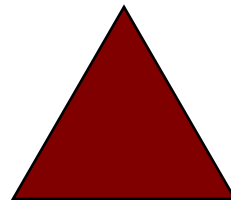


FIAR 2010, FINANCIAL INVESTMENTS DAY  
Wednesday, May 26th, 2010

# Hard lending to rational economics. A difficult lesson to learn

## Part II Macroeconomics of present crisis



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# topics

## **1. Macro policies and stock market, May 2010**

- Correlation: stocks, growth, inflation, deficits, exchange and interest rates
- Cyclical vs. countercyclical; conventional vs. non conventional policies
  - Correlation: money, currency, commodities and stock markets

## **2. Real economy vs. financial economy, 2010**

- Financial sector, a pro cyclical indicator of real economy
  - Lending to negative equity; solvability vs. liquidity
- Real estate market; LT real assets vs. ST financial liabilities

## **3. Macro policies effect on psychology of markets, 201...**

- Investment management in down economies
- Propensity to spend, save or invest in highly volatile markets
  - Risk aversion vs. loss aversion in economic recession

# 1. Macro policies and markets

- Low correlation: stock market, growth, inflation budget/trade deficits, exchange and interest rates, money market, currency, stock, debt and commodities markets

## Policies:

- Cyclical: pro cyclical, correlated with overall state of the economy; ex. tightening monetary policy in recession (*hawkish*); **higher than equilibrium-appropriate exchange rate, fiscal scenarios for VAT and tax rate increase**
- Countercyclical: activist (vs. *laissez faire*), against current economic tendency, lower monetary rate (*dovish*), stimulative in economic downturn; ex: progressive tax, unemployment, **fiscal proposals for 25% and 15% benefits reductions**
- Conventional: Monetary rate, RMOs, (ex. strong Ron = tightening), open market
- Non conventional: easing cost and availability of funds; fiscal monetization:

-aimed at reduced risk spreads, affecting longer term rate across the board, independently of their liquidity and credit risk, affecting the market for risk free assets, government bonds (QE- '*quantitative easing*'); BCE repos

-targeted on the risk spread across assets classes, between those whose markets are particularly impaired (Greek junks as collateral) and those that are more functioning (CE- '*credit easing*'); EU/IMF/EC Stability Fund

# Crisis preparation took a long time; ST liquidity solution probably does not suffice

Zone	GDP (mlns euro/local)			Govt debt (% GDP)			Govt deficit/surplus (% GDP)		
	2009	2008	2007	2009	2008	2007	2009	2008	2007
<b>Euro zone</b>	8.977.933	9.258.895	9.003.902	78,7	69,4	66	-6,3	-2	-0,6
<b>EU 27</b>	11.804.734	12.500.094	12.364.567	73,6	61,6	58,8	-6,8	-2,3	-0,8
<b>AUSTRIA</b>	276.892	281.867	270.782	66,5	62,6	59,5	-3,4	-0,4	-0,4
<b>BELGIUM</b>	337.758	344.676	334.948	96,7	89,8	84,2	-6	-1,2	-0,2
<b>BULGARIA</b>	66.256	66.728	56.520	14,8	14,1	18,2	-3,9	1,8	0,1
<b>CYPRUS</b>	16.947	17.248	15.879	56,2	48,4	58,3	-6,1	0,9	3,4
<b>CZECH REPUBLIC</b>	3.627.188	3.688.994	3.535.460	35,4	30	29	-5,9	-2,7	-0,7
<b>DENMARK</b>	1.657.857	1.737.448	1.691.472	41,6	34,2	27,4	-2,7	3,4	4,8
<b>ESTONIA</b>	214.828	251.493	244.504	7,2	4,6	3,83	-1,7	-2,7	2,6
<b>FINLAND</b>	170.971	184.179	179.536	44	34,2	35,2	-2,2	4,2	5,2
<b>FRANCE</b>	1.919.316	1.948.511	1.895.284	77,6	67,5	63,8	-7,5	-3,3	-2,7
<b>GERMANY</b>	2.407.200	2.495.800	2.428.200	73,2	66	65	-3,3	0	0,2
<b>GREECE</b>	<b>237.494</b>	<b>239.141</b>	<b>226.437</b>	<b>115,1</b>	<b>99,2</b>	<b>95,7</b>	<b>-13,6</b>	<b>-7,7</b>	<b>-5,1</b>
<b>HUNGARY</b>	26.094.824	26.543.252	25.408.080	78,3	72,9	65,9	-4	-3,8	-5
<b>IRELAND</b>	163.543	181.816	189.751	64	43,9	25	-14,3	-7,3	0,1
<b>ITALY</b>	1.520.870	1.567.851	1.546.177	115,8	106,1	103,5	-5,3	-2,7	-1,5
<b>LATVIA</b>	13.244	16.275	14.780	36,1	19,5	9	-9	-4,1	-0,3
<b>LITHUANIA</b>	92.353	111.190	98.669						
<b>LUXEMBOURG</b>	37.755	39.348	37.466	14,5	13,7	6,7	-0,7	2,9	3,6
<b>MALTA</b>	5.712	5.697	5.459	69,1	63,7	61,9	-3,8	-4,5	-2,2
<b>NETHERLANDS</b>	570.208	595.883	568.664	60,9	58,2	45,5	-5,3	0,7	0,2
<b>POLAND</b>	1.342.612	1.272.838	1.176.737	51	47,2	45	-7,1	-3,7	-1,9
<b>PORTUGAL</b>	163.891	166.463	163.891	76,8	66,3	63,6	-9,4	-2,8	-2,6
<b>ROMANIA</b>	<b>491.274</b>	<b>514.654</b>	<b>416.007</b>	<b>23,7</b>	<b>13,3</b>	<b>12,6</b>	<b>-8,3</b>	<b>-5,4</b>	<b>-2,5</b>
<b>SLOVAKIA</b>	63.332	67.221	61.547	35,7	27,7	29,3	-6,8	-2,3	-1,9
<b>SLOVENIA</b>	34.894	37.135	34.568	35,9	22,6	23,4	-5,5	-1,7	0
<b>SPAIN</b>	1.051.151	1.088.502	1.052.730	53,2	39,7	36,2	-11,2	-4,1	1,9
<b>SWEDEN</b>	3.057.056	3.154.630	3.063.145	42,3	38,3	40,8	-0,5	2,5	3,8
<b>UNITED KINGDOM</b>	1.395.872	1.448.392	1.398.882	68,1	52	44,7	-11,5	-4,9	-2,8

