"Yesterday is not ours to recover but tomorrow is ours to win or lose."

Lyndon B. Johnson
36th President of the United States
1963-1969

THE GREAT RECESSION REVISITED

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Ten years ago our country experienced one of the worst financial collapses in our history.

Liquidity in the markets dried up and lending of all kinds grounded to a halt. Personal and corporate bankruptcies almost took down the equity markets. The S&P 500 index suffered a 54% peak-to-trough drop from October 2007 to March 2009. By the time it was all said and done, the S&P 500 index had declined almost 40%. In October 2008, Lehman's bankruptcy shattered all confidence in the markets and remains the single largest failure in U.S. history. We have all aged quite a bit from that March 2009 day when the S&P 500 index closed at a low of 676.53.

It certainly was a time that we will not easily forget.

Wall Street has a saying, *this time it's different*. But academics also have a saying, *history has a way of repeating itself*. Which is it as it relates to The Great Recession? Was it, in fact, different from all other calamities? Or was it something that we all should have expected as financial crises often repeat?

To provide some insight, let's look back at where we have been. What were the root causes of this severe downturn and loss of confidence? While there are certainly many reasons these five have spawned many of the others.

1. <u>Banks took on too much risk</u>. From securitizing and originating loans that banks did not even keep on their own books but sold off to lesser sound institutions, to creating financial instruments like credit default swaps that could not hold up under severe economic downturns, our country's largest banks and brokerage houses lead the charge into riskier financial behavior.

2. <u>Outright fraud</u>. Most of these risky financial products were packaged and sold by Wall Street to all kinds of institutions, from sovereign funds to pensions and endowments, knowing that they were not the credit quality represented. Credit agencies, for their part, did not properly rate these products so most were sold under fraudulent conditions.

3. <u>Short-termism</u>. The urge to create quick profits out of thin air dominated the behavior of our largest financial institutions. Very few insiders at the highest levels of corporate America stood tall to this destructive behavior. Instead most went along, feathering their own nests and allowed reporting of overstated, erroneous numbers to the investment community.

4. <u>A failure in our economic projections</u>. Economists never really grasped the magnitude of the housing bubble, along with the off-balance sheet and shadow banking system risks. Even more mind boggling, they never anticipated the power of the rate decreases from our central bank after 9/11 and how increased liquidity and cheaper money could lead to inflated asset prices down the road. Add to all of that the fact that significant deregulation in the banking area was taking hold at a time when, some would argue, a thoughtful and more pragmatic approach should have ruled the day.

5. Greed. It is easy, and quite correct, to blame Wall Street individuals and their institutions for the calamity of 2008/09. But the human tendency of greed has a way to subvert all of us. More on this later but suffice it to say that greed is at the center of every financial crisis.

Much in the financial sector has changed in the last ten years. The banking system is safer due to needed regulation and a requirement for lending institutions to increase their capital requirements. During the crisis, these firms had around $2 in capital for every $100 of assets. Today, capital has increased to around $7 for every $100. This creates an important cushion to be able to weather future expected downturns.

Leverage in the financial system has declined and has shifted to companies and countries and away from individuals. The larger banking institutions have also reduced their reliance on short-term funding and concentrated more on growing their deposit base. Hence, funding in the overall system is considered more stable. Importantly, U.S. consumers have cut their debt as a percentage of GDP by paying down their loans.

It is estimated that the gross market value of derivatives, what Warren Buffett once called "weapons of mass destruction," sit at the lowest level in more than ten years. These instruments are also more closely followed than at any time in history. Given the strong economy and markets, counterparties of these instruments appear on more solid footing as well.

Short-term thinking is being challenged by members of not only the financial community - from CEO's, to analysts, to economists - but also to politicians and large investors. Important issues like corporate earnings reported every six months instead of quarterly, and scrutinizing executive compensation are now in mainstream discussions.

Despite some of these positive developments, the appetite for risk, and henceforth, risky human behavior, still lurks in the shadows. The surge in corporate debt has fueled issuance of more leveraged loans and junk bonds, by some estimates, doubling over the past ten years. Most of this behavior coincides with the decline in interest rates as investors of all kinds, endowments to retirees, search for yield. Additionally, countries like the U.S. have increased their debt substantially with total U.S. deficits running at around $21trillion. Potential future increases in interest rates by the Fed will certainly cast a long shadow on debt repayment, leading to a crowding out of investment into other much needed areas. The current bet is that sustained economic growth of 3-4%, and the resulting increase in tax receipts, will eclipse any negative impact from rising rates. On the plus side, capital expenditures for corporations have surged to multi-year highs on target for about $341billion this year, due mainly to the recent corporate tax cut. Another positive sign, Goldman Sachs last month published a piece arguing that there is little sign of a recession in the next three years.

Now we must answer the question posed earlier concerning our economic future: will history repeat itself or will things be different next time? Actually, it is really an easy question to answer. As long as there is greed in the world, showing no concern for the *common good*, then history will repeat itself at some level in the financial markets. Greed is at the core of every short-sided financial instrument, every selfish personal financial decision and every stretch for power. It is always a good reminder to remember that capitalism, for all its warts, works best when people base their day-to-day decisions on the *greater good*. Saint Thomas Aquinas had it right when he said, "*Law is nothing other than a certain ordinance of reason for the common good, promulgated by the person who has the care of the community*."
