

# "not too bad" is the new "good"

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## Part I: Global Macro Snapshot

- Risk indicators signal **Green Shoots**
- Too Green to be true?
- The "New Normal"
- $\alpha$  time

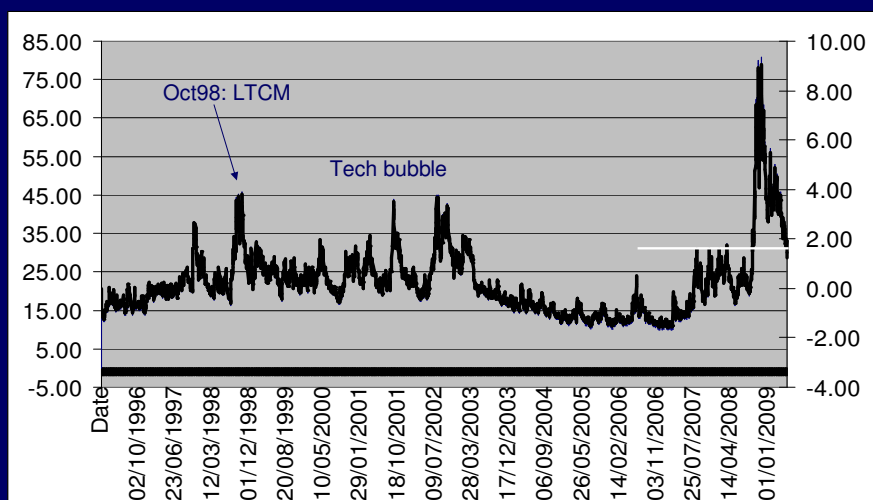
## Part II: Some Risk Lessons

- An organized tirade on financial markets

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## Equity risk: VIX

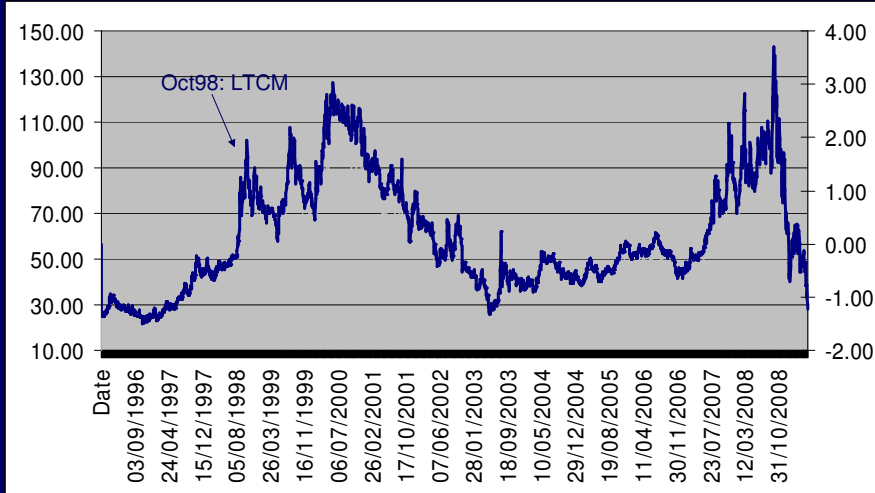
(right scale normalized on 96-07 distribution)



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## Financials Risk: SWAP (avg of 2s 5s 10s)

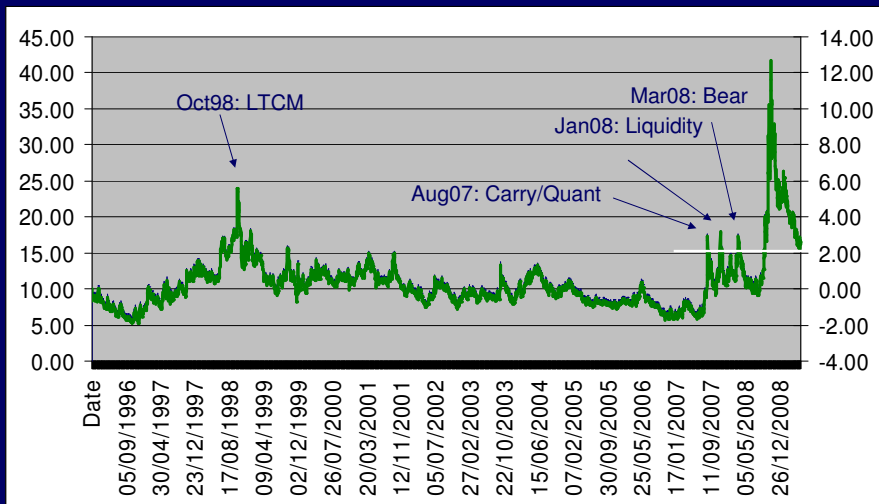
(right scale normalized on 96-07 distribution)



