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RETURN OF THE BAD DIAGNOSIS: THE "ASIAN FLU" AND THE "SUB-PRIME PROBLEM" IN CONTEXT

How Bad Can the Flu Be, Anyway?

At the January 1997 World Economic Forum in Davos, Switzerland, the world's economic and financial experts looked out across the globe and concluded, as one panelist expressed it, "The Goldilocks recovery [is going] global." As far as the economic eye could see, these gurus of Goldilocks insisted, world economies would grow neither too little nor too much, but "just right." At the same time, the International Monetary Fund (IMF) insisted that the next few years would see the most broadly based period of economic growth since the beginning of the twentieth century. The Organization of Economic Cooperation and Development (OECD) chimed in, insisting that for the first time since 1985, all 29 members would enjoy economic growth (see "The Goldilocks Recovery: 'Just Right' Is Just Not Right," **IF 1814**, 5/16/97).

But when the rarefied air of Davos met the stale air of economic reality, things did not go as planned. Financial trouble was spreading in Asia. In May 1997, an Asian analyst at Bankers Trust admitted aloud, "The situation has deteriorated much more rapidly and severely than expected." In July, the Thai baht took a beating in currency markets. The region, according to the same experts who months earlier had seen unending growth, was suffering from an "Asian flu," a localized currency problem. Or as U.S. President Bill Clinton explained, in an infamous mixed metaphor, the global economy was experiencing a "few glitches in the road" (see "The 'Currency Crisis' in Context: The Risks of an Addiction to Growth," **IF 1828**, 9/2/97).

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By November of the year of the Goldilocks economy, World Bank President James Wolfensohn could proclaim publicly that world leaders had the Asian financial crisis "under control" and that he did not expect a slowdown in regional economic growth, because the only real problem was that "people perceive a problem" (see "Denial Is Not a River in Egypt: Context and Three Basic Points on the 'Asian Crisis,'" **IF 1901**, 1/9/98).

But unfortunately for Wolfensohn and others monitoring the situation, Goldilocks evidently "left the building," because by February 1998, U.S. Federal Reserve Chairman Alan Greenspan was saying privately that the crisis was going to have a greater impact than originally thought and that Russia, Brazil and Argentina – hardly Asian currency economies – were showing signs of instability (see "The Global Tsunami: March Madness and the So-Called Asian Crisis," **IF 1906**, 3/5/98).

The "Asian flu" became a global problem because those charged with understanding international economic and financial issues misdiagnosed the situation. In the summer of 1997, local currencies in Asia lost as much as 50 percent of their value against the U.S. dollar. Asian-Pacific leaders blamed international currency speculators, and the IMF blamed faulty economic models – that is, the Asian/Japanese model of protected industries, export-driven economies and low-cost, subsidized production.

They were both wrong. The issue was about trade, productivity and many countries' addiction to growth. As we wrote at the time: "With the ability to make more and more things with lower and lower costs running headlong into slowing economies and declining demand, something had to give. That crunch squeezed Asian countries first because they were the least resistant to economic pressure and most dependent on huge growth figures." We suggested that economic "illness" was not simply a "flu" that would generate a local economic fever and force a few bedridden nights of austerity before allowing the sick economies to return to growth. It was more structural, endemic and international than that. Specifically, we had observed that in December 1996, when workers at a Sanyo plant in Thailand received their annual bonus, they went into a rage because they thought the bonuses were too small. They exacted their revenge by burning down the factory.

We inferred that an addiction to growth had created unrealizable expectations. For the decade ending in 1995, Thailand's exports had grown at an average annual rate of 13 percent, creating new wealth and new markets. In 1996, with Thai producers facing new competition from other countries with lower costs of production (*e.g.,* China and Vietnam) and having to deal with salary increases required by rising standards of living, Thailand's exports actually declined 0.2 percent, as the country shifted from being a net exporter to a net importer. Its gross domestic product (GDP) had downshifted from 14 percent in 1988 to 6.7 percent in 1996.

These were critical facts in understanding that the "Asian flu" was not a currency crisis; rather, it was a larger issue of trade, overcapacity, slowing global markets and spreading production capacity. Countries had enjoyed growth, but spreading industrial capacity and lower costs in new regions of production had pushed margins down and were squeezing formerly growing economies.

