MR Musha Research

30 Sep. 2009

DSI Vice Chairman Commentary

Key Strategy Issues (Vol. 283)

The increasing likelihood of a V-shaped recovery that takes global stock prices back to pre-Lehman shock levels

The pessimistic view is proven wrong by the current powerful rally in stock and bond markets

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No end is yet in sight to the current historic rally in worldwide stock and credit (corporate bonds, MBS and securitized instruments) markets. Driving this recovery is the “negative bubble” that was created by the steep drop in prices on financial markets that began in the second half of 2008. Now we are witnessing an enormous correction that is eliminating this bubble. Many members of the media as well as financial professionals are overlooking this important fact.

Originally, pessimists stated that the financial crisis was caused by a defect in U.S. economic fundamentals: excessive debt and spending. Since the cause is structural, pessimists were convinced that measures to stimulate the economy and save financial institutions could not produce an economic recovery. But recent events have shown that this explanation of the crisis is wrong.

It is still too early to determine the true causes of the financial crisis. But at this point, the most probable explanation is that the crisis was sparked by an extreme breakdown of supply-demand dynamics. The cause of this breakdown is a defect in the financial system. For example, many investors believed that insurance made their principal was absolutely safe. Panic ensued when these investors discovered that this insurance was ineffective. With credit default swaps that incorporate financial engineering techniques, there is insurance for the repayment of principal in the event of a bankruptcy. However, the bankruptcy ratio of the portfolio was much higher than anticipated. Because of these bankruptcies, insurance companies and other companies that had purchased this risk attempted to sell everything at once. The enormous volume of selling created a complete absence of buyers in financial markets worldwide, which resulted in a spectacular collapse of these markets. The climax occurred on Black Monday. A close look, though, reveals that this collapse was linked to a breakdown in the balance between the supply and demand for capital that had almost no relationship with the real economy.

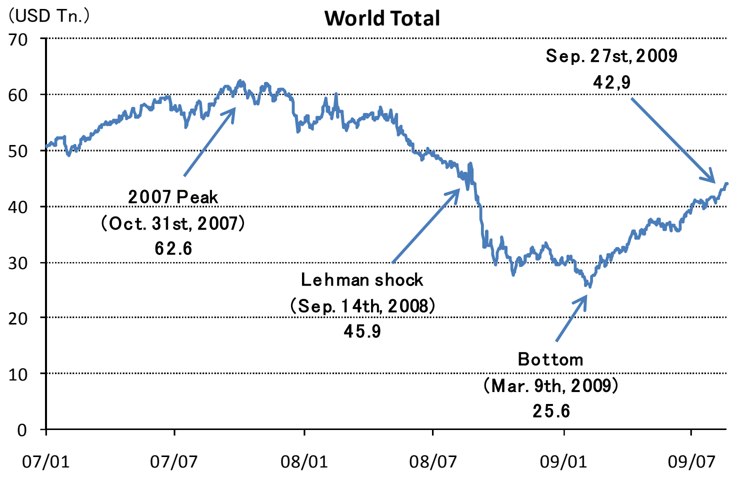
Once the U.S. economy has completed its powerful recovery, we will need to once again study the financial crisis to determine the causes.

(1) The correction of the negative bubble is progressing

One of the greatest stock and credit market rallies ever

Global stock prices have returned to where they were before the collapse of Lehman Brothers. Market capitalization of global stock markets peaked at $62 trillion in October 2007. When Lehman Brothers failed, this figure was down to $44 trillion. Global stock market capitalization finally hit bottom at 26 trillion in March 2009, about 60% below the peak. On September 26, 2009, this number was back to $43 trillion. The 65% rebound over only six months was one of the greatest stock market rallies ever. Prior to the stock market rally, there were rapid recoveries in prices of U.S. corporate bonds and mortgage-backed securities (MBS) after the prices of these securities had plummeted. The ABX index is up more than 30% during the past three months (Financial Times, September 28). In addition, earnings at major U.S. financial institutions, which were at the center of the financial crisis, have rebounded quickly along with these prices. Particularly noteworthy is the substantial progress that financial institutions have made in eliminating non-performing loans due to this strong rally in stock and bond prices. Plunging stock prices severely eroded the market value of bank capital. The result was vicious cycle in which an enormous increase in leverage (assets divided by capital at market value) forced banks to sell more assets, which caused market prices to fall even more. But now that stock prices are rebounding, leverage ratios are falling as bank capital returns to the original levels. The result is a virtuous cycle in which the renewed ability of banks to take on assets with risk is causing asset prices to climb.