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## Currency Risk: FXVol (carry vol)

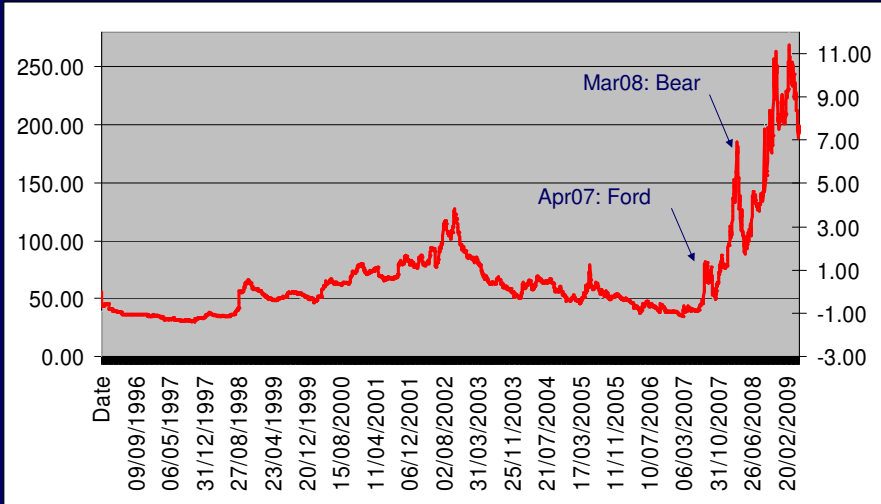
(right scale normalized on 96-07 distribution)



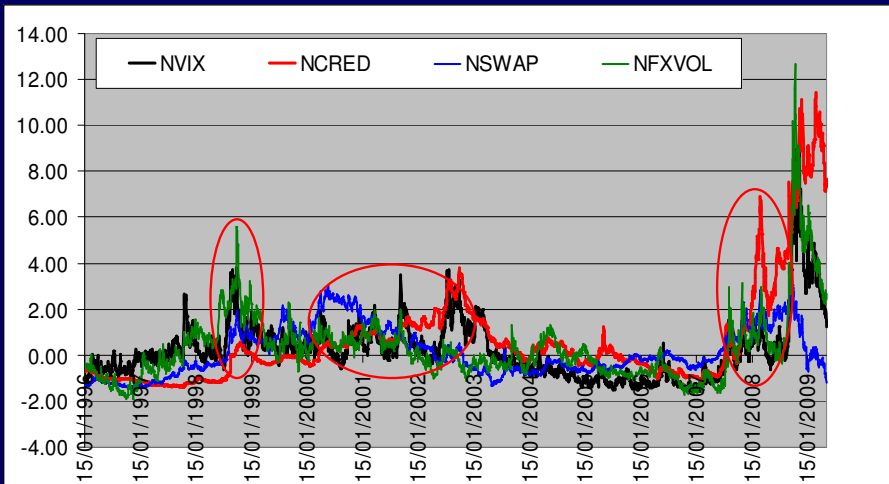
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# Credit Risk: CDX

(right scale normalized on 96-07 distribution)