# Private vs. public leverage; which one is better?

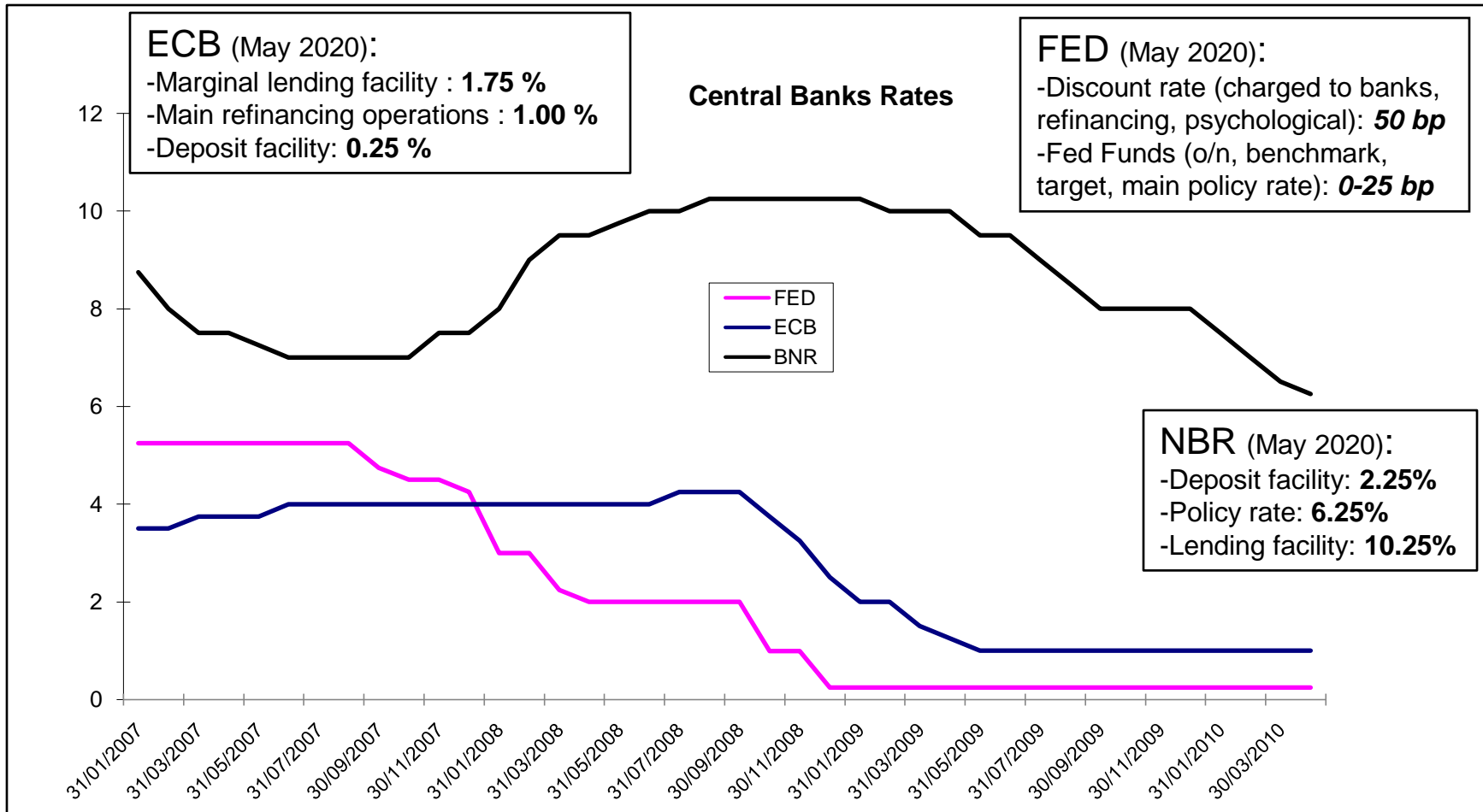
- Too much debt is dangerous. During boom, central banks, investment bankers and politicians all signed up to the cult of debt; **SE Asia is the least levered, best prepared for sustained economic growth (financial and commercial)**
- Companies went for balance-sheet "efficiency" - and homeowners, piled on huge mortgages, were caught out, then discover that it is much harder to deleverage than to leverage up; **basically, only rented home from the bank**
- Globalization doesn't work smoothly by itself. Free movement of capital has facilitated rapid shifts in cross-border capital flows, currency values and prices of commodities; insufficient financial depth (savings and investments/GDP) makes a country vulnerable; **first: save; then: invest; only then: spend**
- Most probable we all, **insufficiently saved, inadequately invested and irrationally spent future cash flows** (governments, corporations, individuals)

# Central Banks moves have mattered

- During a normal recession, the Fed, ECB and other central banks responded with non conventional monetary policies by buying short-term government/quality (except for Greek junks) debt from banks
- Process drives rates on government debt down; investors seeking a higher rate move into other assets, driving other rates down; normally these lower rates will lead to economic bounceback; **in recession, fiscal also matters**
- A lower bound to rates advocates higher government spending: when monetary policy is ineffective and private sector can't be persuaded to spend or borrow more, **the public sector must take its place in supporting the economy**
- Probably the fiscal stimulus is the Keynesian answer to the kind of economic situation we're currently in, and a good mix with monetary policy
- New normal recession requires CBs to be less concerned on inflation? Milton Friedman for growth and John Maynard Keynes for recession?



# Central banks do matter since monetary and fiscal policies look interchangeable, lately



# Conventional vs. nonconventional

- Common to all major crises, is a **combination of reasons**: overleverage, real estate boom, loose fiscal and monetary policies, overspending
  - debt difficult decisions: higher tax or lower spending/expenses?
- ECB: one size fits all monetary policy has its drawbacks, mostly in a downturn economy. Front runners (G) in recovery would rather enjoy an increase once the sustainable growth picks up, but laggards (P, S) would rather see very low rates for a longer term
- Moral hazard introduced into equation by EU/IMF/EC stand by bail out for Greece was a necessary evil (*write off*). Probably, restructuring would have been better, but EU is not yet prepared to accept, manage, convince
- Europe's financial tribulations reflect investors concern that governments have borrowed too much to revive their economies; how do US manage?
- **No matter how smart and big is the bailout (EU Stabilization Fund), most important stakeholders have to buy in: population (to sacrifice) and private investors (to roll over next debt, at reasonable prices)**



