Westpac InstitutionalBank

17 August 2007

When greed turns to fear

Implications for New Zealand of international market turmoil

- **Sub-prime losses will pop up in strange places, but it's gone far beyond that now.**
- **A full-blown credit crunch is the real danger.**
- **The outlook is very uncertain, but brace for a rough ride.**
- **The NZD is New Zealand's insurance policy if it all turns pear-shaped.**

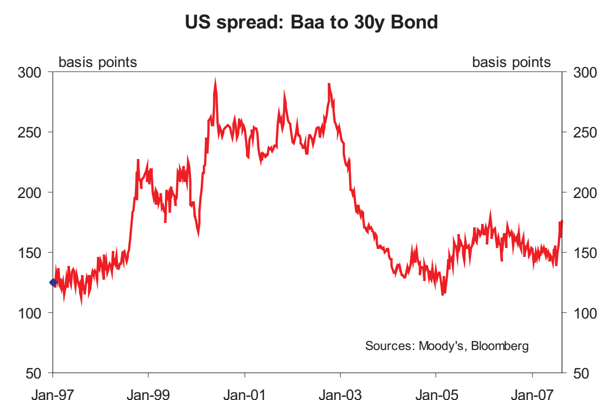
Sharemarkets are dropping, currencies swinging wildly, interest rates lurching, and no one is willing to lend the price of a cup of tea. Or probably even give you a price for a cup of tea. Global debt markets are dysfunctional and central banks are pouring in cash to try to restore calm. Yet merely a month ago money was being thrown around like confetti. How did we end up here?

The background

In brief, widespread reckless risk-taking. Something is awry when a large proportion of spam emails is made up of offers of 100% mortgages at low interest rates, regardless of credit history. Someone's incentives are clearly all wrong. This was the case a couple of years ago in the US. Today, it's all coming home to roost.

Global attitudes to risk have been remarkably carefree in recent years. History is likely to apportion much of the blame for this to governments and central banks. Interest rates on US risk-free investments were very low due to large interest rate cuts by the Fed in response to the collapse of the dot-com bubble and September 11. Some investors perhaps came to believe that the Fed would always "bail out" financial markets in case of crises. Desperate for higher yields, investors rushed into higher-risk investments and demanded very little compensation for doing so. Credit spreads, the difference between "risky" and "safe" credit, narrowed to historically low levels. Figure 1 shows the credit spread between 'risky' (Baa rating) and 'safe' (govt bond) lending in the US over the past decade. Spreads were relatively wide in 1998-2001, declined quickly thereafter, and have now started widening again.

US spread: Baa to 30y Bond



Innovative – and confusing – new financial products with opaque and untested levels of risk, generous credit ratings, and high liquidity speeded the rush to risk. The problems have been focused in the sub-prime (very risky) end of the mortgage market because of the fact that in the US market, mortgages can be made and then sold off in packages as bonds. This means banks can make loans and quickly shift the risk off their balance sheet. When the housing market was booming defaults were low, and these bonds, particularly the riskiest ones, made spectacular returns. They were therefore easy to sell to yield-hungry hedge funds and other investors. An even riskier product was insurance against default on these bonds – these products required no money down and offered good returns, but when times turn bad, they can explode exponentially.

Hedge funds are typically leveraged at least 5 times; 15 times is not unheard of. They used their mortgage-backed bonds as collateral – bonds whose value was typically assessed by investment banks rather than by the open market. In the house price boom their value was marked up continually, enabling yet more lending from the bank to the hedge fund, enabling it to buy

Economic Research New Zealand +64 4 470 8250 bodonovan@westpac.co.nz Sydney +61 2 9284 8372 London +44 20 7621 7620
www.wib.westpac.co.nz

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more bonds, enabling yet more risky housing lending from the initial mortgage lender, and so it spiralled up.

Where it all turns to custard is when the housing market bubble finally bursts, as it has done fairly spectacularly in the US. The bank lending to the hedge funds gets nervous, and demands its cash back. The highly leveraged hedge funds have to sell some collateral to deliver. And at this point the investment bank-assessed prices are revealed as a fiction. This happened in late June, when Merrill Lynch forced a fire sale of assets of two Bear Stearns hedge funds. The sale was halted when it was realised that prices were going to hit rock bottom. It wasn't in their interests to advertise that fact.

Of course it was not only would-be house buyers who benefited from nonchalant attitudes to risk; junk bonds of all kinds were keenly snapped up at remarkably high prices/low yields, providing seemingly unlimited cheap funding for private equity takeovers that pushed up share values. This explosion of debt levels has put many institutions in a vulnerable position.

What is happening now?

So how come this has come out of the blue? It's been well-known that there had to be a reversal of lax credit conditions to more normal levels. And it's been clear for some time that the sub-prime house of cards was going to fall down. What has been uncertain is how large and widespread the fallout would be. The central expectation of most analysts was for an orderly unwind, though the risks of a more dramatic end were certainly evident.

