Who Dares Oppose a Boom? And, Can you Predict a Bust?

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Systemic Risk: Early Warning Indicators

By David J. Merkel, CFA
Principal, Aleph Investments, LLC

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The Challenge

The U.S. Congress recently passed the most sweeping financial reform measure since the Great Depression. The purpose of this legislation is to prevent the risky behavior and decision-making that led to the financial crisis, and to prevent future crises.

- *Does this legislation solve the problems of the past?*
- *Are there other significant issues not addressed?*
- *Does this legislation cause other concerns?*
- *In reflecting on the events of the last two years, is it possible to effectively develop early warning indicators that trigger intervention in advance of a complete collapse of an entire financial system or market?*
- *Does it make sense to have a chief risk officer of, say, the United States of America, whose role it would be to manage/mitigate this risk?*

The Choice

Economics or Politics?

- Economics: Did regulators not have sufficient latitude and knowledge/tools to deal with the growing problems?
- Politics: Or was it a lack of willingness to address problems?

The Nature of Booms

The fool does at the end of a bull market what the wise man does at its beginning.

Wall Street Aphorism

Booms Usually Start Well

- Equity finance
- High return on Assets
- Took some work to make the decision

Success Breeds Imitation

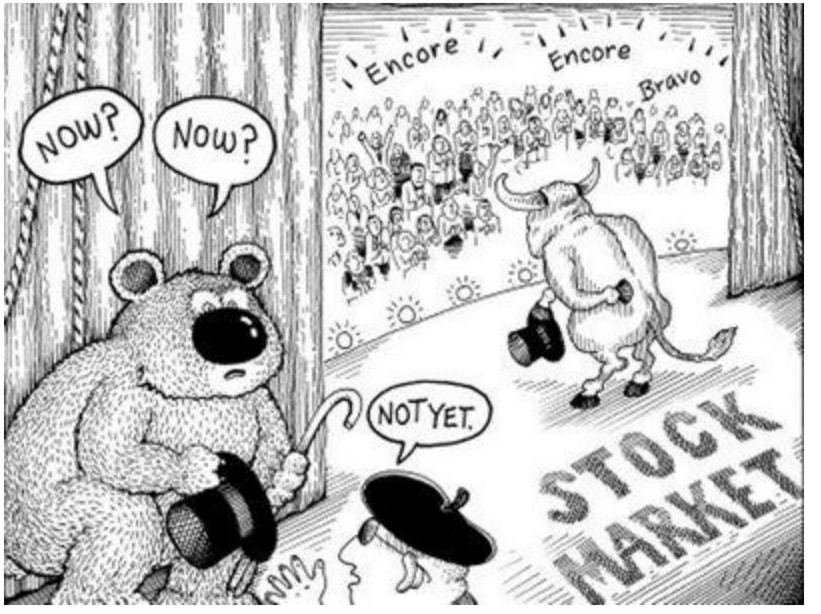
- Opportunity becomes better known
- Deals are lower quality
- ROA is slipping
- Financing more available

Can Become Faddish

- Opportunistic capital shows up
- Drives up prices / Short term finance
- Momentum psychology builds
- “Everyone is doing it”

Tend to Last Longer Than Reasonable

- There are naysayers, but they are derided as mindless bears trying to scare a fundamentally sound market for financial gain.
- Bull cycles in credit take a long time to play out.
- Leverage rises, spreads grind tighter, complexity increases.