# Current phase: sovereign debt pressure

- A bubble in government bonds has been deflated but yields will rise, inflation, oversupply. Need to print money to pay interest on new debt; result: a slower recovery; **growth is a key determinant for deficits**
- Add corporate and private debt to government debt / GDP, the prospect of economic growth paying all that off is moving further in time
- **Debt restructuring, could be the new currency devaluation in the euro zone if not proper measure taken**; higher borrowing cost (LT) could lead to higher deficits; EU Stabilization Plan targets MT/LT rates

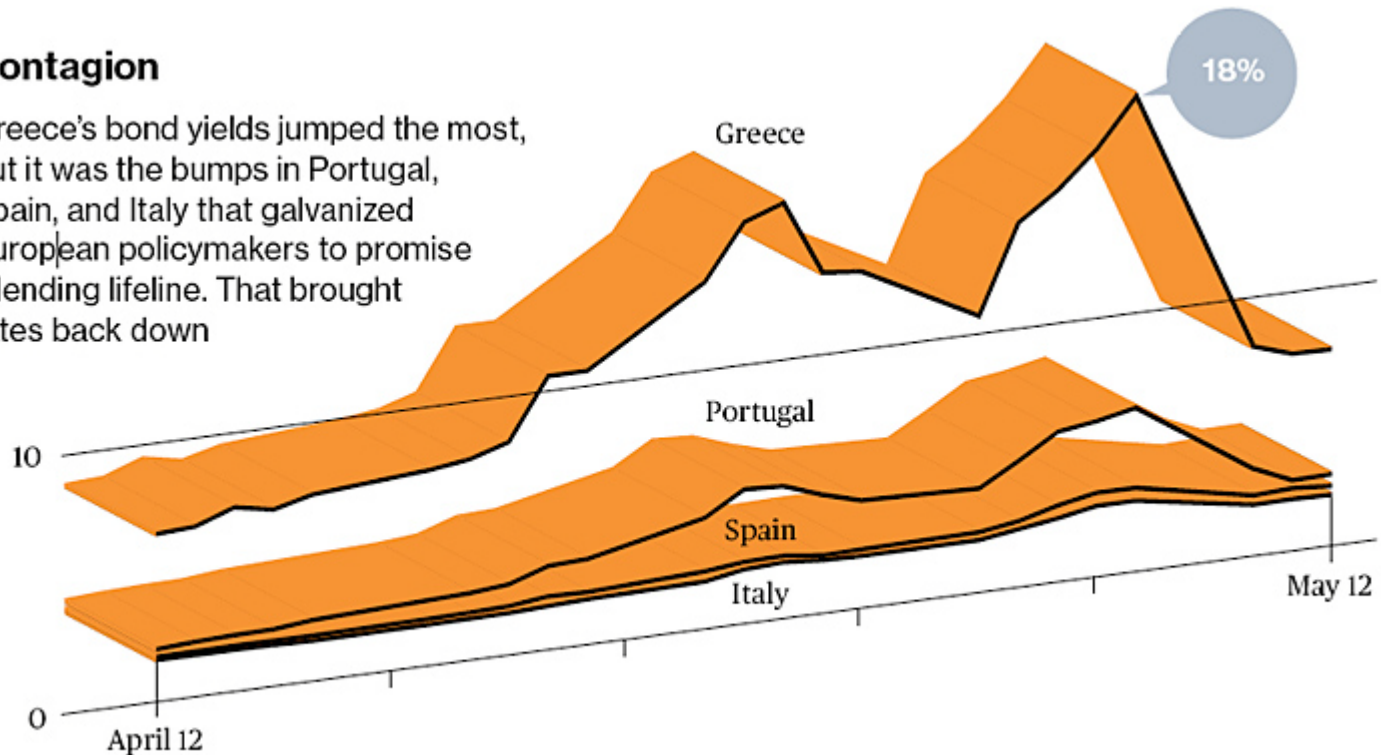
## What is a CDS:

- Credit-default swaps pay the buyer cash should company fail its debt agreements. Increase signals deterioration in credit quality perception
- A basis point (0.01%) on a credit-default swap contract protecting 10 million Euros of debt (except principal) from default for five years is equivalent to 1,000 Euros a year (e.g. on May 7, CDS on European bank bonds temporarily soared above levels triggered by the collapse of LB)

# Contagion containment is not cure

## Contagion

Greece's bond yields jumped the most, but it was the bumps in Portugal, Spain, and Italy that galvanized European policymakers to promise a lending lifeline. That brought rates back down



- Similar to physical disease, financial contagion spreads faster in a weakened population [of investors]
- Creditors are also massive debtors. If the value of their assets declines, **the only way they can stay solvent is by reducing their debt**, and the only way they can pay down the debt is by selling assets, which pushes their price down even further, exacerbating the problem and spreading it to other securities/currency (€)

# *Stratégique Gouvernement économique:* transition to a more competitive economy

- The new normal Romanian consumer society skewed industrial structures away from exporters to domestic market (sheltered from foreign competition)
- Dependence on foreign capital; reason and result of poor competitiveness
- Service FX debts from export; policy directed at shifting resources to exporters
- Increase/reduce VAT/benefits, and reduce taxes on jobs can shift economy from domestic demand to export (**mimicking a non inflationary devaluation**)
- Separate the new brothers in arms: monetary and fiscal policy; government borrowing up for LT, fiscal policy will direct impact on the yield curve (MT/LT)

Automatic Shock absorbers could be helpful:

- Monetary absorber: FX and % policies could be adjusted as needed (vs.€)
- Real economy absorber: flexible labor markets, balance to private vs. budget
- Fiscal redistribution absorber to balance out economic shocks to exports
- W/out fiscal discipline € is doomed; ST compromise has LT drawbacks

## 2. Real vs. financial/virtual economy

- Governments have borrowed too much to revive economies. Probably this is the most important cause of present (May 2010) volatility, pushing the limits of fiscal and monetary stimulation. The current mix of policies most likely will be enough to bring economic recession to end; **financial prosperity, however, takes time**
- Banking and financial sector, a lagging, pro cyclical indicator of real economy; although economy hoped to clearly rebound in 2011, GDP growth is not enough
- Banks will not give loans on concerns of negative equity; pro cyclical attitude: the more credit you need, less able you are. Unemployment is a key indicator
- Post real estate boom market: real assets vs. financial liabilities:

Financial stability: **bail out countries (Greece) is to keep financing banks sovereign exposure solvable**; money-printing is just another way for governments to silently default on their debt