The sub-prime debacle was the catalyst for wider recognition that risk has long been mispriced, and in late July the long-brewing sub-prime woes started to explode into credit markets more generally. People became unwilling to lend because of the uncertainty about who is sitting on sub-prime "bombs", with losses popping up all over the globe. The irony is that the dispersion of losses should make the overall system more robust. But the uncertainty regarding where these opaque instruments are lurking, and how much leverage they entail, caused a "shoot first, ask questions later" approach to lending.

It quickly escalated beyond a wariness of lending to those who may have sub-prime exposure into a general panic and tightening of credit. Interest rates on risky debt skyrocketed. Market participants refused to even make prices on some risky assets. Funds began to incur large losses because the unavailability of liquidity forced them to exit illiquid assets at a significant loss.

Access to credit is now more difficult and expensive for everyone: home-buyers in the US, private equity funds, mortgage lenders in Australia, and banks and corporations in New Zealand. The credit crunch is becoming self-fulfilling – no one wants to lend for fear that borrowers could have trouble raising cash to repay. No one wants to buy a risky asset, whether shares, corporate bonds or an unhedged NZD deposit, because they believe everyone else is looking to sell it. And so it spirals down.

As investors and funds flee risk of all kinds, equity markets have fallen sharply, most notably in the US with its heavy concentration of financial companies. Currencies have moved dramatically, not least the NZD, which is a "carry-trade" currency and therefore more susceptible to changing attitudes to risk. Hedge funds having trouble securing lending have had no choice but to unwind their carry trade positions in order to raise cash. The NZD has lost some 15% from its 0.81USD peak in its fastest ever post-float fall, and the volatility shows no signs of stopping. Meanwhile, the USD, a traditional "safe-haven" currency, has appreciated strongly. One has to savour the irony of stashing the cash under the mattress in the house that's burning.

The ECB and other central banks have repeatedly pumped liquidity into cash markets to restore a functioning market. This has been successful in reducing overnight rates to desired levels, but not in calming markets more generally. Although market pricing suggests an assumption that the Fed will again "underwrite" financial markets with rate cuts as they did in 2001, this is not guaranteed. They will be wary of sowing the seeds of future bubbles by bailing out investors again. The adjustment may be painful now, but it will be no less so for having been deferred for years by accommodative monetary policy that replaced a dot-com bubble with a housing bubble and then a credit bubble. US consumers have been living beyond their means for years, and there are significant imbalances in the economy that need to be redressed. But the Fed may end up with little choice. A credit crunch is a self-sustaining destructive spiral, and if it becomes entrenched, some kind of circuit-breaker will be required to halt it. Rate cuts may in the end be the only option.

In local markets the most obvious effects have been a plummeting NZD and big falls in the sharemarket. However, NZ credit markets have not been left unscathed. The NZ 90-day rate has spiked sharply higher on a lack of liquidity, and it is also now significantly more difficult to secure longer-term funding offshore. Fortunately for NZ, which tends to rely heavily on foreign funding, this has coincided with a marked downturn in demand for mortgage borrowing, and an upturn in funding for banks from increasing term

deposits. At the same time, the market has been becoming increasingly convinced that the RBNZ tightening cycle is over, putting downward pressure on rates, offsetting the effects of lower liquidity.

Where to from here?

The situation is very uncertain, and confident predictions cannot be made. We have no more information than anyone else. But we can flesh out a couple of scenarios.

Scenario 1: It'll blow over

The uncertainty about who is holding the "toxic debt" is causing a degree of panic that is probably out of proportion with the likely losses. Sub-prime loans make up around 13% of the US housing market, or $1.3 trillion. Bernanke has estimated losses at $100bn USD, some 0.6% of US GDP. This may be conservative. But by comparison, the savings and loans crisis of the 1980s, in which more than 1000 institutions failed, resulted in losses of around 2.5% of GDP. And compared to the gains from the US sharemarket in recent years, the losses are fairly small. One could therefore imagine a scenario where the market "sees sense" – perhaps aided by sharp interest rate cuts – and the credit crunch unwinds into a more orderly repricing of risk with limited repercussions for the world economy.

Why might the world economy do okay?

- The sharemarket falls certainly won't help sentiment, but shares make up a relatively small proportion of household wealth.
- The large positive supply shock coming out of China in the form of urbanising workers and a more market-driven economy should continue.
- The world's growth engine is moving out of the developed world and into Asia, which has been growing at double digit rates. World growth currently is the strongest it has been for 30 years.
- China requires a slowing in growth from its current breakneck pace, which is causing all kinds of stresses and strains in their economy. A US slowing could be just what their economy needs to maintain a more sustainable growth path looking forward.
- Central banks around the world currently have plenty of room to ease policy if required.

