Lehman Bros – 10 Years On

It was this time in 2008 that major institutions were in real trouble. Having bailed out Bear Stearns, we expected that other "too big to fail" banks would be similarly rescued. They were not, and we look back.

Why?

"Hawks" wanted to **make an example of somebody**. Demonstrate that despite rescuing other institutions, solvency was not guaranteed. Bondholders were still taking a risk, and needed to prudently assess their choices. **Avoid "*moral hazard*"** – not allow banks to rack up unlimited debt at government rates, and keep all the profits. **Avoid "nationalising losses"** – the more debt can be raised without consequences, the more likely that governments would be stuck with the worst of the losses.

Moreover, by being seen to underwrite banks (at least at senior level), this prevented a **"market signal."** Widening corporate credit spreads flag potential distress, and make it less advantageous to raise more debt. Companies seek an optimum – beyond which, the cost of capital rises. Banks did not really have that discipline in 2007. Functioning market signals were also useful to regulators as an early warning signal.

But more fundamentally: It is widely believed that they wanted to make an example of Lehman Bros CEO Richard Fuld. And he let them by thinking he could get a better deal than a bailout in nationalisation (with no residual value to shareholders) – he wanted the same deal for shareholders that Bear got.

The Next Bailout Decision

Central banks have always stood behind <u>solvent</u> institutions, providing liquidity against a run on the bank. ("Solvent" being practically defined as "*banks that haven't yet admitted losses*.")

Since then, authorities have had time to consider what causes bank failures – they may not be as uncommon as once thought (causing rating agencies to downgrade even survivors heavily since 2008).

The public and their representatives want **failures to be infrequent, and contained to the failed institution itself** - without leading to a systemic crisis. **Public contributions are resented, and rules are designed to minimise their cost.** (Undoubtedly the same people who criticised bailing out banks would have felt that banks holding their <u>own</u> deposits should have been saved. And the ultimate cost to the US of avoiding Great Depression by funding the $700bn TARP was…$0 – loans were repaid, and warrants sold profitably.) The impending **Basel IV further strengthens capital adequacy rules** – already stricter for systemically important ("too bid to fail") banks.

The **two major mistakes** in hindsight were **not to backstop Lehman Bros** (notwithstanding that to do so was technically illegal at the time), and **to bail out even junior creditors** of other banks (such as subordinated debt).

No bailout at all creates the sort of event we lived through – bailing out junior capital instruments creates moral hazard, costs more, makes impost on the public more likely, and impairs market signalling of deteriorating credit.

The world's governments and regulators have **agreed a framework for bailouts in advance**. Decisions no longer need to be rushed through in a weekend, like the events of a decade ago. In a compromise between minimising public cost, and preventing contagion, we have the Bank of International Settlements' *Key Attributes of Effective Resolution Regimes*.

Investors, depositor and other interested parties should expect:

- Before any injection of public capital into a failing institution, **sub-debt and hybrids <u>will</u> be bailed in** (and indeed, should be written in a manner to make this certain).
- Indeed, for hybrids and "CoCos" (*contingent convertibles*), **bail-in occurs on low capital triggers**, not even needing bank failure to occur.
- Bail-in isn't necessarily confiscation, but conversion to equity is likely to be at a time of extremely low equity value, and **could have the effect of near-total loss**.
- There is an expectation that instruments equal to **8% of *Risk Weighted Assets*** will be bailed in before any public contribution – **this could include senior bonds** (although in practice, this has met with resistance when tried in Europe). In effect, this creates a class of "junior senior" bonds, with the government stepping in to prevent failure of inter-bank contracts and other liabilities to the public.
- **Deposit guarantee schemes** explicitly protecting small amounts is the norm, including being legislated in Australia for $250,000. Some conditions apply.
- **Losses above the insured deposit amount appear to be accepted in the US**, where limited deposit insurance has existed for much longer, but are considered extreme events elsewhere. They are not impossible, but **depositor losses in Cyprus reflected bank losses larger than the government was <u>capable</u> of making whole**.

We consider the resolution framework appropriate, and effective. Bank failures, with hybrids bailed in at $0 value, have become infrequent but unremarkable news items. Greece had several rounds of recapitalisation. Spain and even Venice saw a number of institutions fail. There were no broader consequences. Even the more severe Cypriot bail-in programme during a severe recession did not have systemic implications.

<u>Investors – the Decade Since</u>

Assess correctly that TARP, TALF, PPIP, HARP, HAMP *etc* programmes would eventually repair the financial system <u>and</u> low interest rates would be persistent – **the lucky few experienced gains that many had never seen before**. From a low of 666, the S&P500 closed above 2900 during the month.