*Chindia*, probably the best market capitalists have socialist ideology and US will not make it easier for Europe; EU does not make it easier for EU

# Liquidity vs. Solvency

- Liquidity (ST, EU Stabilization Fund) and solvency (LT, deficits) are not interchangeable. Interest rate risk vs. credit/counterparty risk
- Liquidity provided by central banks can make a difference on ST and MT, but not on a LT; markets are becoming completely dependent on Central Banks.  
Dark side of Euro: **one size fits all could be suboptimal in times of crisis**
- **Negative equity:** market value of assets < present value of liabilities  
Deleveraging is a must
- Solvability (long term, renewable ability to borrow) vs. liquidity (short term)  
High debt/GDP, high deficit/GDP, low growth – LT endangered species
- An absolute economic pecking order:  
1: recovery  
2: growth  
3: expansion  
4: prosperity



# Political Accounting and Machinations

- Banks do not trade toxic assets (except with CBs); any trade could trigger a fair valuation of whole portfolio; ok as long as interest rates go down
- Fair value is history (FAS 157, IAS 39); bad loans of the past 10 years; **capitalization by accounting and papering out the crisis are easy but not enough**

Goldman Sachs lesson:

- SEC: *“.. built a “conveyer belt” of mortgage deals and then bet against them, “The toxins that Goldman Sachs and others helped inject into our financial system have done incalculable harm to people who have never heard of a synthetic CDO and who have no defenses against the harm that such exotic Wall Street creations can cause” (as Morgan Stanley did also)*
- GS: *“We didn’t have a massive short against the housing market and we certainly did not bet against our clients”*. It made money every single day of Q1/10, a feat the firm has never accomplished before (as JPMorgan did)



# Probably over economic recession but still under solvability and financial crisis

**2010, Over recession but still under crisis: Equity Risk and Credit Premiums, May 2010**

	Real GDP Growth	Real Earnings Growth	+ Dividend Yield	= Expected Real Return	- Real Bond Yield	= Implied ERP	Expected Inflation	Expected Nominal Return
<b>US</b>	3,0	3,0	1,8	4,8	1,5	3,3	2,0	6,8
<b>Japan</b>	1,5	1,5	1,7	3,2	0,8	2,4	0,5	3,7
<b>UK</b>	2,8	2,8	3,2	6,0	-1,0	7,0	2,0	8,0
<b>Romania</b>	-1	-1	3	2,0	3,0	-1,0	4,0	<b>6,0</b>
	-2,5	-2,5	3	0,5	3,5	-3,0	4,5	<b>5,0</b>
	-5	-5	2,5	-2,5	3,75	-6,3	5,0	<b>2,5</b>
<b>Europe</b>	2,3	2,3	2,9	5,2	-1,0	6,1	2,0	7,2
<b>World</b>	2,5	2,5	2,3	4,8	0,4	4,4	1,8	6,6

# Currencies and stocks

- Then (2009): reverse correlation; when the dollar would fall, stocks would rise and vice versa; euro was strong, EM currencies, including Ron, were under pressure
- Why: CT investors were using a currency that cost almost nothing to borrow (\$,¥) to buy undervalued stocks, with a bias toward emerging markets; combination lift stocks off their 2009 March lows
- Now (2010): stocks and the dollar are moving **up in tandem again, but not down** (weak Euro); a signal for investors to put more money into \$ denominated assets? a signal to sell Euro denominated assets and buy into emerging markets (Ron?)
- Countercyclical Dollar and Yen are now less favorite CT currencies, due to their strengthening and overall volatility
- Ron (and other cyclical/emerging markets currencies) only relatively attractive; **if deficit not tamed < 8%, Ron can be under pressure**

