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Ten years after Lehman

Market Comment, September 2018

Ten years after the collapse of Lehman Brothers, the US is leading the global economy on a scale not seen since President Reagan. Even if Trump is obviously not Reagan, he has provided significant assistance to US markets and the US economy – though not to other regions. Trump's surprising announcement to increase the volume of punitive Chinese tariffs by a factor of five has pushed down emerging-market and European shares, but has lent further support to US equities – a segment in which we have long held an overweight stance. In fundamental terms, the US economy has improved dramatically since September 2008. Unemployment is the lowest in 50 years, whereas in Europe – in Italy, for example – the unemployment rate is still higher than it was in the US ten years ago.

In the late summer of 2008 I was on business in New York, and was surprised at how normal the business mood seemed. No one appeared to be concerned about the US economy, even though a storm had been brewing for many months – and not because of the hurricane season. Nine months earlier I had been asked by the bank I was working for at that time as CIO to draw up my scenario for 2008. Instead of the usual study of 6-10 pages, I wrote just one page, but all in capital letters. I kept it brief and to the point, saying that I would not be surprised if equity markets corrected by 40% and bank shares slumped by some 80% due to the complete lack of transparency over their exposure to the US real estate market via complex derivatives. For some months before I wrote this, three things had struck me as unusual. Firstly, US house prices had recorded a year-on-year decline since the third quarter of 2007 – something that had never happened in the recessions of 1980/82, 1990 or 2001/02. Secondly, more than 70% of all new US mortgages were no longer issued via the traditional US lenders Fannie Mae and Freddie Mac, but via complex quasi-bond securities that included bad quality so-called "subprime" mortgage loans. Thirdly, within a very short space of time there had been an extreme widening of credit spreads, i.e. the market had started to impose huge risk premiums on corporate bonds compared to government bonds, which would logically meant a huge increase in financing costs for the private sector. As the saying goes, the rest is history. Equity markets fell even more than I predicted (by 50%), while banking stocks slumped by more than 80%. The world experienced a recession of a magnitude not seen since the 1930s, and the financial world would never be the same again.

What has improved since then? The US displayed a bold and rapid crisis management, led by Fed Chairman Ben Bernanke. In the fall of 2008, the US government forced the (too) many banks to merge or acquire equity capital from the state (including even those banks that did not require it). This had the effect of aligning the interests of the American state and the big banks, as the US was now itself a holder of bank equity – a move that was signed off only reluctantly by Congress in a second vote.

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> Gérard Piasko, Chief Investment Officer

But the Eurozone never experienced such an alignment of interests between the still excessive number of big banks and national government via the path of state assistance involving equity capital participation. And herein lies one of the problems: There is no government in the Eurozone. Too many governments? Perhaps not, but certainly too many banks, which can nowadays barely keep pace with their reinvigorated American counterparts in areas like investment banking and increasingly also asset management – unless they specialize or merge. When measured in terms of their return on equity, the profitability of US banks has surged back up to 9% or so since the financial crisis, whereas the equivalent figure for European banks (which also continue to hold a large volume of distressed loans on their books) is barely half that.

In other words, even "ten years after Lehman", we should not be surprised if the stock markets of the Eurozone – in which the financial sector remains the most heavily represented at more than 20% – were to continue to underperform US equities. We should also not be surprised to see crisis situations erupt in the Eurozone every so often, as was the case in 2011/12 due to the problems of Greece and other South European countries, particularly as the European financial sector has never really undergone the kind of restructuring seen in the US. Indebtedness in the Eurozone – and most notably in Italy, the third most important Eurozone economy – remains too high. Time and again, this is a factor that weighs on the euro. A country like Italy, which has a government debt burden of more than 130% of gross domestic product, can only tolerate bond interest rates (i.e. financing costs) of 3% or more if its economy is growing at least as fast. As things stand, however, the leading indicators do not point to anything of the sort.

Six months after the collapse of Lehman (it should be noted that the US government decided to rescue AIG rather than Lehman, as AIG was deemed to be much more important globally), the US stock market began a rally on March 9, 2009. That has now become the longest bull market in US financial history, whereas European equities – taking the Eurostoxx 50 as a benchmark – continue to trade still some 25% below their pre-crisis levels of 2007.

From a fundamental perspective this is not unjustified. Led by its technology titans, the US has an immensely powerful economic engine to drive the earnings growth of its private sector and equity market. This is something that Europe lacks.

Moreover, the US economy as a whole has been performing extremely well, delivering growth of 22% since the recession of 2008/09. During the recession 10 years ago, 8.7 million jobs were lost – but a staggering 16.6 million jobs have been created in the meantime. Unemployment has fallen to its lowest level in half a century. Taking Italy as an example, by contrast, unemployment currently stands at 11%, higher than the equivalent figure for the US in the very depths of the recession a decade ago.

Gérard Piasko

Gérard Piasko is CIO and head of the investment committee of private bank Maerki Baumann & Co. AG. Before he was for many years CIO of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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Maerki Baumann & Co. AG
Dreikönigstrasse 6, CH-8002 Zurich
T +41 44 286 25 25, info@maerki-baumann.ch
www.maerki-baumann.ch