It was a mistake to conclude "*that strategy was a failure*" and "*we will never do that again*." Other than bonds, that would have left <u>nothing</u> to invest in. Property, credit (including structured credit), infrastructure, shares – all returned at least to normality, if not their 2007 boom-time levels. **Seniority and leverage mattered** – senior secured loans recovered quickly and leveraged / last claim / equity took much longer. **But even buying at the top of the 2007 boom would have ultimately delivered satisfactory returns.**

The more nuanced message was that, as we have previously written, **credit <u>didn't</u> fail** – ***provided all links in the chain from borrower to ultimate lender had alignment of interest***. Corporates paid back their loans, because to not do so would see shareholders wiped out. Homeowners assessed by competent lenders who wanted to be repaid generally <u>did</u> repay, or they would lose their homes and deposits. Structured credit built from corporate or creditworthy homeowners performed in line with expectations through an economic cycle. In "normal" sectors, **default rates were below the credit spreads** charged to bear those risks.

Catastrophic failures resulted from conflicts of interest - borrowers with no "skin in the game," offered often fraudulent loans through corrupt intermediaries, passing them to banks to earn structuring fees and again onsell them. No-one, until the purchaser of subprime RMBS, cared about repayment.

Leading Markets

The MSCI World ex-AUS increased +1.35% after the US and Mexico have agreed to enter into a new trade deal to replace the current NAFTA. Emerging markets were down -0.55%. The Dow Jones finished +2.56%; the S&P500 and NASDAQ set record closes after rising +3.26% and +5.85% respectively.

The collapse in the lira saw Turkish stocks lose another -29%, with -10% losses also coming from Greece, South Africa and Brazil. Generally positive results were seen around Asia. Another crisis from Argentina dragged Frontier Markets to a loss of over -5%.

US 10-year bonds closed at 2.86% from 3% at beginning of August, despite welcome trade news and strong data supporting the stockmarket’s new highs.

Other Highlights

The US Q2 2nd estimate of GDP growth upgraded to +4.2%, *vs* 4.1% 1st estimate – the fastest rate since 3Q14. This took YoY growth to +2.9%.

US headline CPI stood at 2.9% in July, unchanged from June and slightly better than market expectations of 3%. Nonfarm payrolls increased by 157,000, following an upwardly revised 248,000 from June; Unemployment rate fell to 3.9%, from 4.0 % in June.

The raid on Pres Trump’s attorney resulted in prosecutions over Cohen’s own taxes, but relatively minor campaign finance breaches.

Italian bond yields remained elevated at 3.25%, after key figures hinted that the country would outline a 2019 budget in breach of EU spending rules.

The trade war between the US and China continued to escalate, with Pres Trump applying tariffs on another $200b in Chinese goods from month end and China threatening retaliatory measures including soybean tariffs.

China's trade surplus narrowed sharply to USD 27.91 billion in August of 2018.

The Eurozone economy expanded 0.4 percent on quarter in the three months to June 2018.

Domestic

The ABS announced the 25 millionth Australian during the month.

The ASX200 finished +1.42%, setting another post-GFC high. Solid earnings in mining, financial and health care contributed. Smallcaps eased -0.29%.

Australian 10-year bonds tightened -13bp to 2.52%, with the gap between US 10Y bonds at -34bp.

The RBA kept the cash rate at 1.5% in September meeting. Out of cycle mortgage rate hikes from several banks, including Westpac, suggested that the RBA would be less aggressive in its next cycle. Rates fell at the short end in response, with no change now forecast until 2020.

Australia's unemployment rate inched lower to 5.3% in July, the lowest jobless rate since November 2012, on a lower participation rate of 65.5% (-0.1%). -3,900 employed persons disguised higher hours worked; full time employment rose slightly.

Private investment is off its 2016 lows, but has peaked around $30bn p.m. and turned down again. It is almost flat (+0.4%) over a year, with construction -4.7%.

The latest average weekly earnings (AWOTE) accelerated to +2.7% YoY, well off its lows. This ticks off two of the RBA’s 3 guidelines for a rate hike: Wages recovery, and lower unemployment. Inflation is at the bottom of the 2-3% target range, but no longer below it.

Total Dwelling approvals overall fell 5.2% MoM in July and trended down -5.6% over a year. Finance for new dwellings also plunged -4.9%. The number and value of finance commitments both slumped to a year's low.

Commodities and Currency

WTI oil finished higher to $69.80/bbl (+1.51%) while Gold fell to $1,201.2 (-1.86%). Iron Ore finished lower at $66.03/t (-2.54%).

Base metals were weaker. The $A finished at US72.60c (-2.30%).