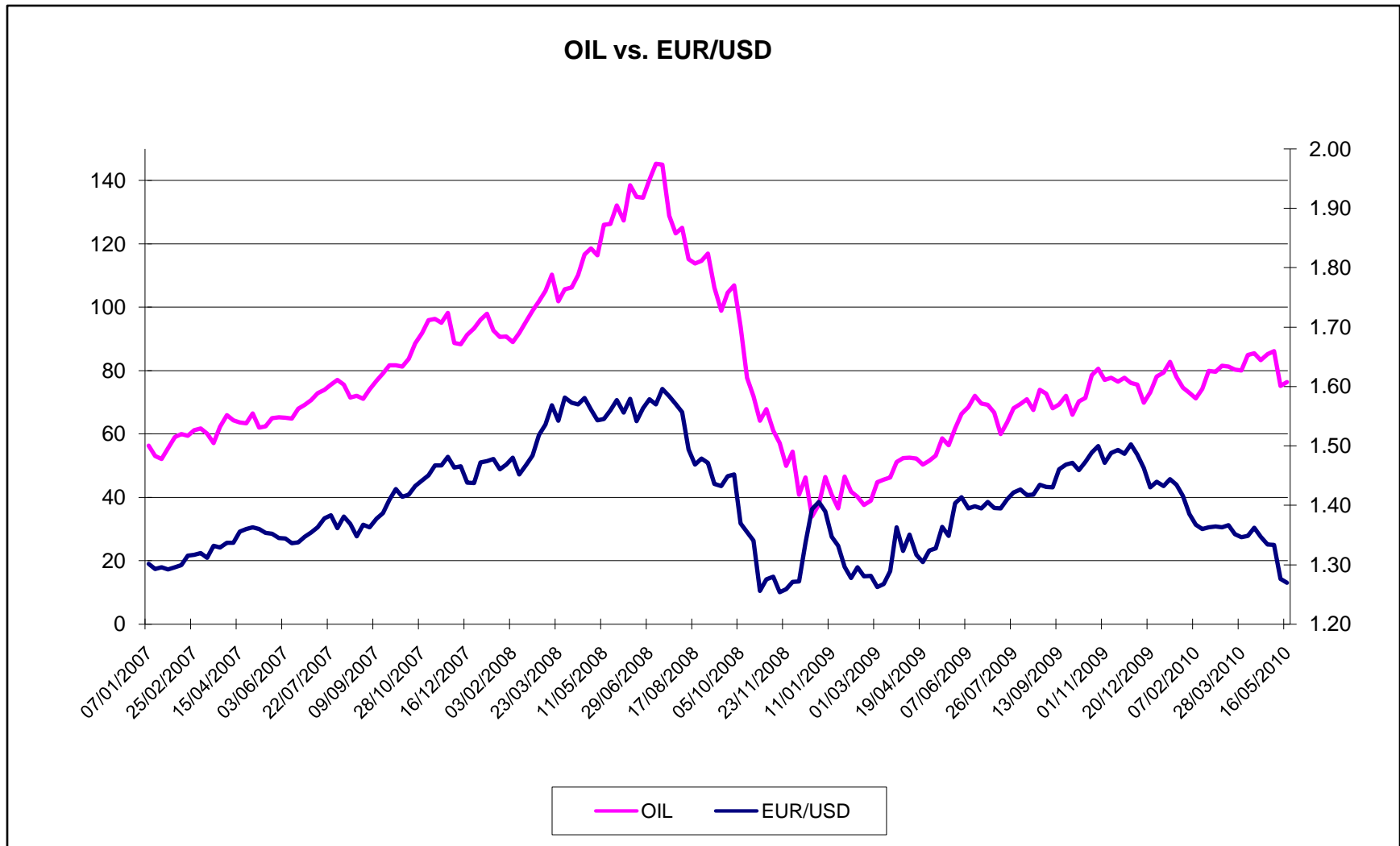
# Dollar, Euro

- The typical paradigm for an export oriented Europe was that a strong dollar / weak euro is good for trade, for both US and China. A weakening euro (a political not economic currency) is of benefit to PIIGS, alleviating some of their excessive deficits and making their products more competitive
- Raw materials, mostly denominated in dollars are making inputs prices more expensive adding additional strain on the expected growth differential vs. US. This, in turn, will lead probably to an earlier interest rate hike, make now dollar assets more attractive
- During the toughest part of the recession, the dollar weakened against most of other currencies. A depreciating currency is a good antirecessionary tool; **a low \$ exports recession and a strong \$ imports growth**
- Banks are a lagging indicator of economic conditions. Central banks, trying to protect currency stability and debtors, would rather sacrifice future, potential debtors/present depositors than current debtors solvability position
- Main risks to fiscal consolidation stem from plethora of too optimistic assumptions and lack of specification of consolidating measures; if EU didn't have common currency, it would have bigger problems or vice versa?

# Ron

- Bolstered by low interest rates from EU, with construction accounting for more than 15% of GDP, a building boom created an unbalanced economy
- Recession left with a large economic hole to fill. Wages systematic increase coupled with low productivity growth relative to competitors - a major source of **competitive disadvantage**
- Spending is not a significant value adding economic activity
- High Ron DAE and stable/appreciating Ron make EUR borrowing slightly more attractive to households and companies; debt in a depreciating currency is more efficient and naturally hedged; vice versa for deposits
- One way for the country to remain competitive is **to increase productivity and investments and cut spending**, since it cannot lower prices artificially through a relative stable (5%) exchange rate
- Pro cyclicality does matter; strong Ron, low Ron rates, low Euro, strong Dollar are all potentially helping solvability, banks and financial economy

