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Featured G

Why Doesn't Lightning Strike in the Same Place Twice?

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If you have been to Yellowstone National Park in the last 25 years, you know what a landscape that had a devastating forest fire in recent memory looks like. Even a cursory look at this picture makes it obvious that the risk of another fire *today* is almost nonexistent.

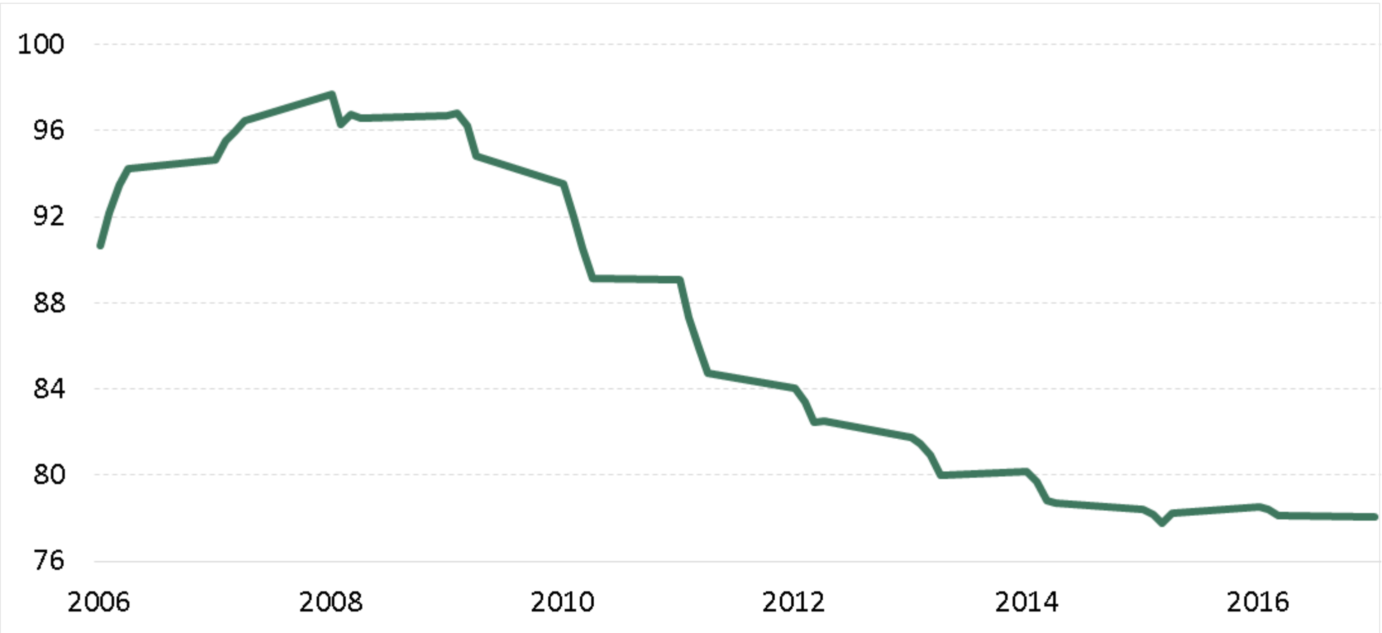
Just as a forest fire requires fuel, a financial crisis requires financial excesses. Despite the generational banking crisis in the U.S. in 2008, we continue to take comfort in the fact that we see no serious excesses in current U.S. bank lending behavior. Perhaps this is not despite, but because of the crisis.

Lessons Learned and Not Forgotten

Chart 1 below shows that outstanding household debt not only bottomed since the Great Recession, but has hovered near that low:

Chart 1: US: Household & Nonprofit Outstanding Debt

As a Percent of SAAR GDP, As of 3/31/2017



Source: Federal Reserve Board/Haver Analytics

The 2008 crisis in the U.S. was the worst financial crisis since the Great Depression in the 1930s. It could have very much turned into another great depression had regulators not stepped in to stabilize the financial system. The 1930s crisis was a very painful lesson in banking for U.S. borrowers and banks. So much so that in the decade-plus following the crisis there were virtually no credit losses.