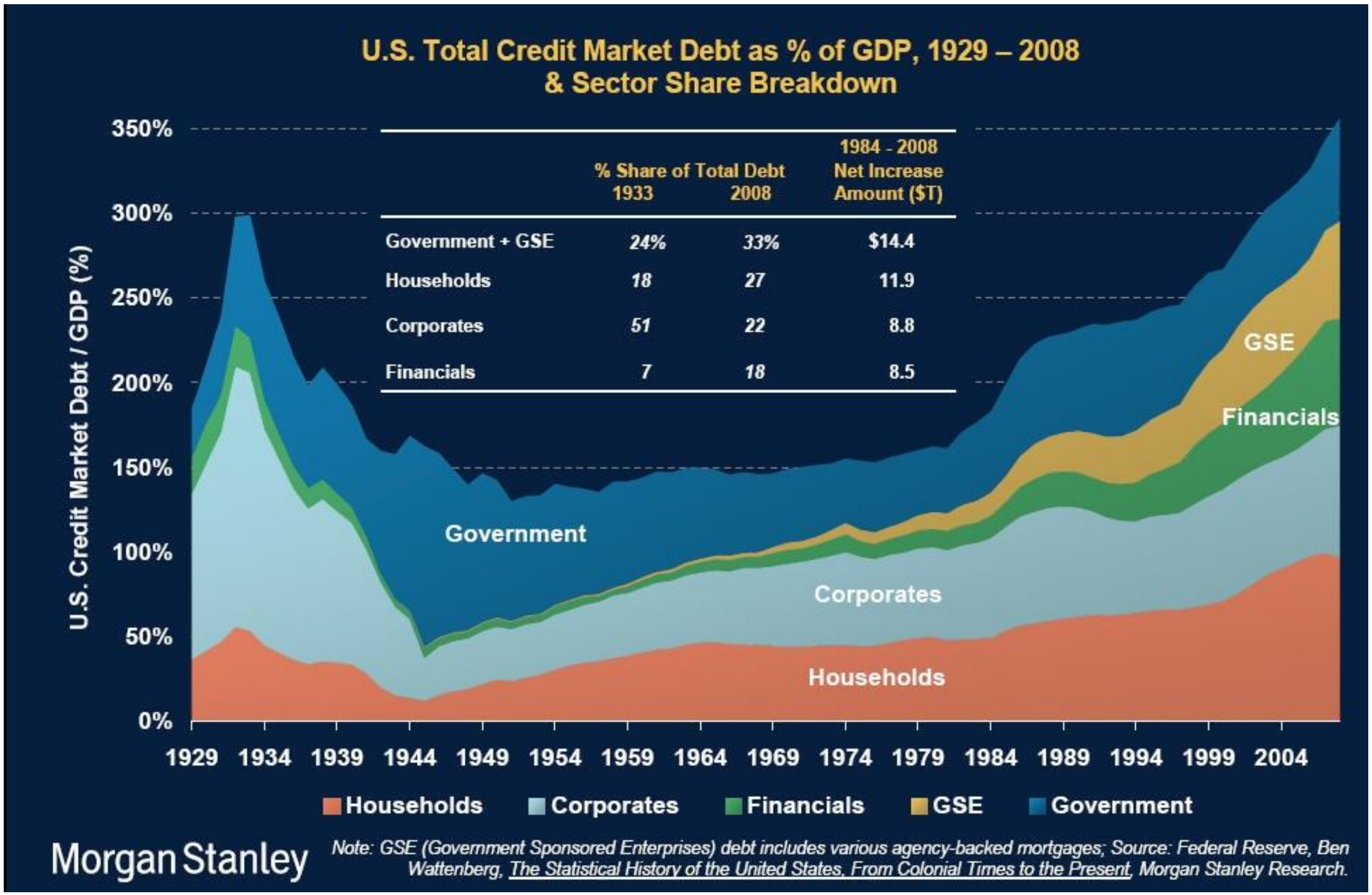


Conditions at the End of the Boom

- Indebtedness high
- Short-term finance prevalent
- ROAs are low
- Opportunistic capital fully deployed
- Long-term players w/flexibility are gone
- Players have to feed the asset to keep it.
- Average player IQ is low.

Can You Spot an Unsustainable Boom?

Spot the Large Debt Increases



Credit: Morgan Stanley

Stop the Large Debt Increases?

- Easy to SPOT; easy to POST; hard to STOP.
- Disbelief
- Derision
- Political-connectedness
- Regulatory capture / Revolving door
- Near the end of a credit cycle loss statistics typically look good.
- Economists think debt is neutral
- Favorable trend helps governments in short-run