KEY FINANCIAL MARKET DATA – AS AT 31ST AUGUST 2018 (UNLESS SPECIFIED)

Interest Rate Markets

Index Performance	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
AustBond Bank Bill Index	0.17%	0.51%	0.99%	1.85%	1.81%	1.95%	2.20%

Key Rates	Aug-18	Jul-18	Jun-18
Australian Cash Rate	1.50%	1.50%	1.50%
90 day BBSW	1.95%	1.96%	2.11%
3 Yr Commonwealth Bonds	2.00%	2.10%	2.07%
10 Yr Commonwealth Bonds	2.52%	2.65%	2.63%
CDX North American 5 Yr CDS	60bp	58bp	68bp
iTraxx Europe 5 Yr CDS	68bp	61bp	73bp
iTraxx Australia 5 Yr CDS	73bp	74bp	81bp
US Fed Funds Rate	1.75%-2.00%	1.50%-1.75%	1.75%-2.00%
US 10 Yr Bond Rate	2.86%	2.96%	2.85%

Equity Markets

Domestic	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
S&P/ASX 200 Acc. Index	1.42%	6.19%	7.33%	15.40%	12.56%	11.46%	8.94%
S&P/ASX Small Ord Acc. Index	2.49%	2.53%	6.75%	22.32%	12.35%	16.90%	9.19%
A-REIT 200 Acc. Index	2.71%	5.97%	14.18%	15.82%	3.55%	10.52%	13.04%

International	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
US: S&P 500 ($US)	3.03%	7.25%	6.92%	17.39%	15.61%	13.73%	12.18%
US: NASDAQ ($US)	5.71%	8.97%	11.50%	26.15%	24.72%	19.30%	17.70%
MSCI World Acc. (Local Currency)	1.34%	4.87%	5.77%	14.08%	14.76%	11.89%	11.51%
MSCI World Acc. (AUD)	4.06%	9.18%	11.95%	24.04%	16.86%	11.18%	14.92%
FTSE (£)	-4.08%	-3.20%	2.77%	0.02%	4.69%	5.96%	2.99%
MSCI Emerging Markets ($US)	-2.90%	-5.78%	-11.65%	-2.92%	8.70%	8.85%	2.58%

Fixed Interest Markets

Bonds	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
BarCap Global Agg Acc. (AUD)	2.90%	4.10%	5.80%	8.18%	1.34%	1.77%	5.65%
AusBond Composite Bond Acc.	0.81%	1.45%	2.65%	3.84%	1.56%	3.08%	4.48%

Data*	Current Period		Previous Period	
Employment Data				
Employment Growth	Jul	-3,900	Jun	50,900
Unemployment Rate	Jul	5.30%	Jun	5.40%
Participation Rate	Jul	65.50%	Jun	65.70%
Lending Finance				
Housing Finance	Jun	-1.00%	May	0.70%
Personal Finance	Jun	0.80%	May	-4.50%
Commercial Finance	Jun	7.20%	May	-2.20%
Lease Finance	Jun	2.40%	May	12.80%
Other				
Balance on goods and services	Jul	24m	Jun	-233m
Retail Sales	Jul	0.00%	Jun	0.40%
Building Approvals	Jul	-5.20%	Jun	6.40%

*All data is seasonally-adjusted.

Median Fund Manager Returns (Morningstar)	1 month	3 month	6 month	1 year	2 year p.a.	3 year p.a.	5 year p.a.
Australian Equity Large Cap	1.33%	6.50%	7.03%	16.96%	12.86%	11.21%	8.81%
Australian Equity Small Cap	2.06%	3.22%	6.04%	19.51%	10.07%	15.11%	11.54%
Global Equity Large Cap	3.13%	7.23%	9.64%	20.61%	15.42%	9.63%	13.22%
Global Equity Small Cap	5.39%	7.06%	10.89%	23.94%	16.78%	10.00%	14.73%
Australian Fixed Income	0.67%	1.19%	2.14%	3.37%	1.30%	2.70%	3.85%
Global Fixed Income	0.06%	0.22%	0.79%	0.15%	0.74%	2.86%	4.41%
Australian Listed Property	2.40%	5.47%	12.51%	13.18%	2.85%	9.76%	11.85%
Australian Cash	0.14%	0.40%	0.76%	1.46%	1.48%	1.60%	1.90%
Conservative[1]	0.38%	1.11%	1.75%	3.31%	2.70%	3.20%	3.81%
Moderate[2]	0.64%	1.87%	2.56%	4.76%	3.62%	3.98%	4.72%
Balanced[3]	0.85%	2.80%	3.65%	7.47%	6.22%	5.82%	6.53%
Growth[4]	1.07%	3.68%	4.64%	10.23%	8.34%	7.25%	7.75%
Aggressive[5]	1.57%	4.72%	6.03%	13.54%	11.13%	9.24%	9.58%

[1] Growth Assets 0% - 20%
[2] Growth Assets 21% - 40%
[3] Growth Assets 41% - 60%
[4] Growth Assets 61% - 80%
[5] Growth Assets 80%+

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