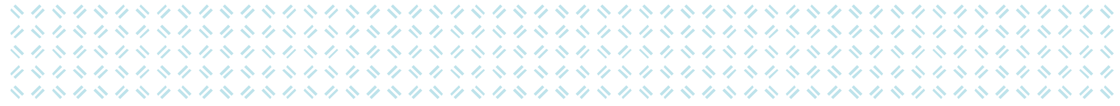


BT Investment Solutions

Back to the future

Should we be concerned about another Global Financial Crisis?
4 February 2016

Markets have been volatile in the early weeks of 2016, with sharemarkets falling sharply and bond yields moving towards historic lows. A natural question for investors to ask is whether the global economy is set for a repeat of 2008.

Is oil the new subprime? Could we see a complete breakdown in trust between financial institutions? Can policymakers act decisively this time around? In this article, we attempt to answer some of these questions. We conclude that while there are parallels between what is happening today and what occurred during the crisis, there are also some key differences which gives us confidence that we will not see a repeat of 2008.

The global financial crisis of 2008

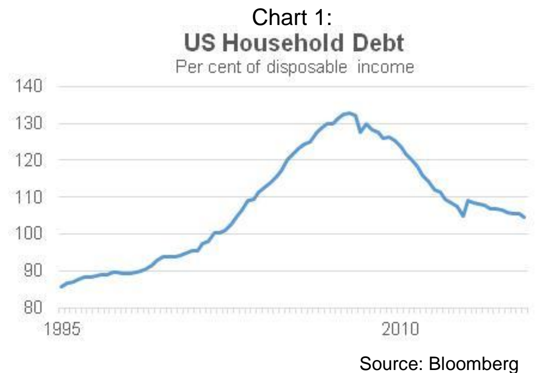
The crisis of 2008 originated in the US mortgage sector due to a rapid rise in household debt in the preceding years. US household debt rose from 90 to 140% of disposable income in less than a decade as shown in Chart 1. There were a number of contributing factors including interest rates being kept too low after the 2001 recession, the relaxing of credit standards and poor supervision and enforcement across the financial sector. When interest rates eventually began to rise, households began defaulting, particularly those who had enjoyed low rates for the first years of their loans.

However, a number of other critical factors turned a housing downturn into a crisis. There was a five-fold increase in financial derivatives during this period many of which were linked to the housing market as shown in Chart 2. Poor regulation of the derivatives market and conflicted ratings agencies also played a role. Then, when the crisis hit, central banks underestimated the risk of contagion between banks and the broader ramifications of the failure of a bank like Lehman.

Is it different this time?

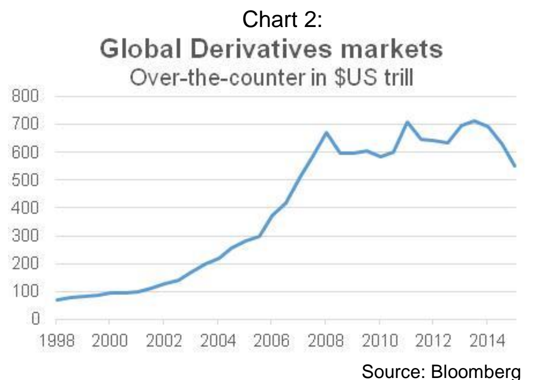
There are some parallels between what is happening today and 2008. The first is that there has been a rapid increase in debt in recent years. This time, the debt accumulation has been in emerging economies that have been taking advantage of very low interest rates. This debt has been used to finance investment in commodity projects in Latin America and the Middle East, and domestic expansion in Asia, particularly China. Chart 3 shows that emerging market debt has risen from 120% to 160% of GDP across all emerging markets.