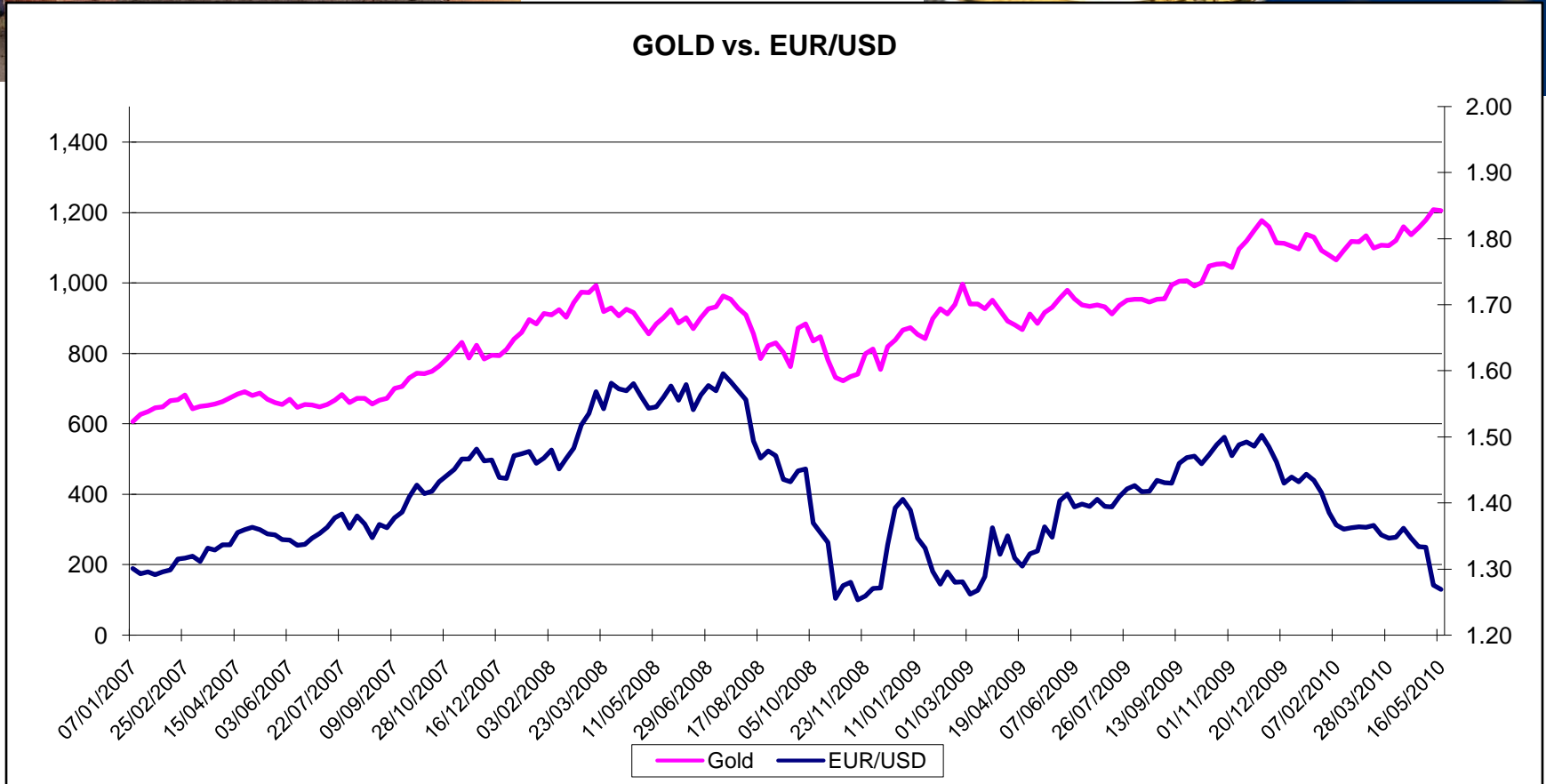
# Commodities correlate w/ currencies



# Lately, Euro looks less countercyclical



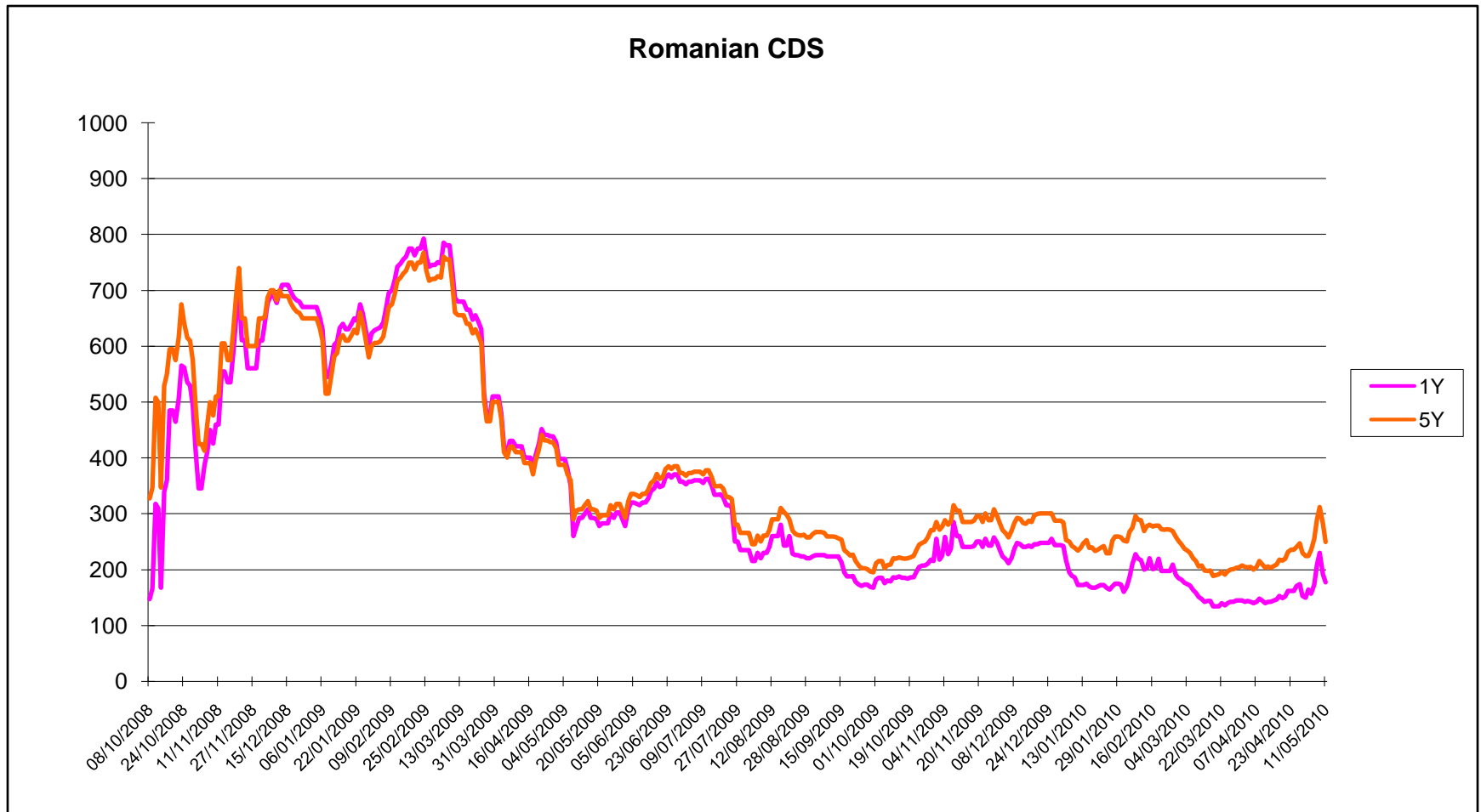
**GOLD vs. EUR/USD**





# Bail outs = sell CDS for free

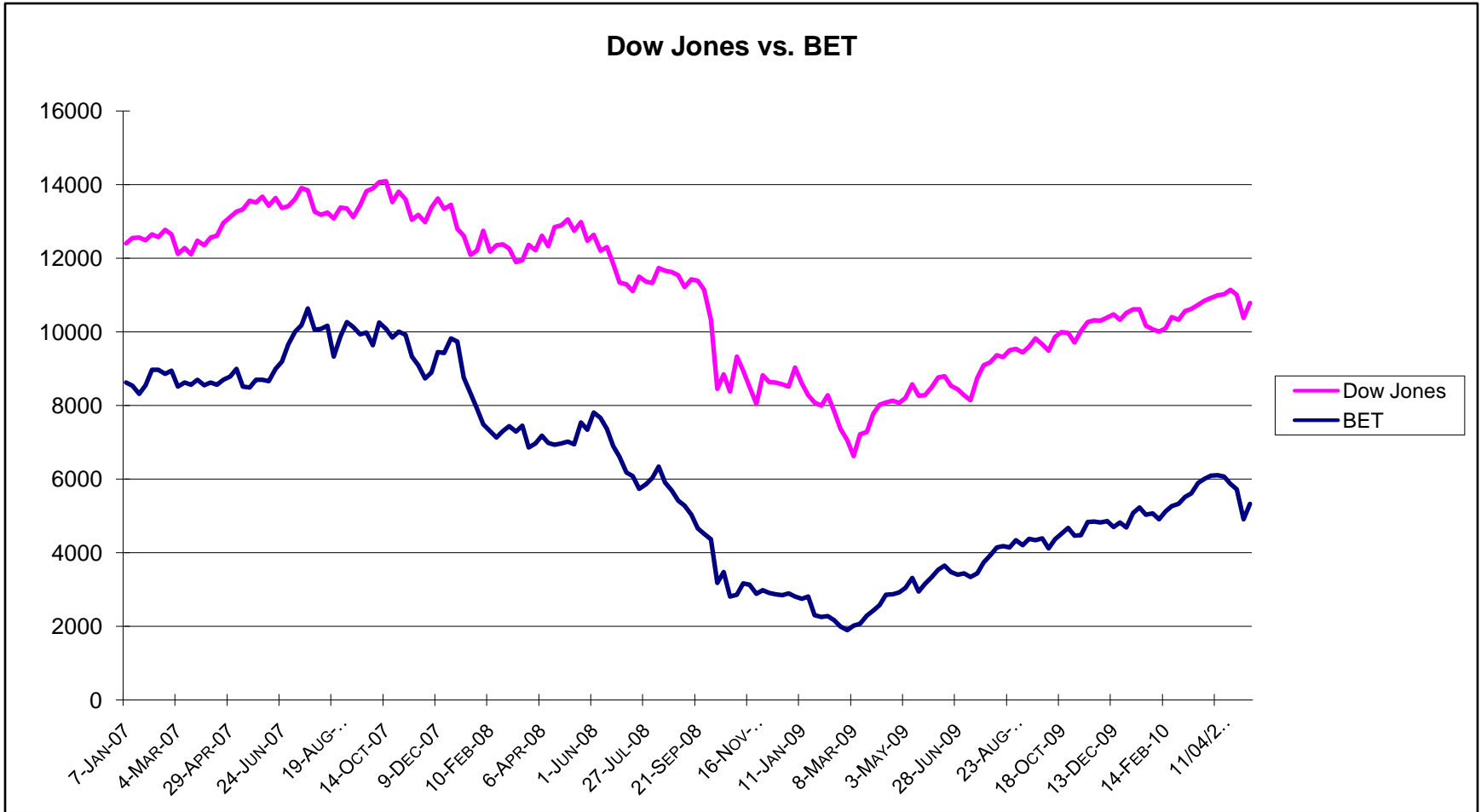
# Bonds = monetize the CDS



## 3. Macro policies and psychology of markets

- **Greatest risk is no risk at all.** Investment management into post recessionary, high volatility low growth environment is difficult:
  - Can an informed investor make money systematically by exploitation of behavioral, cognitive and psychological inefficiencies of the market?
  - Financial behavior analysis relaxes the fundamental analysis requirement for convergence of price and value. The difference between the two is seldom systematic, so probably it can be exploited by a rational and disciplined investor
  - There can be no reward, without risk. Gaining a sustainable advantage over so **many skilled and knowledgeable competitors**, in a free market, is difficult
  - Managing in bear market is the skill. Bear correlations can easily destroy the hard earned return
  - Risk aversion vs. loss aversion; by making a loss you can still make money
- Propensity to borrow, spend, save or invest under change from crisis; a major rebalance of wealth and social benefits commensurate with productivity and economic value added; most likely, **some of us have lived better than economically sustainable**

# Asset Allocation (*psi finance*) matters, Diversification (classic finance) less



# Highest velocity ever of a market reaction, May 6, 2010

(the panic, the fat finger and the revenge of the machines)

