Turmoil in financial markets

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Financial markets and investors around the world have had to contend with dramatic upheavals over the past few weeks as a result of developments which have their origins in the meltdown of the US sub-prime mortgage market.

Typically, Americans buy their homes using 30-year fixed rate mortgages. Provided they comply with conditions stipulated by the two major US Government backed mortgage insurers, many of those mortgages have been 'securitized' and on-sold to investors rather than remaining on the books of lending institutions.

Earlier this decade, however, after the US Federal Reserve had cut its benchmark interest rate to a four-decade low of 1%, mortgage lenders in the United States began offering variable-rate loans to borrowers previously considered uncreditworthy (hence the term 'sub-prime'), on what in Australia we would refer to as 'honeymoon' terms such as a below-market interest rate for a two-year period before reverting to a standard variable rate. In some cases these loans included 'affordability options' such as the ability to defer and capitalize part of the interest owing in the initial period of the loan. As in Australia, 'low-doc' (or, as they have been called in the US, 'Alt-A') loans became more commonplace. And as American house prices rose rapidly, it became increasingly common for new mortgages to exceed the US$475,000 ceiling for government-sponsored mortgage insurance.

These categories of mortgages, which were ineligible for Federal insurance, were in many cases instead securitized into complex products such as 'collateralized debt obligations' or CDOs, structured in such a way as to obtain investment-grade credit ratings, and sold to a wide range of investors around the world.

Many of these loans allowed families hitherto unable to access mortgage finance to become home-owners. But a significant proportion of them were made to people who could never have sustained the repayment obligations, or indeed had no intention ever of doing so. And as US interest rates began rising after mid-2004, and house prices began leveling out, mortgage lenders lowered their lending standards in order to maintain the flow of new business. The incentive to ensure that borrowers could service their loans was, for some, diminished by the knowledge that the loans would be on-sold.

This combination of imprudent lending, rising interest rates and, in many areas of the United States, flat or falling house prices has led to a rising tide of mortgage defaults. But rather than showing up primarily as an increase in the number of bad or delinquent loans on the books of banks and other lenders, these defaults have triggered sharp drops in the value of CDOs and other investment products. And since these products have been so widely dispersed across the global financial system, the revelation of these losses has occasioned much surprise.

And that has, in turn, prompted an evaporation of confidence in a much broader range of asset-backed securities, including commercial paper which plays a role in the US financial system similar to that played by bank bills in Australia. Unsure of who is exposed to what, lenders and investors have become, almost overnight, much more 'risk averse' than they had become during the preceding years of ample liquidity and low interest rates. With banks and others eager to hoard cash and reluctant to lend it, interest rates on loans, even for very short periods, to all but government-backed borrowers have been under upward pressure.

The sudden increase in 'risk aversion' has showed up in other ways, too, including sharp falls in equity markets and a large decline in the A$ (which had been propelled higher by 'carry trades' involving borrowing in low-interest rate currencies such as the yen in order to invest in high-interest rate ones such as the A$ and NZ$).

In these circumstances the first responsibility of central banks is to ensure the orderly operation of the financial system and to maintain public confidence in its stability. And that is what central banks have been seeking to do, by injecting large amounts of cash into financial systems through 'open market operations', and in the US Federal Reserve's case by cutting the interest rate at which banks can borrow from it. These actions appear to have prevented any further loss of confidence but, at least at the time of writing, have not yet resolved the underlying uncertainties.

At this stage it is unclear what impact all of these developments will have on economic activity. The US economy clearly slowed during the first half of this year, partly as a result of a sharp downturn in the housing sector which has further to run. Adverse wealth effects of the fall in share prices, combined with the effective increase in interest rates paid by business borrowers as a result of developments in financial markets could, if sustained, result in a further easing in economic growth. To offset that, and as a means of providing further support to the financial system, the Fed has foreshadowed a cut in its cash rate at its next meeting on 18 September, and further rate cuts could follow if economic data suggest that growth has materially slowed.

Outside of the US, economic activity has for the most part been stronger than expected, particularly in China. That has also been the case in Australia where, as the Reserve Bank noted in explaining its decision to lift the cash rate to 6.5% on 8 August, the non-farm economy is growing at an above-average pace in circumstances where there is very little spare productive capacity left. In that context, as demonstrated by the higher-than-expected outcome in the June quarter, the risks to the outlook for inflation are on the upside. Indeed the Reserve Bank raised its forecast for underlying inflation for the year to June 2008 to 3%, the top of its inflation target band. Given the manner in which the Reserve Bank formulates its inflation target this effectively means that the Bank sees some risk of inflation exceeding the target over the next 6-12 months.

Hence the possibility of another increase in Australian interest rates cannot be dismissed – and Reserve Bank Governor Glenn Stevens has been quite explicit in ruling out the suggestion that if it thought a rate rise was necessary during the forthcoming election campaign, then it would not be dissuaded from doing so. Of course, in making that judgement, the Reserve Bank will be influenced not only by the outlook for inflation but also by the extent to which the interest rates actually paid by borrowers have been pushed up by market forces. Depending on whether the current degree of extreme 'risk aversion' persists, the Bank may decide to defer consideration of any further increase in interest rates until early February.

Whatever the eventual outcome, the dramatic turn of events in financial markets over recent weeks has provided a timely reminder of the trade-off between risk and return. For much of the preceding four or five years, many investors had taken on increasing amounts of risk in order to enhance returns in an environment where yields on more conventional investments had fallen to unusually low levels. In many instances, it would appear (and not simply with the benefit of hindsight) that investors did not fully appreciate the nature or extent of the risks to which they were exposing themselves.

At the time of writing, sentiment has swung too far in the opposite direction – lenders and investors are hesitating to take on any risk at all, a stance which if sustained for any length of time would inevitably have serious consequences for the operation of the financial system and for the level of economic activity.

It is thus in everyone's interests that central banks and other authorities succeed in their efforts to restore a sense of normality in financial markets. But equally, if investors remained more cautious in their assessment of the risk-return trade-off than they had been prior to these developments, that would be no bad thing.

- *Saul Eslake*
Chief Economist, ANZ