The Goldilocks gurus managing the crisis focused on the currency issue, with the IMF prescribing a wide range of classic IMF cures, in this instance directed at the wrong illness. As a result, the "under control" message that the good doctor Wolfensohn sent in November 1997 proved inaccurate: By the summer of 1998, Russia had defaulted on $1.3 billion in sovereign bonds, and in the fall, the Federal Reserve had to orchestrate a bailout of Long Term Capital Management to forestall a global financial meltdown.

"Can a rising tide lift a boat that has a huge hole in the bottom?"

This Sounds Familiar

Some interesting parallels exist between the decade-old Asian crisis and the current financial crisis.

✦ Experts in the Asian crisis perceived the problem as a currency or policy issue, and experts today see the current situation as a sub-prime or regulatory issue.

✦ Asia experts back then blamed shady currency traders for the Asian flu, and more recently, economic experts in the U.S. have blamed shady sub-prime lenders for the current financial malaise.

✦ Leaders then said that the flu was a localized problem with only regional effects, and leaders today have said that the sub-prime problem is localized problem in a small area within the mortgage business, perhaps affecting corporate liquidity but not the economy.

✦ Like the eventual Fed-directed bailout of Long Term Capital to avoid a global financial meltdown, German banks rushed to save IKB, a specialist lender, because, according to a German regulator, they wanted to avoid "the worst banking crisis since 1931."

"Ed does all the marvellous new things they do with money."

When sub-prime mortgages started causing problems, many tried to characterize the situation as the product of questionable practices in a tiny part of the mortgage industry. As a result, many concluded that this situation was of only limited importance. In May of this year, U.S. Federal Reserve Chairman Ben S. Bernanke insisted, "We believe the effect of the troubles in the sub-prime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the sub-prime market to the rest of the economy or to the financial system."

But then, as with the Asian flu prognosis, events turned against the experts' diagnosis. The "troubles in the sub-prime sector" spread to more traditional loans, into the wider real estate market, and from there to complicated opaque financial instruments, thereby seizing up liquidity, triggering shutdowns in hedge funds and bank funds and forcing large institutions to disburse billions of dollars to try to halt the slide. Mortgage houses that trafficked in the questionable sub-prime area sought protection in bankruptcy court, but soon thereafter, mortgage firms with only tiny exposure to the sub-prime market were taking their place in the bankruptcy line. Suddenly, the "jumbo" market vanished (in Europe) or charged highly elevated interest rates to place loans. Stock markets fluctuated wildly, as investors tried to believe everything was fine but then sold holdings just in case things were not so fine. Computer-based trading programs went into overdrive because their signals were set for normal markets, and this was anything but a normal market. And then, for the first time since immediately after the terrorist attacks of 2001, the Fed put emergency funds into the financial system to try to calm troubled markets. The Fed's actions followed that

of The European Central Bank, which had offered unlimited capital, starting with $130.2 billion the first day. (*Christian Science Monitor*, 8/10/07)

"We aren't willing to base our financial strategy on you laying eggs."

In the midst of this spreading crisis, investors and analysts expressed "surprise" that it was happening. One market strategist admitted more than surprise. "It's been more of a shock factor than a surprise factor." (*Christian Science Monitor*, 8/10/07)

In short, as with the Asian flu, the popular diagnosis of the current situation – excesses in the sub-prime market – was proving to be inaccurate. The "shock" should have been that so many people ever believed that this was just a "sub-prime" issue, given the entire culture of cheap money, value bubbles, overreaching financial instruments, indifference to risk, and games, games, games everywhere.

As a means to get to the context for the current financial crisis – that is, to get to the correct diagnosis – we pose the following question:

What Happens When Your Economic Symptoms Include:

1. **Underpriced Money and Overpriced Houses**
2. **An Elevated Pressure to Perform**
3. **A Dangerously Low Perception of Risk**
4. **And No Immunity to Gaming?**

The curt answer is: We are finding out right now. But a more meaningful and useful answer involves a closer look at each of those symptom as a way to reach a truer diagnosis.

Symptom Number One: Underpriced Money and Overpriced Houses

Cheap money started to appear after January 2001, when the Fed initiated a precipitous and, in retrospect, overzealous lowering of interest rates. Interest rates, which started at roughly 6.5 percent took a nose dive, leveling at 1.0 percent in July 2003.