Figure 1 : Market Capitalization of Global Stock Markets



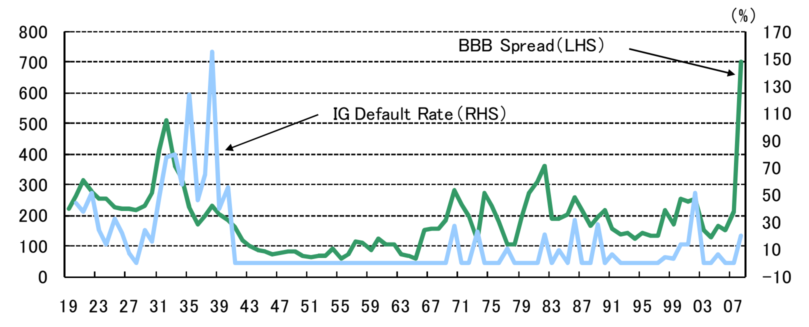
Sources: Bloomberg, Musha Research

A huge return for both financial institutions and regulatory agencies

Falling market prices of assets has forced financial institutions to book massive losses as they marked down the value of their assets. With prices now rebounding, though, financial institutions are able to reverse this process by recording massive gains on the mark up of assets. These mark-up gains may even produce a positive surprise when U.S. financial institutions report their earnings for the third quarter of 2009.

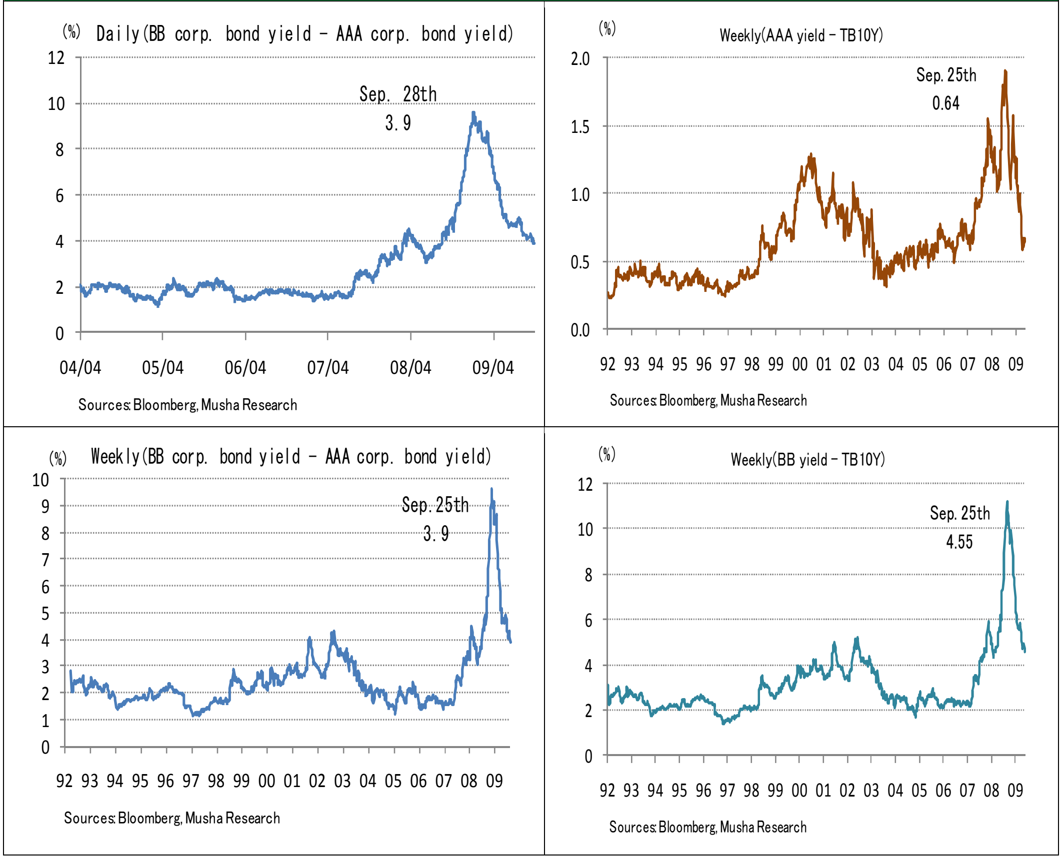
U.S. regulatory agencies that supported financial institutions are also chalking up enormous returns (not losses) as stock and bond markets bounce back. In the first half of 2009, the Fed recorded a profit of $16.4 billion in relation to its total assets of ¥2,100 billion. Half of this profit came from measures to rescue financial institutions, such as purchases of MBS, commercial paper and U.S. treasuries. Furthermore, the Treasury Department recorded a first half profit of $9.5 billion from its Troubled Asset Relief Program (TARP) expenditures of $248.8 billion and the Federal Deposit Insurance Corporation (FDIC) recorded a first half profit of ¥9.3 billion from its guarantees of debt totaling $386.0 billion. The Treasury Department's return on its TARP account is said to be an annualized 7% even after excluding the $16.5 billion gain from the recovery in bank stock prices (Wall Street Journal, 9.2.2009).