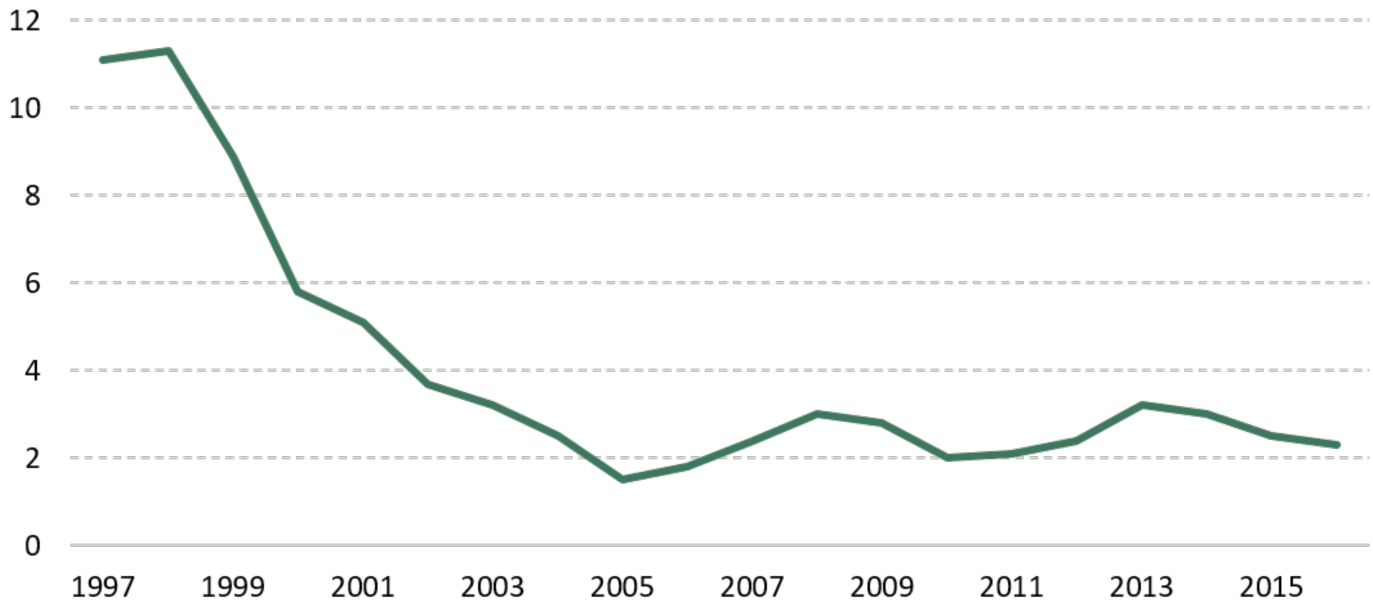
There is good reason for a conservative bias following a banking crisis. After a crisis of such magnitude, no board or executive is going to approve resuming the kind of practices that caused such vivid pain. Even if they do, few investors are going to be willing to fund these practices. Lastly, and perhaps most important, even if a bank wants to do something stupid again, regulators will not let them. Today, large U.S. banks hold twice the equity ratios they held before the crisis, with a regulated, substantial cash buffer on top of that.

Investors likely overestimate the risk in countries that recently had banking crises. Many of these investors suffered brutal losses in the prior crisis and said never again. Availability bias makes it far easier to recall a crisis that happened eight years ago than one that happened forty years ago. We've seen this bias consistently reappear as U.S. industry analysts use an event like the Great Recession as a plausible downside scenario in their own industry stress tests. We think the odds of repeating a market event of this magnitude in the near term are unlikely. Yet conversely, places that have not had a crisis for a long time are where arguments similar to "U.S. housing prices never fall" can develop with dangerous results.

As an example of how long this caution can last, we met with senior executives of large banks in Turkey and Mexico. These two countries are not without issues, but a reckless bank lending culture is not one of them. We think looking at the level of non-performing loans within these countries is an appropriate metric in determining the amount of risk-taking within their respective banking sectors (see Chart 2 below).