The Fed sought to mitigate the damage that was rumbling toward the economy from the collapsed dot-com mania, and in the process, set in motion new behaviors that would yield another wave of mania, albeit in a different arena. Cheap money sent the country skipping toward a credit frenzy, which triggered huge market shifts in the residential real estate market. Home-loan principals ballooned, home-equity loans increased, credit-card debt lunged forward and housing prices skyrocketed. Flipping houses – sometimes buying a yet-to-be-built home and selling it at a higher price, even before construction started – became commonplace and had all the markings of tactics learned during the reign of the "new economy," with buyers paying higher and higher prices, assuming that prices would go higher and higher still. The logic behind this thinking sounded a lot like the reasoning behind rising stock prices during dot-com mania: "They're going up tomorrow because they've gone up today."

Home prices increased at 5 to 20 times the rate of inflation, with prices in some resort markets jumping in percentages not seen since the dot-com mania. Owners tapped this equity for cash when needed, which crammed

liquidity into consumer markets, enabling consumers to keep spending right through the recession that followed the dot-com collapse. In one ominous sign, hardly noticed by many in their rush to find another property to buy or sell, the average sales price of a new home increased 48 percent between 2000 and 2005 and the median price increased a whopping 46 percent. During this same period, household incomes were only up, on average, 11 percent - and were actually negative in real terms (*Census Bureau Data*).

Unlike other post-World War II real estate bubbles, this one grew and expanded as an integral part of the larger economy. In the past, real estate bubbles had grown alongside an expanding economy, typically benefiting from the economy's growth. Thus, when such bubbles deflated, they had little effect on the larger economy. But this time, the real estate industry has played a critical role in the economy's steady (albeit slow) growth:

✦ Roughly 5 percent of the country's gross domestic product comes from home building and construction. According to one study, housing and related industries now comprise 23 percent of the overall economy.

✦ From 2002 through 2006, 40 percent of new jobs created in the U.S. were housing related.

✦ Between January 2005 and January 2006, employment in residential construction increased 4.5 percent, while overall U.S. job growth increased 1.6 percent.

✦ In the second quarter of 2006, 88 percent of borrowers with Freddie-Mac-owned loans who refinanced took new loans with a principal 5 percent higher than that of the previous loan, up from 73 percent in the third quarter of 2005.

✦ For the consumer, housing equity started supporting spending. For instance in 2006, 16 percent of new car buyers in Florida used home-equity loans to fund their purchase.

All in all, this seems to bring forward another new economy, one based on a perpetual-motion machine called liquidity.

Symptom Number Two: An Elevated Pressure to Perform

Since 2000, we have monitored the pressure to elevate performance in the face of greater and greater competition. The elevated and quick returns that the dot-com mania delivered set a high-water (and artificial) mark that subsequent investors felt compelled (or were compelled) to match and even exceed. As we noted in one *Briefing*, "Whereas the possibility of getting ahead once propelled the system, now the fear of getting trampled or, less starkly, the fear of getting left behind underlies institutional and individual pressures to perform" (see "Fear Nation Infuses Wal-Mart Nation: Performance Mania and Its New Motivation," **IF 2432**, 12/18/03).

The causes behind the Asian crisis – that is, slowing growth – made "hitting the numbers" harder to do, and with the Fed steadily lowering interest rates and the economy stumbling along, contemporary investors found it more and more difficult to hit their numbers. Debt and leverage became critical tactics for elevating returns to meet the distorted and unhistorical returns.

✦ Between 2000 and 2003, new bond issues rated B or below accounted for roughly 20 percent of

"Perkins, what about this trip on your expense account to 'Fantasy Island'?"

the overall high-yield ("junk") bond market. In 2004, that figure jumped to 40 percent, and the following year, it rose to 50 percent.

✦ Between 1998 and 2004, pension funds increased their investments in hedge funds by a factor of five, even though 56 percent of those pension-fund managers admitted in a survey they did not understand the risks they were accepting.

✦ The credit swap market skyrocketed from $1 trillion in 2001 to $8 trillion just three years later. The most leveraged segment of that market, synthetic collateralized debt obligations (CDOs), rose from a tiny segment of the credit swap market at the turn of the century to as much as two-thirds of that market by 2005.

✦ In the first half of 2007, leveraged loans comprised 29 percent of all loans, up from 22 percent in 2006. In the same six months, the amount raised in debt capital markets – both junk and investment grade – reached a record $1.45 trillion, up 32 percent from the same period one year earlier.