Figure 2： Risk Premium and Default Ratio



Sources: Deutsche Bank Credit Strategy Research

Figure 3： U.S. Credit Risk Premium



(2) The two reasons that we avoided another depression: government policies and globalization

The pessimistic view cannot explain current events

Thus far, I have merely stated the obvious. The current financial market rally is a correction of the negative bubble that was created by the global plunge in prices of stocks and credit instruments that started in the second half of 2008. The conclusion regarding pessimists is equally obvious. There is no doubt that pessimists were completely wrong to subscribe to the following belief: Measures to stimulate the economy and rescue financial institutions would not produce an economic recovery because the financial crisis was caused by defective fundamentals of the U.S. economy, namely excessive debt and spending.

Bold U.S. monetary and fiscal initiatives prevented deflation

First, we need to recognize two critical factors that make this financial crisis different from the Great Depression: government policies and global markets. This time, government initiatives were highly successful at terminating the vicious economic cycle. The Fed believed that the preference for cash was at the heart of this crisis. To eliminate this cause, the Fed concentrated on maintaining the dollar's liquidity and supporting asset prices by serving as the buyer of last resort. At the same time, the US Government used two types of fiscal expenditures: spending to support the financial system and spending to create demand. By taking these actions, the US Authority succeeded in completely blocking the path to a deflationary spiral. The greatest benefits were the recovery in financial institution earnings and rapid restoration of equity capital at these institutions. In other words, financial institutions were able to continue allocating capital in order to acquire assets with risk. This is a decisive difference between recent events and what occurred during Japan's "lost decade."

Blessings of economic globalization

In the 1930s, the process of dividing the world into separate blocks was completed as the world entered a period of trade protectionism. This policy prevented the international division of labor, which is a driving force behind economic growth. Today, the situation is exactly the opposite. The international division of labor is firmly entrenched because of the globalization of economies. As a result, companies can constantly take advantage of two remarkable opportunities. The first is the huge volume of domestic demand in countries with emerging economies. The second is ability to benefit from the rapid improvement in labor productivity in emerging economies. More specifically, this benefit is the ability of companies and consumers in industrialized nations to reap higher profits due to the so-called "cheap labor gift." The strong performance of U.S. companies that I discussed in my previous report (Key Strategy Issue Vol.282 "A recovery has started despite declines in employment and credit extensions. Progress in corrections by U.S. companies points to greater likelihood of a V-shaped rebound.") is the direct result of globalization.