Chart 1:



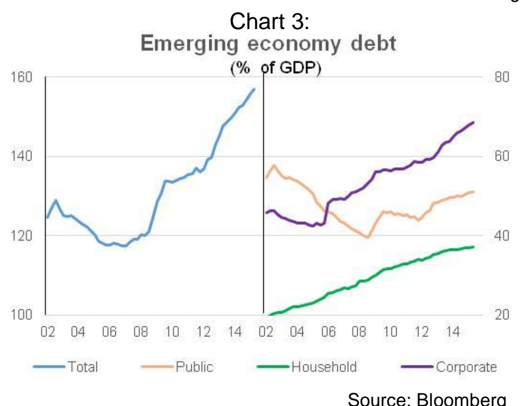
Source: Bloomberg

Chart 2:



Source: Bloomberg

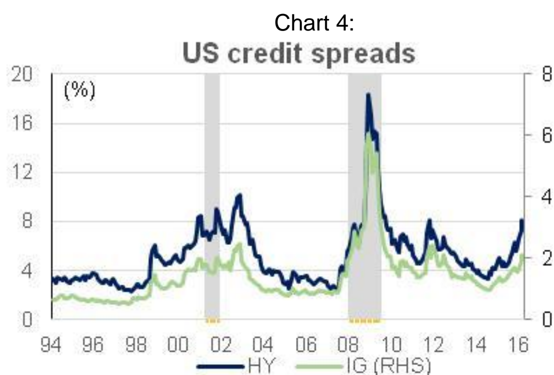
Chart 3:



Source: Bloomberg

The second parallel is that corporate stress is rising in credit markets, although this time the cause is the fall in commodity prices rather than higher interest rates. High yield spreads in the energy sector have risen sharply over the past couple of years as the oil price has collapsed as shown in Chart 4. This is similar to the signs of distress that became evident in the US mortgage sector before the crisis in 2008.

Chart 4:



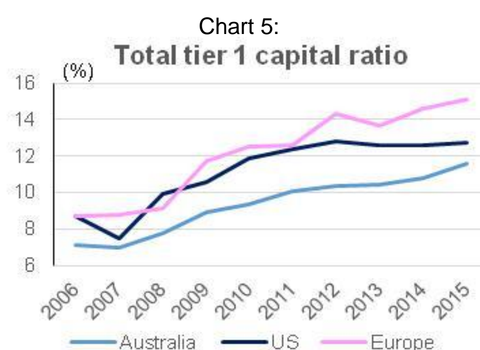
Source: Bloomberg

There are also some key differences with 2008 which gives us confidence that a financial crisis can be avoided. First, emerging economies and the energy sector are small parts of the global economy. As an example, energy comprises around 2% of US bank loans, ½% of employment and 1½% of GDP compared to 6% of employment and GDP for the US housing sector at the height of the crisis according to Bloomberg.

A second difference is that there is now a greater understanding of financial contagion risks. Before the crisis investors had a poor understanding of the risks associated with derivatives and central banks did not have a sufficient understanding of the systemic financial risks from credit events. Since the crisis, derivatives have been more tightly regulated, their risks are better understood and central banks will be quicker to respond to any potential systemic risks.

Third, banks are better regulated, have larger, stronger balance sheets and are better able to withstand write-downs. US bank profitability is returning to pre-crisis levels, asset quality is robust and capital levels have trended up and are above regulatory requirements in most countries as shown in Chart 5.

Chart 5:



Source: Bloomberg

In summary, there are some similarities between what is happening in markets today and what occurred during the crisis of 2008. Debt levels have increased in emerging markets and corporate stress is rising in the energy sector. But there are also some key differences which gives us comfort. Unlike 2008, there is greater transparency in markets and a better understanding of the risks which are in the system. The energy sector, which is the greatest source of concern today, is a much smaller part of the US economy than the subprime sector was a decade ago. Meanwhile, banks have solid balance sheets to absorb losses. This gives us confidence the global economy will be able to avoid another financial crisis.

For more information on current market risks and how these relate to your investments, please contact BT Financial Group.

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