✦ In the eight years ending June 2007, individuals added $1 trillion to their consumer debt load. It had taken them nearly twice that long to add the prior $1 trillion. Meanwhile, between 1999 and 2006, consumers extracted $2.62 trillion from their homes' equity in the form of refinancing with "cash outs" and home-equity loans.

✦ At the end of 2006, the global value of interest rate swaps, currency swaps and interest rate options reached $286 trillion, six times the gross global product. (See "'Leaning on Air' and 'Puking Tranches': Lingering Elevated Expectations Meet Post-Growth Realities," **IF 2613**, 6/17/05)

"I'd like to supersize my overdraft."

Symptom Number Three: A Dangerously Low Perception of Risk

The more individuals and institutions employed leverage and debt to sustain their financial returns (or consumer standing), the more comfortable they got with the practice. For consumers, the need for debt was becoming structural. For instance, both avearage and median household incomes actually **decreased** between 2000 and 2005 in real dollars. Median household income, the income of those in the 50th percentile, actually decreased by 2.7 percent when adjusted for inflation, while the average household income decreased by 2.2 perent when adjusted for inflation. That reality puts the $1 trillion of new consumer debt figure in a slightly precarious context, but as we will see, that was not the only new debt consumers assumed during this time (*Census Bureau Data*).

With real estate values continuing their climb, however, individuals discovered that housing equity could replace wage increases. Similarly, investors who dabbled in highly leveraged instruments discovered that returns helped them sustain the distorted performance goals. Over time, practices that historically would have been considered risky became commonplace.

✦ The number of Americans devoting more than half of their incomes to housing increased from 1.9 million in 2001 to 15.6 million in 2004.

✦ In 2000, the sum of consumer and mortgage debt was less than the sum of personal income. At the end of 2006, the debt-to-income figure had surged from well below 100 percent to 125 percent.

✦ Loans for leveraged buyouts jumped 65 percent from 2005 to 2006, reaching $1.4 trillion.

✦ In 2006, the CDO market issued $1 trillion in leveraged instruments, and half of all CDOs were backed by mortgage-related debt.

✦ In 2006, hedge fund assets rose 24 percent, topping $1.89 trillion.

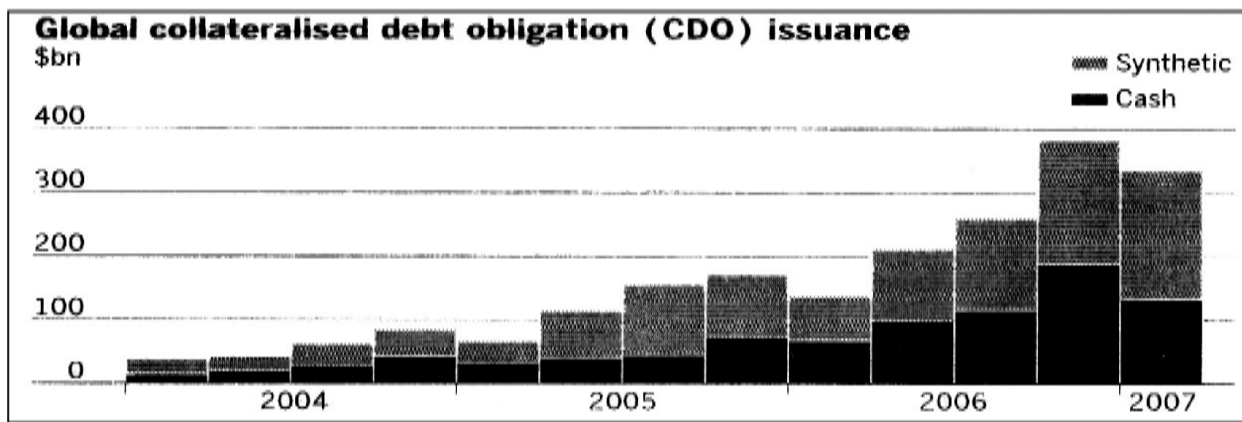
✦ More than one-third of all loans issued in the first five months of 2007 were "cov-lite" loans, meaning the lender eased the covenants typically required of borrowers to monitor repayments. Although no numbers have yet surfaced, bankers report an increase in