Figure4： Labor Share

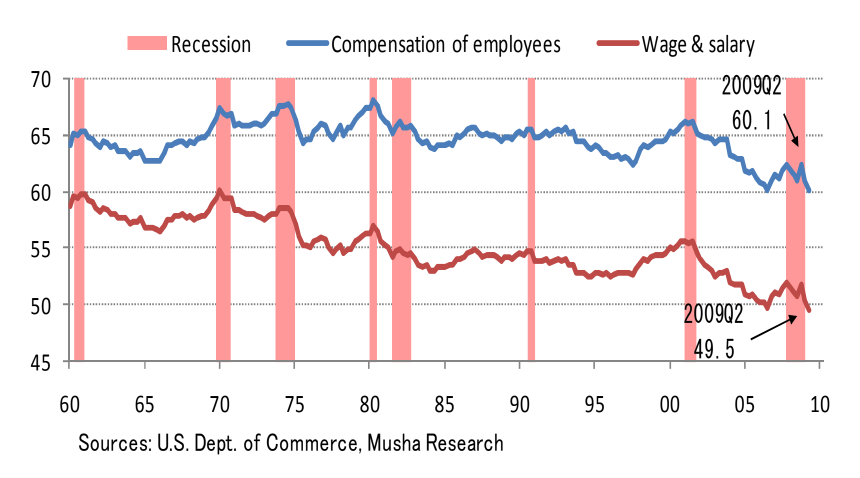
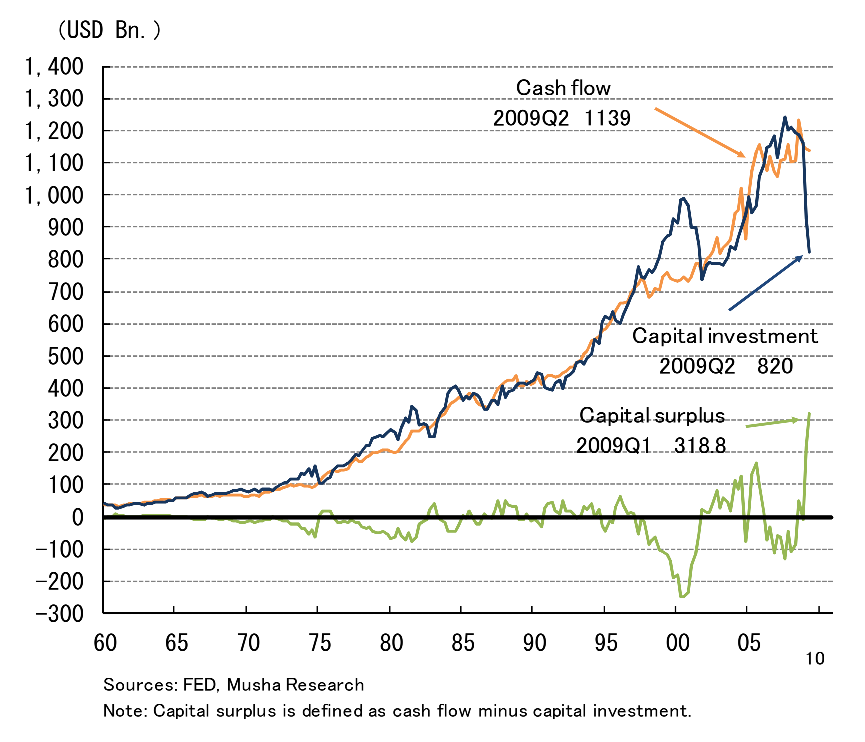


Figure5： Cash Flows, Capital Expenditures and Excess Capital at U.S. Companies



(3) Why was there a financial panic? (Intermediate Analysis)

Insurance turns out to be illusionary

As I have just explained, I believe that the global economy has started to stage a V-shaped recovery. In particular, it is becoming increasingly evident that there will be no change in the trend toward globalization, which holds the key to global economic prosperity. But this still does not explain why we have just experienced a once-in-a-century financial panic. The most likely reason is a flaw in the financial system that triggered an extreme breakdown of the balance between supply and demand. Markets were paralyzed as a result. For example, investors were completely confident in their ability to recover principal that was protected by insurance. When they discovered that the insurance provided no protection, these investors panicked. Credit default swaps (insurance that repays principal even if a counterparty becomes bankrupt) using financial engineering ended up having a much higher default ratio than was anticipated. These defaults forced insurance companies that had purchased this risk to sell their holdings all at once. The result was a spectacular collapse of global markets as buyers disappeared from the world's financial markets. This is what happened on Black Monday. However, the breakdown of the supply and demand for capital had almost no relationship with the real economy.

