Markets

Time spent thinking about the next financial crisis is not wasted

Crises have increased in frequency, but do not flee risky assets

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We are all prisoners of our own experience. For me and the people of my generation who now tend to make the key decisions in finance and investment, our experience has included several huge financial bubbles and crises in the western world, and an unprecedented range of crises in the emerging world. Does that mean that we spend too much time thinking about potential future crises?

The markets research team at Deutsche, led by Jim Reid, think not. This week they produced the latest edition of their annual long-term assets survey, and devoted almost all of it to “The Next Financial Crisis”.

https://www.ft.com/content/52c33d8a-9f71-11e7-9a86-4d5a475ba4c5
It is an enormous and excellent piece of research, from which I will try to gloss the most
interesting points. First, the era we live in does indeed have more financial crises than those
that went before. This is true globally, demonstrated with a welter of statistics, and there is a
clear point at which the crises began to accumulate — August 1971, when President Richard
Nixon brought the Bretton Woods agreement to an end, ending the tie of the dollar, and
ultimately most other currencies, to the price of gold.

Before this point, gold had in real terms lost an average of 1.5 per cent each year since 1900.
Since the end of Bretton Woods, it has averaged a return of 3.7 per cent. The equivalent
figures for US equities are 6.4 and 6.2 per cent.

Meanwhile, the authors hold that the move to currencies backed by governmental fiat rather
than the supply of gold being extracted from the ground has enabled a build-up of debt
without parallel. Their global estimate for the total amount of stimulus in the decade since
the crisis, which combines extra money printed plus widening of government budget deficits,
is $34tn. Leaving the straitjacket of the gold standard (and they do not advocate a return),
has at least given governments the option to deal with a crisis by injecting new money, and
they have taken it.
In a system that has grown prone to crises, and with unprecedented debt, that is enjoying its longest lull in two decades, the chances of a future crisis are overwhelming. I cannot dispute this argument.

But perhaps the most alarming part of Deutsche’s study is the sheer range of possible triggers for the next crisis that they mention. It could be driven by; an economic recession (which would find governments out of bullets and asset prices exposed); a central bank unwind, as attempts to retreat from extreme stimulus (which the Federal Reserve will start in a very gentle way next month) push up rates and trigger a collapse; deflation, which would bring more monetary stimulus and more negative rates, and finally force a banking collapse; stretched asset prices, in which obviously overpriced equities and bonds would at last begin to collapse under their own implausibility; or a lack of financial market liquidity, as trading has steadily evaporated particularly in corporate bonds, allowing relatively minor sales to magnify into a catastrophic fall.

If you want more specific trigger points, Mr Reid and his team mention Italy (a big and
heavily indebted economy with a stricken banking system and an unpredictable election (upcoming); China, which still has deep financial imbalances with the west, and where the rate of debt growth post-crisis appears unsustainable; Japan, which has been in a demographically driven slump for decades, but where the Bank of Japan's huge balance sheet now adds a greater dimension of risk; and Brexit, which could endanger the financial and defence architecture of Europe. Then there is the risk of populism everywhere. Take your pick.

What conclusions should investors draw from this? The first point, I think, is that the sheer range of disaster scenarios shows that the experts at Deutsche simply do not know what will happen next. Several of their scenarios are mutually contradictory. They have shown that the status quo cannot be sustained indefinitely; they have not shown how long it will last or how it will end. They are not alone; there is a lack of historical precedent. We should all work on the assumption that we do not know what will happen next.

On that basis, it would be an unacceptable risk to get out of risky assets altogether. Putting all your money in cash, if you need your nest egg to grow, is in some ways as risky as putting it all in stocks. You could miss out on that one great spurt of growth in the stock market that would have enabled you to fund your pension, pay for your kids’ university education, or whatever. And as the risks spread from Italy to China with many points in between, it would be wise to stay diversified.

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Second, however, Deutsche have made clear that a crisis is coming, and therefore it is imperative to prepare for it. That might mean gold and precious metals — but they can be hard to trade in some circumstances and would do badly under deflation.

The wisest course is to carry rather more cash than you usually would. Cash itself could be endangered in some Armageddon scenarios. And if the equity rally continues a while longer, which it well might, it means reducing your gains — although you will still have gains.
But the point is that it gives you optionality. It is easy and costless to get out of it and move into something else in a hurry once the shape of the crisis begins to grow clear. Best to be prepared.

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