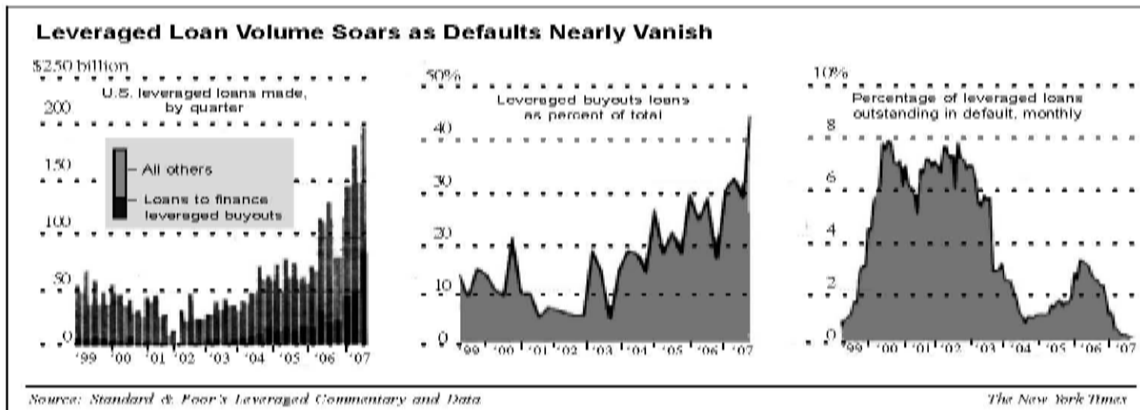
"cov-loose" loans as well, meaning they eliminated the covenants that require borrowers to provide loan and repayment status.

✦ As of early July of this year, 75 percent of **sub-prime** residential mortgage-backed securities (RMBS) were rated AAA, with another 10 percent rated AA and a further 8 percent holding an A rating. Just 7 percent of these sub-prime-based instruments carried a BBB or lower rating.

In 1998, in the middle of the expansion of "irrational exuberance," we noticed that traditional perspectives on risk were weakening in favor of quick profits. "What happens," we wondered, "when the potential high-impact consequences of risk behavior lose their power to limit such behavior…when confidence reaches such a peak that individuals begin to believe that the consequences of risk behavior have all but been eliminated?" In the 18 to 24 months that followed, the answer became obvious (see "A Risk-Free Society: Questions About Rising Confidence and the Perceived End of Risk," **IF 1910**, 4/6/98).

In the months and even years before the sudden interest in the sub-prime loan market, a similar risk-indifferent perspective became evident. Yield curves inverted, first in the U.S. (2005) and then in Europe (2006). By the end of 2006, the spreads for emerging market debt, corporate junk bonds and small-company stock had all reached historic lows. Defaults on leveraged loans steadily declined, from roughly 8 percent in 2000 to somewhere near zero by the end of 2006. To many, society and markets had delivered the "end of risk"…again. Confidence was riding high. (see *eFocus*, **eF 110**, 12/19/06).





Symptom Number Four: No Immunity to Gaming

In American literature, a "confidence man" is one who plays tricks on others to take advantage of their naïve confidence that individuals are honest and the system is fair. With confidence in ascendance and

the pressure to perform at new heights, confidence gamers appeared in abundance. Athletes used performance-enhancing drugs; scientists produced sham data to validate sham discoveries; drug companies manufactured altered studies to bolster a drug's chance of approval; corporate executives manipulated company books to bolster a threatened bottom line (and their stock options); and financial professionals traded on inside information or purloined money from company accounts.

These illegal activities have also had a huge complement of "legal" confidence games, practices intended to outmaneuver markets, regulations and/or consumers – often to meet performance targets. Consider these examples of "light" gaming in regular markets:

✦ In 2003, one percent of Washington Mutual's option adjusted-rate mortgages (ARMs) was in negative amortization – that is, the monthly payment from the borrower did not cover that month's interest on the loan, thereby causing the shortage amount to be added to the loan principal. One year later, the figure was 21 percent, and by the end of 2005, the percentage of loans with negative amortization reached 47. In terms of overall dollar value, those negative amortization loans represented 55 percent of the WAMU's loan portfolio.

✦ As long as the payment shortfall in a negative amortization loan is added to the principal, lenders have been allowed to book the loan as income and not bother listing it as in arrears.

✦ In the fourth quarter of 2005, so-called piggyback loans – traditional mortgage plus a home-equity loan – reached 42.9 percent of all loans, up from just over 14 percent in 2001.