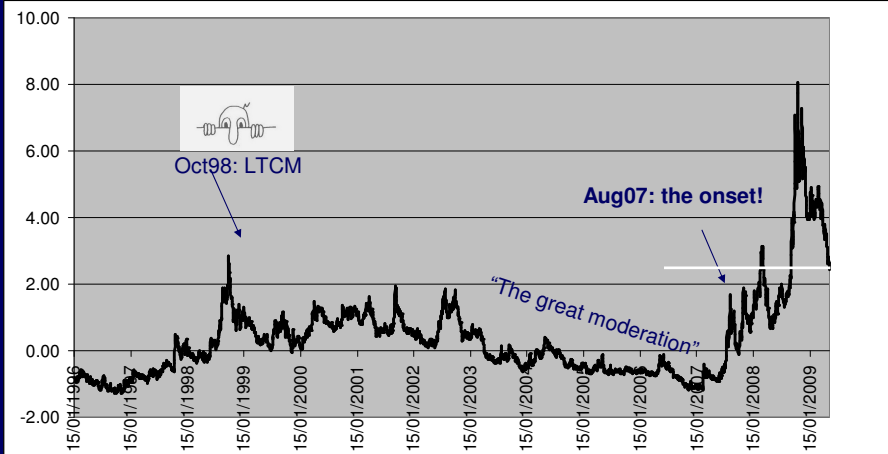
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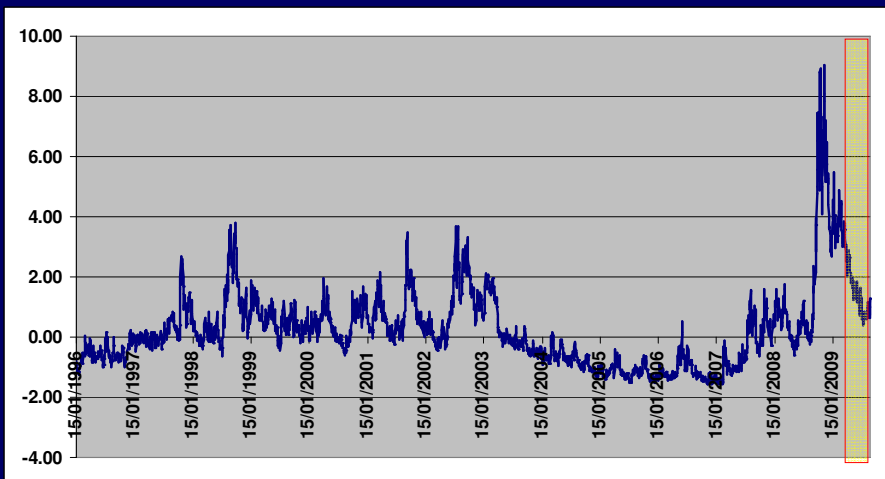
## NormedBarometer

(avg., scale normalized on 96-07 distribution)



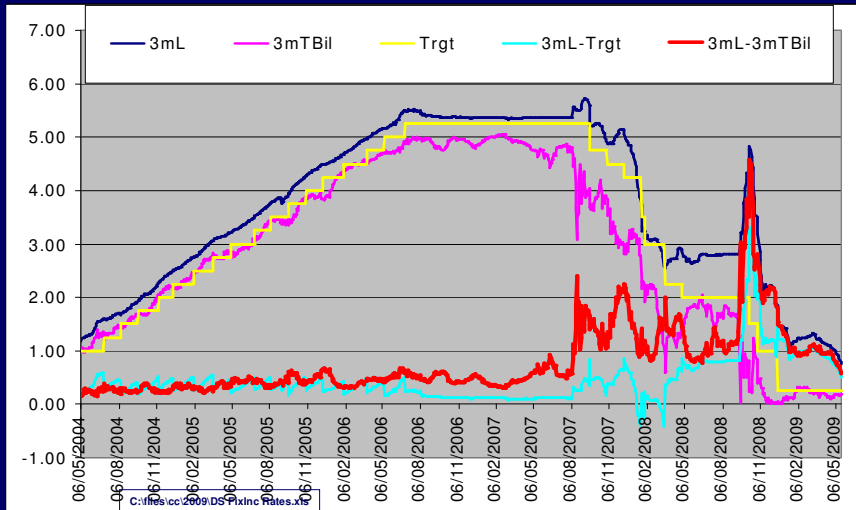
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## Sep6, 2009 update



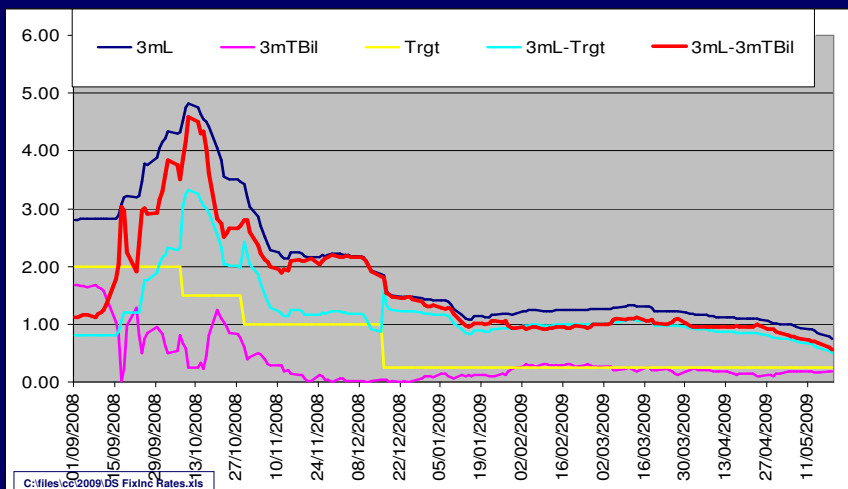
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## Libor Spread