A 21st century style run on the bank

Fed chairman Ben Bernanke characterized the financial crisis as a type of classic 19th century bank panic (Washington Post, May 28, 2009). Events during the two-year period that led to the collapse of financial markets were definitely a recreation of a classic bank run. In the 19th century, a typical bank panic started at the peak of an economic cycle with rumors that a bank's borrowers were insolvent. Depositers then rushed to the bank to withdraw their money. This triggered a chain reaction of bank panics, causing one bank after another to shut down. Bank panics ended about 75 years ago. The main reasons were the end of the gold standard, the safety net (lender of last resort, financial system) provided by the central bank, and the establishment of the deposit insurance system. However, the bank panic appeared once again in the 21st century age of securitization. But this is not the 19th century. People save their money with conventional deposits as well as money market funds and bonds and other securities. Another difference is what banks do with their deposits. Instead of using deposits for new loans, banks today often use deposits to invest in securities. Unfortunately, a defect suddenly appeared in securities investments, which everyone had believed was safe. Terrified investors rushed to cash out, just like a run on the bank, by selling all their securities.

Immediate settlements spelled sudden death for financial institutions

At the heart of the financial panic is the fact that every financial institution would become insolvent if all customers demanded their money immediately during a shortage of capital. Even the soundest bank backs up its earning assets (loans, securities, etc.) with about 10% equity and 90% liabilities. Banks earn profits by procuring deposits and other short-term funds and then locking up these funds in long-term assets. Immediately liquidation of a bank's assets would require the sale of earning assets at a large discount. Loans would require a discount of 30% to 40%. For securities, a typical discount is 50% to 60%. Liquidating assets like this would immediately give a bank negative equity and prevent the bank from servicing its liabilities. Deposit insurance and the central bank's role as lender of last resort were created for the purpose of avoiding the need for banks to liquidate assets immediately. Unfortunately, this time we saw a "run on securities" rather than deposits. As a result, the conventional safety net did not function at all and the crisis spread like wildfire. Moreover, the entire world was linked by securities investments. Because of this, the destructive power and speed of this financial crisis were much greater than with a 19th century bank panic. Furthermore, strict application of mark-to-market accounting and the high BIS capital adequacy ratio requirement reinforced the immediate-settlement mentality, adding even more momentum to the financial crisis.

Market bias destroyed supply-demand dynamics

In the wake of the recent panic in securities markets, we need to pay attention to a serious problem: the peculiar structure of supply and demand in today's securities markets. The majority of trading activity is conducted by salaried employees working for institutional investors and hedge funds who are using financial engineering in pursuit of short-term returns. This trading produces very high volatility. The reason is that markets jump up and down when all these traders move in the same direction at once. Using financial engineering means that investment decisions are made using statistical processes. Some risks (called tail risks) are eliminated from consideration because they are statistically very unlikely to occur. Now, we have witnessed the magnitude of the problems these tail risks can cause when they occur. Recent research in econophysics and other fields has revealed that only 5% of all changes determine new trends. The remaining 95% are random walks that have no relationship whatsoever with major trends. What this means is that major trends are included in changes (unusual prices) that have been excluded from average caluculation. Applying this lesson leads to one of two types of investment strategies. First is the strategy of pursuing the average random walk. One example of this strategy is an approach assuming no change in the extremely consistent pattern of stock prices rising at an annual rate of 5% over any 10-year period. This is called the nickel strategy. In other words, traders aim to make a small amount of profit every day.

However, even though stock prices might increase 50% over 10 years, there is also the possibility of a 50% loss in a single day. The approach that takes this possibility into account is called the black swan strategy. U.S. economist Nassim Taleb created the term black swan. Until European explorers reached the Southern Hemisphere, everyone believed that all swans were white. But the discovery of black swans in the Southern Hemisphere proved that the conventional definition of a swan was incorrect. In the same manner, the black swan strategy focuses on obviously mistaken definitions. Investors use this strategy to lie in wait for a catastrophic event that occurs only once in a decade.