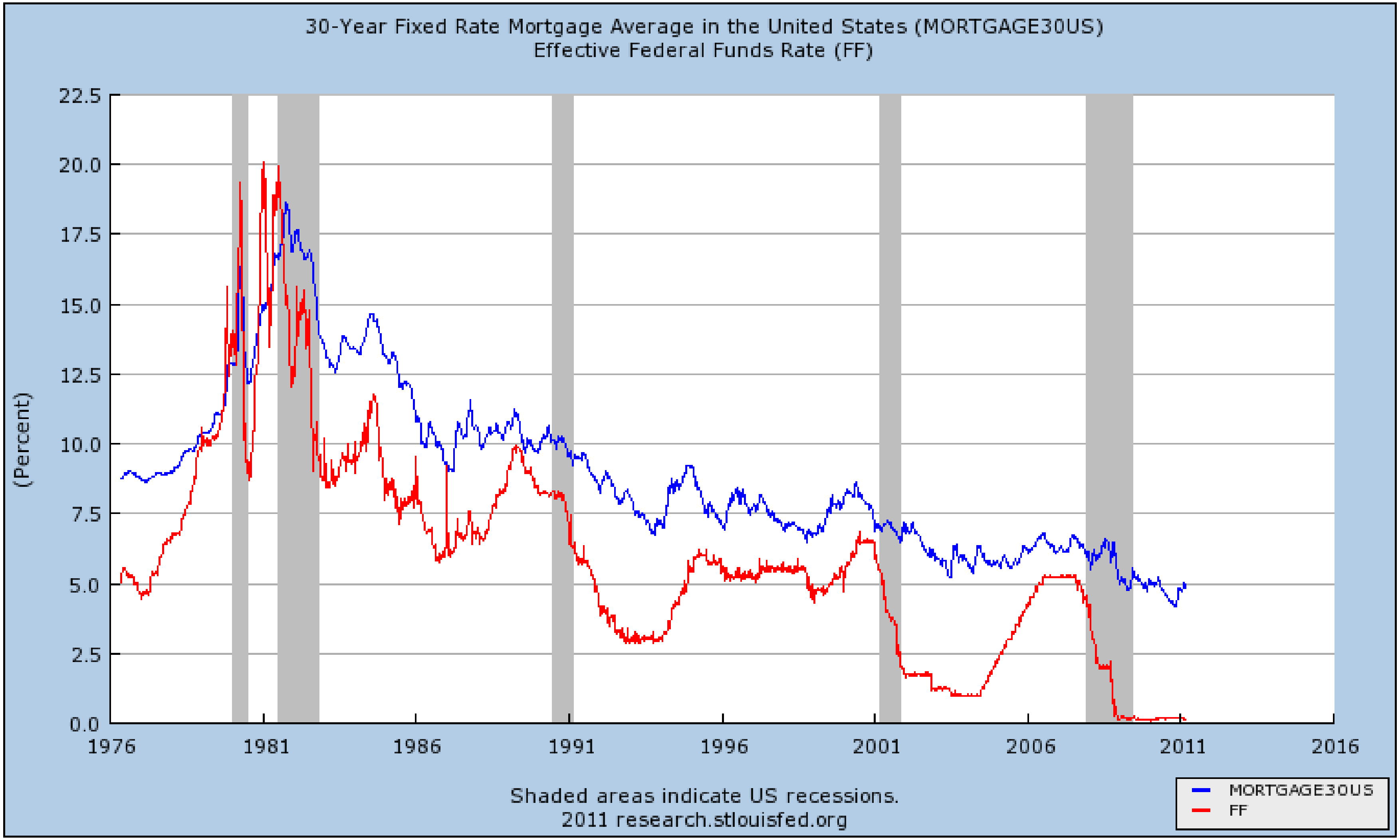
Who Dares Oppose a Boom?

- Hedge Funds
- Value Investors
- Leftists
- Cranks

- No one with any real political power ever opposes a boom

Quis custodiet ipsos custodes?

Can Systemic Risk be Controlled?



Can Systemic Risk be Controlled?