Under this scenario, as panic subsides, markets will find a floor. Sharemarkets will selectively punish stocks of companies based on assessments of their probable loss exposure, rather than indiscriminately selling all markets. The NZD would stabilise, and eventually start moving higher as markets realise that the fundamentals that underpinned the NZD's rise are still in place. In addition, structural factors have been driving USD weakness: namely, a marked and ongoing diversification of investments (by US real money accounts, Asian and oil-economy governments, and Japanese retail investors). There is no reason to think, in the medium-term, that this structural adjustment will stop. The trend weakness in USD is therefore likely to be reasserted eventually.

The timing for this "return to normality" scenario is very difficult to pick. Bouts of anxiety can be just as persistent and overdone as exuberance, and this one feels like it may have quite a way to play out.

The outlook for interest rates would in this scenario depend heavily on how domestic data pans out. While the NZ economy is experiencing a soft patch in the second half of this year, by next year when higher dairy incomes start to hit pockets (and bounce out) the economy should pick up. The hurdle for further hikes would be considerable, but strong inflation pressures from very stretched resources and the weaker NZD would give the RBNZ little room to ease policy until domestic data definitively slowed.

If the NZD were to fall further and stay low despite our commodity prices holding up and no serious hiccups for world growth, then the Reserve Bank would be facing a large inflation problem. Conservatively, for each 10% the exchange rate falls, CPI inflation typically increases by around 1% over the following year. Of course, the exchange rate 'should' be strong if our commodity prices are good. But 2001 showed that this is by no means always the case.

Under this scenario, we could still expect very volatile times going forward, and asset prices, commodity prices and the NZD would likely undershoot, before strong fundamentals saw them return to more appropriate levels. Even if panic subsides relatively quickly, the NZD could fall much further before recovering.

Scenario 2: It'll blow up

The second scenario is that the credit crunch continues to worsen. Credit is crucial oil in a well-functioning economic engine. Without it, good firms around the world would fall over in large numbers because they simply can't fund themselves. In this scenario the US plunges into a full-blown recession and world growth soon follows along. The brave new world is proven to be a chimera. After all, deep recessions tend to be preceded by solid growth and optimistic claims that good times are here to stay. Credit crunches typically presage much uglier real economy developments, and it is not inconceivable that this one turns very ugly indeed.

In this scenario, commodity prices could fall sharply. The doubling of our dairy prices would be seriously under threat, although because much of it is driven by supply rather than demand factors (drought, ethanol production raising grain feed costs, changes to European subsidies), we would not expect to see a complete unwinding. But commodity prices generally would be vulnerable. Our tourism and non-commodity export sectors would also directly suffer from weaker growth overseas.

However, although as a nation we are heavily reliant on foreign funding, NZ is well placed to come through the global ructions better than many others. The NZD is New Zealand's insurance policy. If the global economy implodes, our exchange rate will continue to drop like a stone, buffering the impact on our exporters and dispersing the pain by making consumers take some of the hit in the form of more expensive imports. The credit crunch could also see New Zealand's tap of relatively cheap foreign credit shut off, further exacerbating the fall in the NZD. A significant number of Uridashi bonds come due this month and next, and if these are not rolled over, the NZD could be hit hard. These investments tend to be held for the long term, but the maturities nonetheless represent a further source of vulnerability for our currency.

Another source of comfort is that with our high current and neutral interest rates, NZ has the ability to ease monetary conditions massively if required. This puts us in quite a different boat to Japan, for example, with their extremely low interest rates and now sharply appreciating currency.

But rate cuts in short order are far from a given. The plunging NZD will be causing the RBNZ to revise up their inflation forecasts dramatically. Although the RBNZ looks through direct inflationary impacts of the exchange rate, they would take note of the stimulatory impacts on the economy and the potential impact on inflation expectations. Any interest rate cuts may therefore be later and slower than one might think. On the other hand, financial stability issues and much weaker world growth would call for lower rates. Three key factors for NZ interest rates will be the behaviour of dairy prices, the Federal Reserve, and the NZ housing market, which we think could be headed for a faster, larger crunch than generally thought. NZ lenders have not been as reckless as the US sub-prime lenders, but NZ is also due for payback from a seemingly limitless appetite for debt in recent years.

Looking forward

The situation is changing by the day. We'll be watching commodity futures and spot prices – particularly but not solely for NZ's exports – for evidence that the financial crisis is spilling over into the real economy. So far, dairy prices have been unaffected, rising 3% last week! Industrial metals prices are a key indicator, as they tend to reflect expectations for growth in Asia. Emerging market shares may also prove to be a leading signal of how Asian growth is faring. Our central expectation is that the world economy is strong enough to wear this.

It is impossible to know how things will evolve from here. But volatility is a given. Those not in a position to cope with large swings in financial assets, particularly the NZD, may wish to hedge their exposures to a greater degree than normal. It's going to be a rough ride.

Brendan O'Donovan, Chief Economist, Ph: (64-4) 470 8250
Sharon McCaw, Markets Economist, Ph: (64-4) 470 8251