- A big block of P&G (2:30), followed by another huge block, right before the market crashed, then, nothing, probably sell orders, big enough to blow all the bids, for a few minutes, buyers just disappeared
- Existing stop-loss orders on P&G forced selling into a no-bid market
- Every \$1 change in price in a stock, results in a 7.56 ( $1/0.132319125$ ) change in DJIA
- Worst timing: stocks had started selling off earlier, panicked. The velocity/severity triggered stop-loss selling, **feeding on itself**
- Even as P&G's share price was recovering, bids were falling rapidly in the other 29 Dow components; at one point was down 997



# We like weekends, but we don't like Mondays



- EU/FMI financial assistance of 750 billion Euros to counter “severe tensions” by purchasing government and private debt and restarted a dollar-swap line with FED
- ECB said it will conduct “interventions” to ensure “depth and liquidity” in markets
- Probably this will lead all central banks (apart from China) to have a **looser monetary policy for longer**
- Spain’s benchmark stock index, the [IBEX 35](#), rose the most on record





# Some Behavioral Traits and Patterns of Investors; more pronounced during economic/market pressure

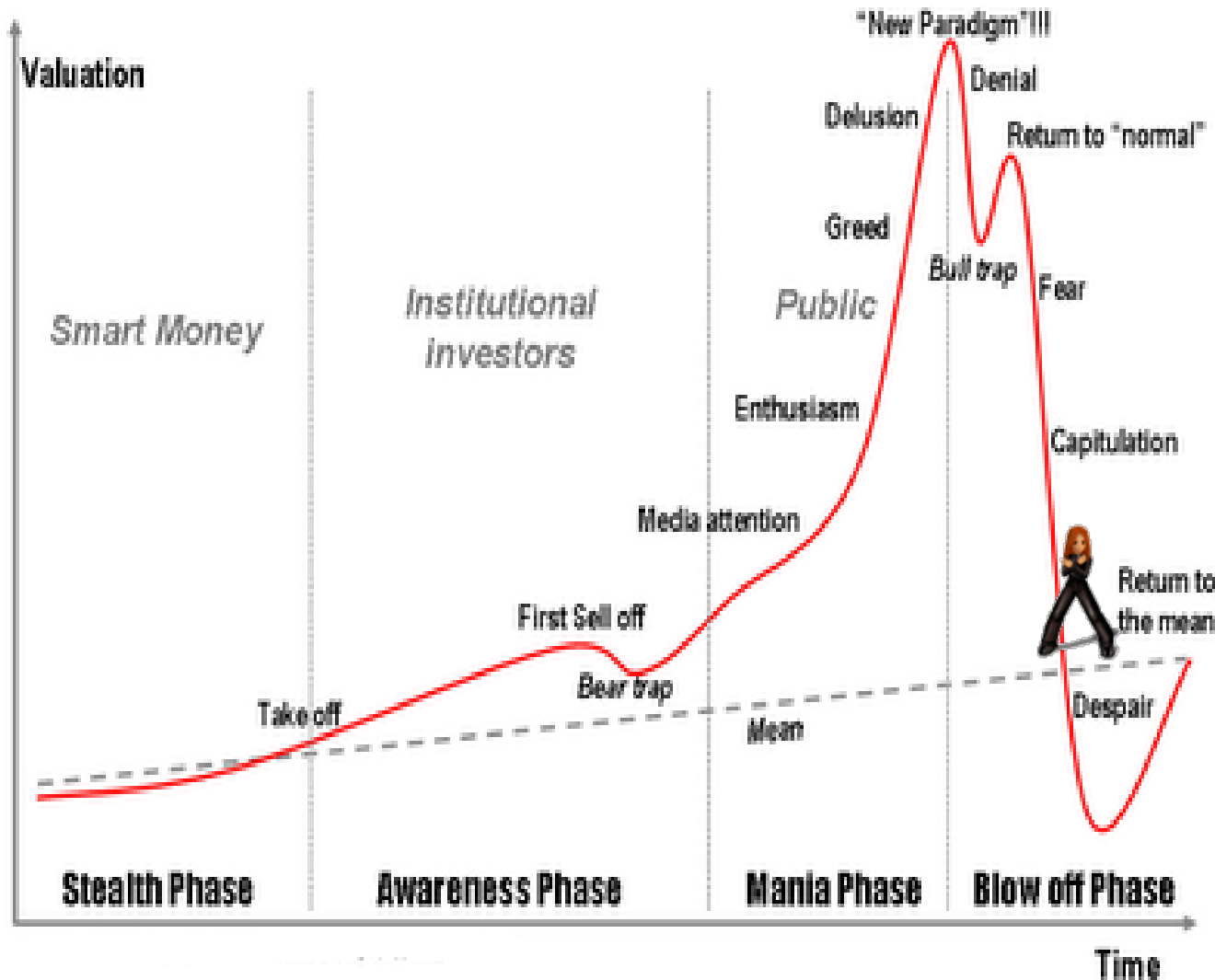
Illusion of control  
Conservationism  
Mistaken Causality  
Extrapolation  
Mental Accounting  
Risk Compensation  
Framing  
House Money Effect  
Selective Memory  
Protection of Blame  
Rationalization  
**Denial**  
Herd Instinct  
Extremism  
Ambiguity Aversion  
Heuristics  
Anchoring