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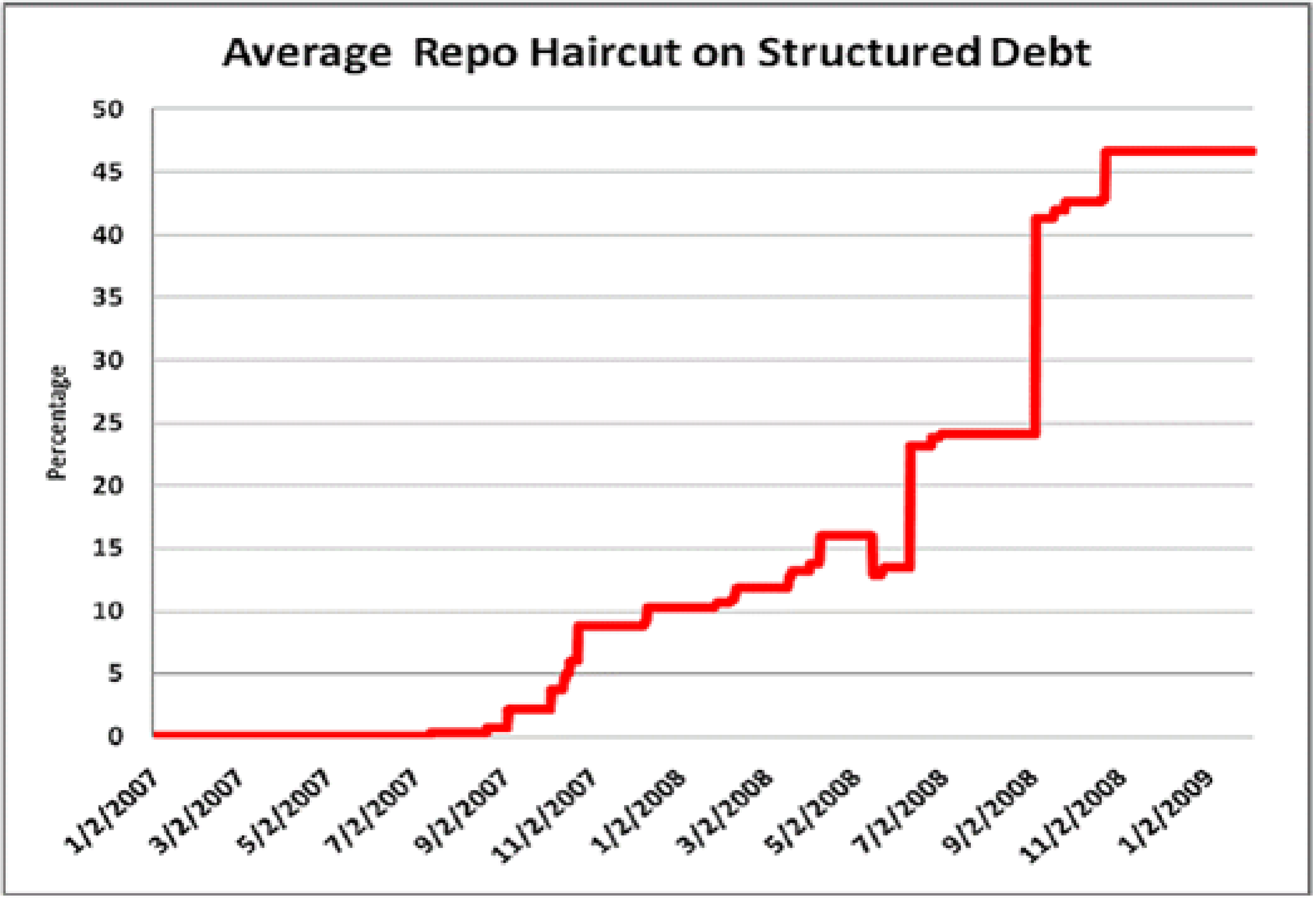
Interest You Paid (See page A-6.)	**10**	Home mortgage interest and points reported to you on Form 1098	**10**
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-7 and show that person's name, identifying no., and address ▶	**11**
Note. Personal interest is not deductible.	**12**	Points not reported to you on Form 1098. See page A-7 for special rules	**12**
	13	Qualified mortgage insurance premiums (see page A-7) .	**13**
	14	Investment interest. Attach Form 4952 if required. (See page A-8.)	**14**
	15	Add lines 10 through 14	

Can Systemic Risk be Controlled?



Can Systemic Risk be Controlled?

Systemic Risk Can Be Detected

- Low credit spreads and equity volatility
- Low TED spreads
- High implicit leverage at the banks
- High levels of short term lending/borrowing
- Credit complexity and interconnectedness
- Poor Credit Underwriting
- Carry trades are common

And Then You Wait

Summary

- Politically difficult to stop booms; everybody loves them while they are going.
- Regulators had more than enough tools to deal with credit and leverage issues. They did not use them. Why will they use the new tools next time?
- Let the government focus on underlying regulatory capture and try to prevent it.
- Let the banking regulators set real leverage, ALM, counterparty, and other limits for banks.
- Who will limit the Fed and its monetary policy? When will they realize that systemic risk is largely their creation?
- Do we have the backbone to fire regulators that have failed?
- When will we as a culture accept that smooth permanent prosperity is not possible, and toss out the politicians that promise prosperity? We should know they can’t deliver.

Contact Data

David J. Merkel, CFA

david.merkel@gmail.com

http://alephblog.com

Aleph Investments, LLC

aleph.investments@gmail.com

410-750-7894