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## Libor Spread



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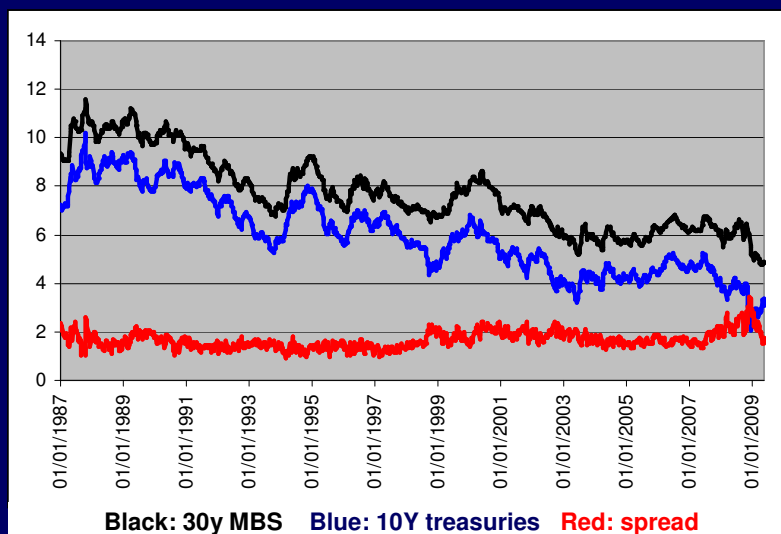
## Green shoots or yellow weeds? The fundamental cycle of horror

(\*) "M&A activity in the sector will pick up, but...we have enough in our hands" (Ken Lewis)

- **CONSUMERS: tapped out**
  - De-lever? How?
  - Home equity ↘
  - Savings ↘
  - Wages stagnant, commodities up
- **CORPORATES: tapped out**
  - De-lever? How?
  - Credit EXPENSIVE
  - Earnings ↘
  - Capital investment ↘
  - Freeze frame
- **BANKS: tapped out**
  - Earnings + writeoffs ↘
  - Toxic assets
  - More trouble ahead? (cmbs, consumer,...)
  - Freeze frame\*
- **INFLATION**
  - Deficit >10% as far as the eye...
  - Why not? (export ↘, debt ↘...)
  - Why not? (the alternative ☹)
- **EMPLOYMENT**
  - Lagging AND leading
- **The \$**
  - Inflation
  - Deficit >10% as far as the eye...
  - Central bank rebalancing
  - Further LT bond purchases (?)
  - Safety allure dented (AAA?)
- **CREDIT**
  - Government-run sector (no exit)
  - Priority, hence pricing, in disarray
  - Equities pressured
- **REAL ESTATE**

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## Real Estate



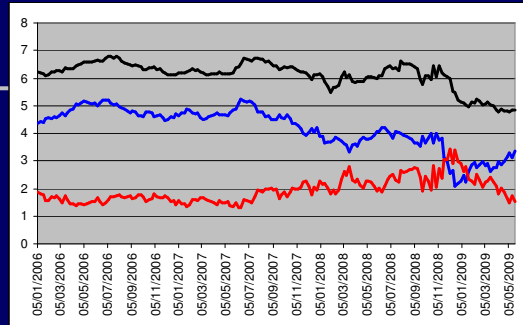
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## Real Estate

- Recovery critically depends on the housing sector (consumers, banks,...)
- 30y mrtg =4.9%  
10y rate =3.35%  
→ spread=1.55%

very low by historical standards

- For \$100K you pay \$535/m @5%, \$600/m @6%, \$665/m @7%
- 90% of originations by gvmnt
- Easier to subsidize spread ( $1\%pa \times \$1Tril = 10bil\ pa$ ) than to control the 10y rate ( $\$300bil\ didnt\ do\ the\ trick$ ), but close to tapped out
- Modifications not working and cause sever moral hazard  
→ trapped?