Heroics  
Overconfidence  
Overweighting Recent  
Stereotyping  
Narrow Framing  
**Disposition Effect**  
Hindsight Bias  
Regret  
Idealization  
Avoidance  
Loss Aversion  
Optimism  
Representativeness  
Categorization  
**Pain of regret**  
Pain of loss  
Three is a trend



# The same old sun: easy to be smart on hindsight



*Over optimism is a basic tenet of human species*

*In general, people do not spend time looking and understanding bad news*

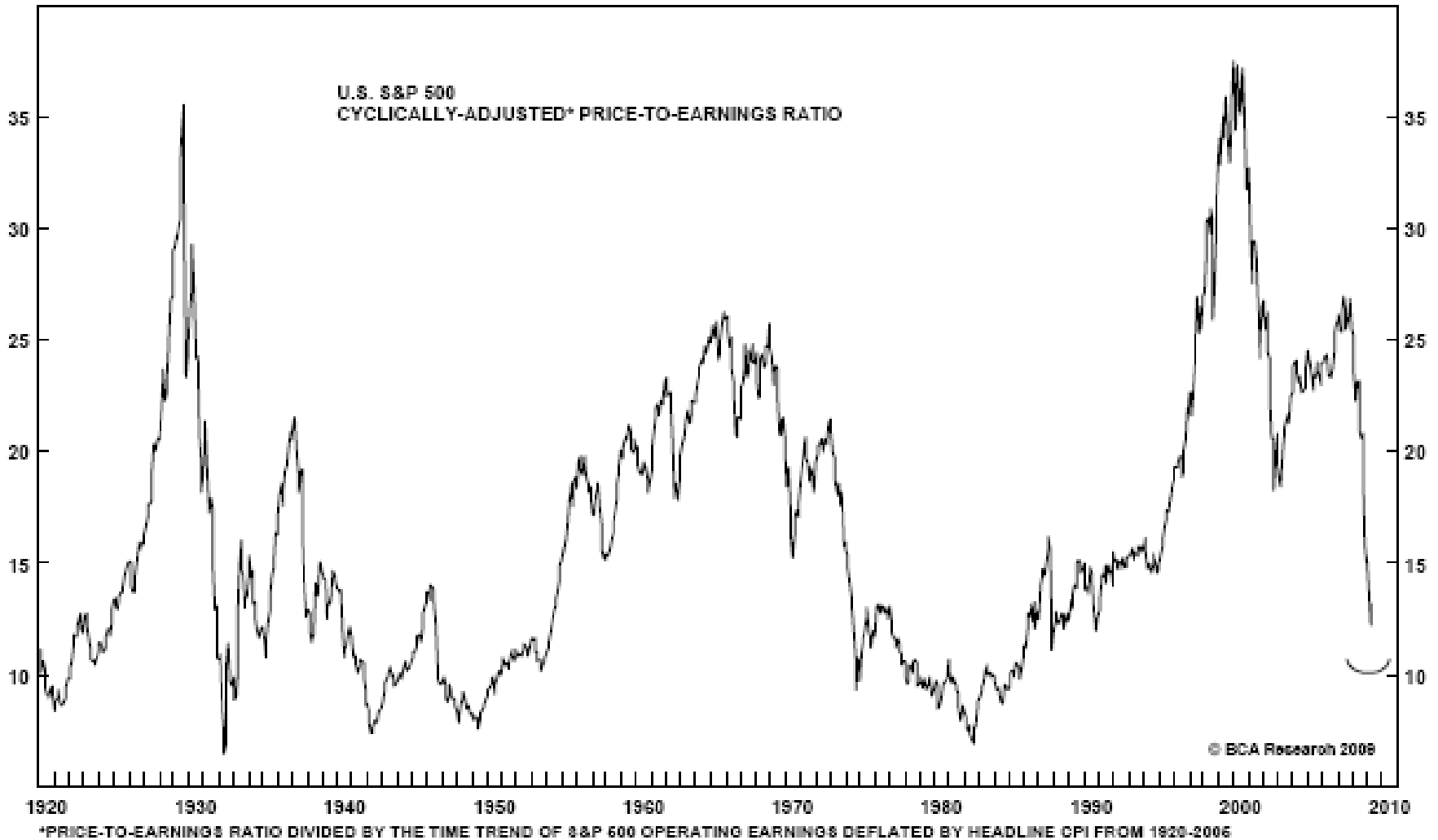
*Investors would rather prefer to focus on the bright side of the moon and they do not see things that they do not expect to see*

*What you see is what you look for*

***Where are we now?***

# Price does matter, but mostly on the long run

## S&P 500 Adjusted P/E: Historical Perspective



*Too big to fail but fit enough to carry trade the easy money*



*Paper out the crisis*





*May 10<sup>th</sup> 2010: markets to ECB,  
FED: pls paper out (0.75 trillion  
Euro) this also for the later*



*May 10<sup>th</sup> 2010  
25%: ~ no salary for 3 months  
15%: ~ no pension for 2 months*

