Plus ça change: credit crunch 10 years on

Blog By Chris Darbyshire, Chief Investment Officer, Seven Investment Management (7IM)

Viewers of Paramount's 'The Big Short', will remember a scene towards the end of the film when the US housing market is in freefall, mortgages are defaulting all over the country, mortgage lenders are going under, but the critical securities used to short the mortgage market are *holding steady*. The protagonists had seemingly done their homework well: correctly identifying the weaknesses in the mortgage industry, finding ways to short that industry and putting their money on the line. Surely, all they had to do was wait for the inevitable collapse in prices to occur? But the collapse had come, and prices hadn't moved! Tearing their hair out, the protagonists are running out of money and patience. Their backers are threatening to pull the plug. How could a system designed to price assets become impervious to risk?

Ten years on from the Credit Crunch, we now know that the tipping point wasn't the mortgage market itself, but the delayed impact it had on the little known – but huge – 'repo' market. Repos (short for 'Sale and Repurchase Agreements') were used by large investors to lend short-term funds to each other. When repo users began to doubt the value of mortgage-backed collateral, the repo market rapidly contracted, sucking trillions of dollars of liquidity out of the economy and depressing asset prices. It was a run on the banks, 21st century-style and, unlike the runs of the previous century, lenders could no longer just bring the shutters down, although arguably Northern Rock came close.

What is striking today is that a decade on, we also see investment prices shrugging off some potentially worrying developments in the 'real' world. It took stockmarkets about a fortnight to overcome the shock of Brexit. It took them about two hours to overcome the shock of Trump. Since then, stockmarket volatility has fallen to all-time lows, suggesting that investors are actually more confident than ever before. To be fair, company profits have recently demonstrated strong growth and this has been enough to convince investors to pile in. Company profits, though, do not predict the future. You might expect investors to have learned in 2007 that stockmarkets are *most* risky when they are *least* volatile. Plus ça change!

Stockmarkets' upwards trajectories may be right. In fact, we would not disagree with the view that everything will most likely be fine. But investors have had a great run recently, despite the potential headwinds of Brexit and Trump. However we are more concerned with ensuring that we can sustain returns over the longer term, so we can't just ignore unpriced threats. Moreover, when we actively consider what those less-favourable scenarios could look like, and estimate the probability of their occurrence, it takes the gloss off expected short-term equity returns.

Banks, and the financial system generally, remain important engines of growth. Over the last few decades consumer credit and, more particularly, mortgage debt has been used in the Anglo-Saxon world as a substitute for economic growth and, in the decade since the credit crunch, this continues apace. Citizens have been able to improve the quality of their lives through taking on debt; most visibly evidenced in their being able to buy bigger houses. This apparent wealth-creation may have made up for the loss of income or opportunity as our industrial base, under threat from Emerging Markets and automation, adjusted from manufacturing industries towards the service sector. Post-Credit Crunch, central bankers did their best to shield all levels of society from the potential devastation of the Credit Crunch, but this came at the expense of even lower mortgage and debt payments!

While things will most likely turn out OK, the risks are elevated in new and strange ways. Frankly, no-one has any idea if there will be any monetary, political or geopolitical fallout, what kind of fallout might occur, or how big and long-lasting its impact might be. Our seatbelts are fastened.

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For further information, please contact:

Jemma Jackson
PR Manager, 7IM
jemma.jackson@7im.co.uk
020 3823 8696
07776 204 610

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