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## Back to Normal? **The NEW NORMAL**

- **Consumers**                      unemployment-scared  
no access to credit but need to delever  
tapped out and try to save
  - **Corporates:**                      low consumer demand  
excess capacity (downward price pressure)  
wide credit spreads 3-5yrs
  - **Financials:**                      underwater books  
forbearing while frozen  
stragglng for tier1 capital
  - **Governments**                      provide a floor (for as long as they can!...)  
overspend and then some (!)
  - **Global economy**                      trade protectionism  
trade imbalances -- lets talk in 5yrs...  
china still spending on infrastructure
- tension between inflation and deflation  
→ low (below potential) growth  
→ excess regulation

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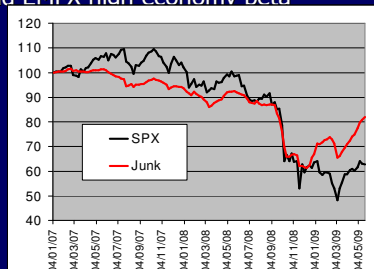
## It's alpha time

- The era of 6X, 10X, 30X is over
    - Credit scarce or too pricy
  - The era of riding beta long term is over
    - poor fundamentals as far as the eye can see  
(rough guess for  $P=E*PE$  is  $55*13\approx 700$  to  $65*17\approx 1100$ )
- ... and clearly hence all the derived tricks are all gone:  
diversification=value, 2&20, levered beta over negative alpha etc
- Time to earn a living: it's alpha time

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## INVESTMENT THEMES

- **Equities:**
  - low growth → low earnings → fundamentals weak as far as the eye can see
- **Fixed Income:**
  - low policy rates, long rates under pressure, "Stay under the umbrella"
- **EM:**
  - some sovereign spiking, some likely to bubble
- **FX:**
  - bearish on USD while EUR and EMFX high economy beta
- **Commodities:**
  - (still the) inflation outlet?
- **HUGE opportunities** →
- **...but Risk stays very high**



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## ***Part II: Some Risk Lessons***

### **An organized tirade on financial markets**

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### **Pointing fingers**

- It's all about **INCENTIVES/GOVERNANCE** ("agency")
  - on governance: completely true (Goldman vs Lehman)
  - on compensation: "Sound Compensation Practices" of the finnci stability board, G20 recent white paper
    - ...try paying traders with "risk-adjusted \$s"*
    - ... and is this really the issue?*
  - on delegated asset mgmt: how make "move to cash" possible?
- It's the **SHADOW BANKING SYSTEM**
  - Banks **MUST** be the only major bearers of liquidity mismatches
    - ...yeh, right, look where it got us*
    - ...and how do we kill the "riding the liquidity curve" incentive?*

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## Pointing (some more) fingers

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- It's the **TBTF/VLFI PROBLEM**
  - Lesson wasn't taught! We'll pay the (smaller) price
  - Charging for TBTF won't solve systemic risk problem
  - **"MacroPrudential Supervisor": kill it when it's small**
- It's because of **VaR**
  - We knew: all did stress tests, 5sigma, correlation breakdown etc.  
...just didn't know we won't be able to liquidate (really?)

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## Pointing (even more) fingers

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- It's all because of **REGULATORY COMPETITION**
  - 9 rating agencies... multiple regulators... lack of coordination
    - Will be fixed...
    - Who will pay the bill
  - Coordination/consolidation
    - SEC looses out? ... but global coordination is a lost cause
  - The future of Basel II ?
  - BUR: who failed us? was it HFs? Or the super-regulated banks?
- It's all those **FINNOVATIONS/DERIVATIVES/CDSs**
  - CDSs will be fixed: "insurance" → capital, Futures-style settlement, Disclosure, end of off balance sheet sham
  - Securitization MUST be resurrected

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## Bottom line

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- Liquidity bites
- Leverage kills
- TBTF fails
- Implicit (guarantees) become explicit
- Hard (predictable) lesson on govnt-private sector "partnerships"

→ **RISK MANAGEMENT:**

– **Market:**

- VaR useless w/o liquidity and a liquidation gameplan

– **Credit:**

- no more 30X, no more 10X, ...
- Days of negative alpha debt gone (for 7yrs...)
- Black box correlation models – back to school

– **Liquidity:**

- Can we price it right? we better, or else...
- how do we proceed w/o the shadow banking system?
- Back to back-to-back...

– **Avoid asset-class and counterparty concentration**

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