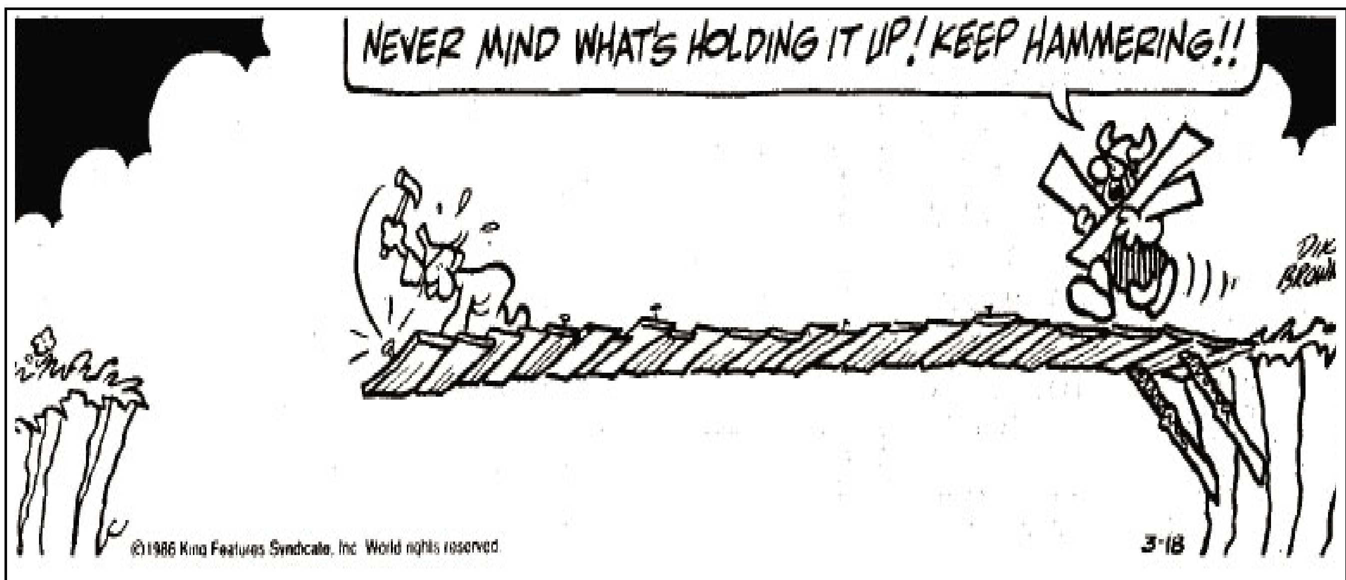
✦ Between 2004 and 2006, the nation's biggest banks received a 37 percent bump in their earnings growth from reductions in their loan-loss reserves.

✦ In 2005, 32.6 percent of new mortgages and home-equity loans were interest-only loans, up from 0.6 percent in 2000.

✦ In 2006, 38 percent of sub-prime loans were made for 100 percent of the home's value.

✦ As of the third quarter of 2005, according to First American Real Estate Solutions, roughly 9.8 percent of all mortgage borrowers were "upside down" – that is, the borrower owes more on the mortgage than the market value of the house. If real estate values decline **10 percent**, First American reckons, the percent of upside-down homeowners will reach 48 percent.

These symptoms hint at larger problems than can be encapsulated in the sub-prime diagnosis. This is a different financial system with different financial risks and different financial instruments than in past financial crises. Like the "Asian flu" diagnosis, which did not take into account the structural changes under way and what they were doing to world economies, the "limited sub-prime" diagnosis does not take into account this larger range of activities that have pushed leverage, debt, risk and performance pressure to new levels, all while confidence gamers have been plying their trade.



Asian Flu = Sub-Prime Market?

In what may be the most emblematic television commercial of this era, Jessica Simpson, after hearing about the specifications and capabilities of high-definition television, looks into the camera and admits: "I totally don't know what that means, but I want it." Ignorance and deal-making have been a dangerous combination in the recent past, and the costs of that deal-making are starting to break through the economic surface.

