This left housing unaffordable for most Americans and led to a collapse in prices from an unsustainably high level.

Given the importance of housing to the economy the slowdown in housing prices and activity was sure to cause a recession. What turned it into a financial panic was excess leverage in the financial system. Starting with the repeal of Glass-Steagall under Bill Clinton, banks became ever more aggressively capitalized and sought out riskier, higher margin lending opportunities. This left the banks with little buffer to handle non-performing loans and write offs when they began to occur. At the beginning of 2008 Lehman Brothers was levered 30:1, meaning just a ~3% drop in the value of their assets would result in insolvency, which is exactly what happened in September 2008.

Over the subsequent decade markets and the broader economy largely recovered. Unemployment peaked at 10% and today is less than 4%, a level not seen since the tech bubble. U.S. GDP growth is above 3% on a real basis and running close to 7% on a nominal basis; the stock markets — both in the U.S. and international — have fully recovered all the ground lost in 2008.

In addition to the economic and market recoveries, many of the problems laid bare by 2008 have been fixed. U.S. housing prices have fully recovered to their 2006 peak, but housing looks to be on much firmer footing today. Despite the recovery in prices, relative to rents, home prices remain significantly below the 2006 peak. In addition, due to income growth and low interest rates, housing remains very affordable. Lastly, lenders have shown more discipline, demanding meaningful down payments, verified income levels, and conventional 30-year fixed mortgages compared to the “no-doc” interest-only loans that were very popular in the lead up to the housing bubble. The financial system is also in much better position, with much higher capital ratios and leverage levels of less than 12:1. Finally, Basel III, Dodd–Frank, and the annual Federal Reserve stress tests have kept banks focused on traditional lending and limited their ability to pursue higher risk businesses.

However, there remain many challenges as we look ahead. The financial crisis led to a significant transfer of debt from the private to the public sector. As a result, U.S. debt/GDP increased from ~35% before 2008 to over 80% today and is forecast to exceed 100% over the next decade. Furthermore, the Federal Reserve and other central banks...
around the world embarked on a large asset buying program, known as quantitative easing ("QE") to support financial markets. As a result, central banks now hold over $14 trillion of securities and their collective balance sheets have increased over four times in the last decade. Given that this is the largest monetary policy experiment in history, it is impossible to forecast exactly how the unwinding of central bank balance sheets will affect the market and the economy. Lastly, “too big to fail” became a defining phrase of the financial crisis, but little has been done to solve the problem. Today the 50 largest banks in the U.S. control ~80% of all industry assets due to continued consolidation in the banking industry. While banks are less likely to fail, if there is an insolvency, it is more likely to require a government bailout than ever.

Even with a decade of hindsight, 2008 was still a very painful experience for investors. The good news is many of the problems that caused the last crisis have been addressed, so the next bear market will almost certainly look different than the GFC. Critically, many important lessons were learned, and while there are still plenty of potential potholes in the road ahead, the financial system is on stronger footing than a decade ago. 🔴

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