Chart 2: Mexico Bank Nonperforming Loans to Total Gross Loans

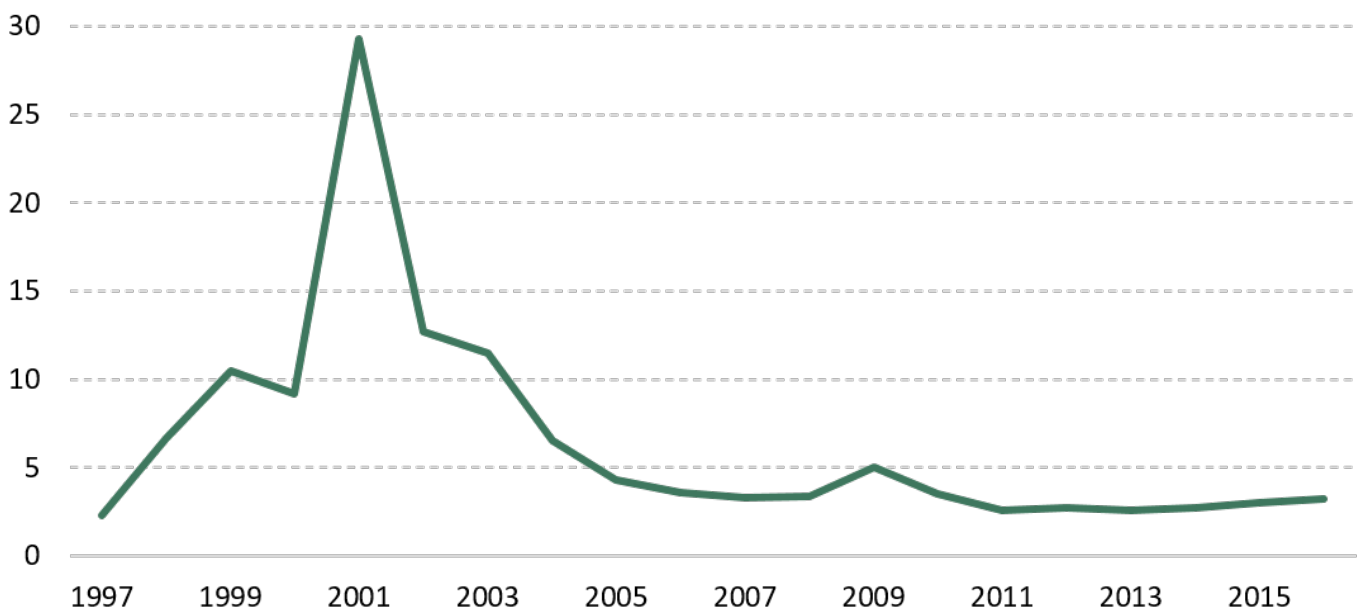
Percent, As of 12/31/16



Source: Bloomberg (© 2017, Bloomberg Finance LP)

Chart 3: Turkey Bank Nonperforming Loans to Total Gross Loans %

Percent, As of 12/31/16



Source: Bloomberg (© 2017, Bloomberg Finance LP)

A Mexican banker cited the "Tequila Crisis" of 1994—over 20 years ago—to explain the banking system's caution today. Borrowers remember they lost their homes so they don't want to borrow unnecessarily, regulators continue to keep the banks on a tight leash, and reserves and capital levels are kept conservative. The Turkish bankers we met cited their country's 2001 crisis as the impetus for major regulatory change and important

lessons learned which still persist after 16 years. Neither of these countries' banks got in trouble in 2008. We would add Japan, which suffered its own existential banking crisis in 1990, to those countries that avoided the temptations which led to the last crisis.

Conclusion

In this context, the 10 years that have passed since the global financial crisis are not long enough for either lenders or investors to forget the mistakes made and the pain suffered. As a result, we do not believe that there is fuel in the forest necessary for a fire. While we will continue to be vigilant, we think those assuming that irresponsible lending will repeat need to go back further in time and broaden their study of similar crises around the world.

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