Addiction to growth in the Asian economies in the mid-1990s created unreal expectations, as exemplified by the Sanyo workers who responded to their year-end bonuses by burning down the factory. Similarly, the low cost of money, steadily increasing real estate values and the seeming disappearance of risk have yielded unrealistic expectations among investors and consumers. Professional investors buying CDOs (or the more extreme version, CDOs squared or even CDOs cubed – that is, CDOs of CDOs of CDOs) bought these instruments not knowing fully what they were buying and unaware of how those instruments could be priced should the need arise. They were deals that simply promised higher returns. Meanwhile, in 2005, residents of Orange County (CA), even with interest-rate increases occurring at regular intervals, said they expected house prices to increase by an average of 23 percent per year for the next 10 years. (*Fortune*, 2/20/06)

The symptoms that can lead to a correct diagnosis – depression-level-cheap money, a housing bubble that has supported major parts of the economy, an intensifying pressure to perform in the financial services industry, a historically low perception of risk and extensive gaming – make the early diagnosis of "troubles in the sub-prime sector" as the cause of the recent financial turmoil seem especially naïve. The fuller diagnosis is more troubling: The current financial stresses are signs of the system starting to revalue historically distorted values – valuations that are everywhere in the economy.

Now that the cost of money is being increased, the housing bubble is bursting, risk is being reassessed and gaming is being exposed, the economy faces considerable downward pressure that has not been taken into account by those who anticipate upturns in the near term. International markets may, indeed, help bolster U.S. stock markets in the near term, but over time, those international markets may feel the downward draft of the U.S. economy.

A lingering question arises from the recent turn in events. One contributor to the current financial malaise – the pressure to perform – has yet to unwind in any meaningful way. Like the last thrust by a monster that refuses to die in…(name your favorite horror movie)…the pressure to perform is still around and can still wreak damage.

Besides this outlying danger, the diagnosis we have inferred from all the symptoms at hand suggests a difficult recovery is in store. Because the economy has come to depend on an overpriced housing market, adjustments in that industry as they continue to emerge are going to affect the larger economy. The use of debt for buyouts, stock buybacks and

consumer spending is at risk, not just because of the current freeze-up in liquidity, but for a longer period of time as the cost of money returns to historic norms. Using financial games to increase profits may come under closer scrutiny by regulators and stakeholders, making that array of maneuvers more difficult to access.

These kinds of changes in financial and market conditions suggest global economic weakness (more likely recession), steadily escalating risk premiums, global equity markets under significant pressure, central banks facing growing pressure to lower interest rates, and eventually deflationary rather than inflationary pressures rising.

These effects will come as either a "surprise" or a "shock" to those accepting the current diagnosis of sub-prime woes causing localized financial disturbances. Those adhering to the official line should soon be able to see, showcasing in a theater-economy nearby: Return of the Bad Diagnosis.

"I'm at the point where I find mixed signals reassuring."

Liquidity: Big Moves, Big Risks

Low Risk Perception

1985 → 2001
•Liquidity expansion
•Derivatives/Junk market

1985 → 2001
•"Free Money"
•Low interest rate/capital spending
•Weak borrowers borrow on weak collateral

1994 →
•Non-traditional investments
•Emerging technologies

1993 →
•Globe shrinks
•Foreign trade expands
•Capital flows into peripheral economies around the globe

1995 →
•New technologies impact social behavior
•24/7 work

1996 →
•"Addiction to Growth"
•Strange economic environment provides growth/profits
•Asset appreciation

1997 → 1999
•Asian financial crisis – "send money"
•Russia defaults
•Long term capital

1999 → 2001
•"Manias"
•Explosive market
•"No Risk"

2001 →
•Manias unwind!!
•Contraction of capital/deal mania

2001 →
•Interest rate decline
•Money supply growth
•9/11 attacks
•Flood system with capital
•"Carry Trade"

2002 →
•Housing asset explodes globally
•Housing markets generate increased capital

2002 →
•Pressure to perform heightens
•Gaming leads to U.S. regulations (sarbox)

2002 →
•Chinese surpluses mount
•International capital appeal/access

2003 →
•Oil price increase; all "producers" become wealthy
•Nationalized companies recreated

High Risk Perception

2004 →
•Emerging market IPOs
•Russian surplus mounts

2004 →
•Pensions move capital to alternatives
•Share buyback explosion

2005 →
•Nationalized companies do M+A deals
•CDO market explodes
•"Trick" mortgages spread

2006 →
•M+A Frenzy
-Investment banks
-Private equity
-Hedge funds
-Nationalized companies
-Pensions

2007 →
•Bear Stearns margin call

Low Risk Perception

Hang On!!

Revaluations
•Housing
•Equities
•Financial instruments
•Money
•Risk
•Regulations

Spreading Effects
•Wider economy hit
•Layoffs
•International economies hit
•Central banks stimulate

Economy an Issue in 2008 Elections

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