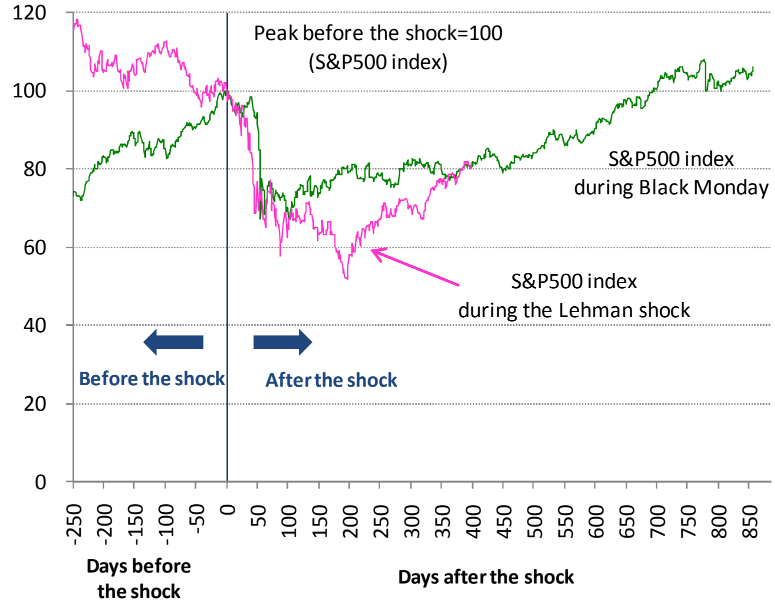
Which strategy should we choose? For salaried fund managers, the only choice is the nickel strategy. Selecting the black swan strategy could produce an enormous profit 10 years from now. But the manager would certainly be fired because of the poor performance during the time leading up to that big profit. This is why everyone becomes institutionalized. When markets are ruled by funds invested by these “business investors,” the entire market is dominated by the nickel strategy. Naturally, the black swan and its 5% probability are completely ignored. When this happens, a return from an event with a 1% probability (for example a sharp drop in stock prices), which means an event that happens once in a century, will instead occur at a frequency of once every decade. After all, everyone is chasing nickels. Obviously, the black swan will have a higher probability of producing a better return in this environment. Consequently, intelligent people who adopt a long-term stance can use the black swan strategy to make a profit. George Soros is an excellent example of the successful use of this strategy.

The existence of this extreme bias toward the nickel strategy in the world’s financial markets made the collapse of these markets even worse. Many people call this a financial engineering problem. But this is not true. The real reason is that markets are driven by institutions and salaried fund managers. Few people invest from a long-term perspective or by taking responsibility for their own actions. We are now in an era where fund managers must compete based on the evaluations of their performance by other people. Everyone uses the nickel strategy. No one would dream of choosing a strategy that targets an opportunity emerging once every 10 years. In this environment, when a once-in-a-decade event is transformed into a once-in-a-century catastrophe. Isn’t this the real nature of the subprime loan crisis that began in the middle of 2007?

Similarities with Black Monday

Investors experienced a similar plunge in prices on financial markets on Black Monday in 1987. In a single day, the Dow Jones Industrial Average plummeted $508, losing 23% of its value. The drop sparked panic selling. But the crisis was quickly resolved thanks to the skillful actions of Alan Greenspan, who was then Fed chairman. In all, stock prices fell 36% in two months. But as the U.S. economy continued to expand, only two years was needed for stock prices to return to the pre-Black Monday level. According to the Brady Report, which was written by the Brady Commission (led by then Treasury secretary Nicholas Brady), Black Monday was caused by the rapid growth in the use of a new investment technique called portfolio insurance. With passive asset management using portfolio insurance, a sharp drop in stock prices automatically generated a sell order. Clearly, the more prices fall, the more sell orders will be produced, causing prices to fall even faster.

Figure 6： U.S. Stock Prices on Black Monday and after the Lehman Collapse



Sources: Bloomberg, Musha Research

Analysis of the financial crisis is still ongoing

Once the global economy has recovered, economists will probably study the financial crisis again to determine its theoretic and historic ramifications. Until that time, we must avoid excessive sensationalism. Instead, learning more about this crisis will require steady analysis that is squarely based on the facts one by one.

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