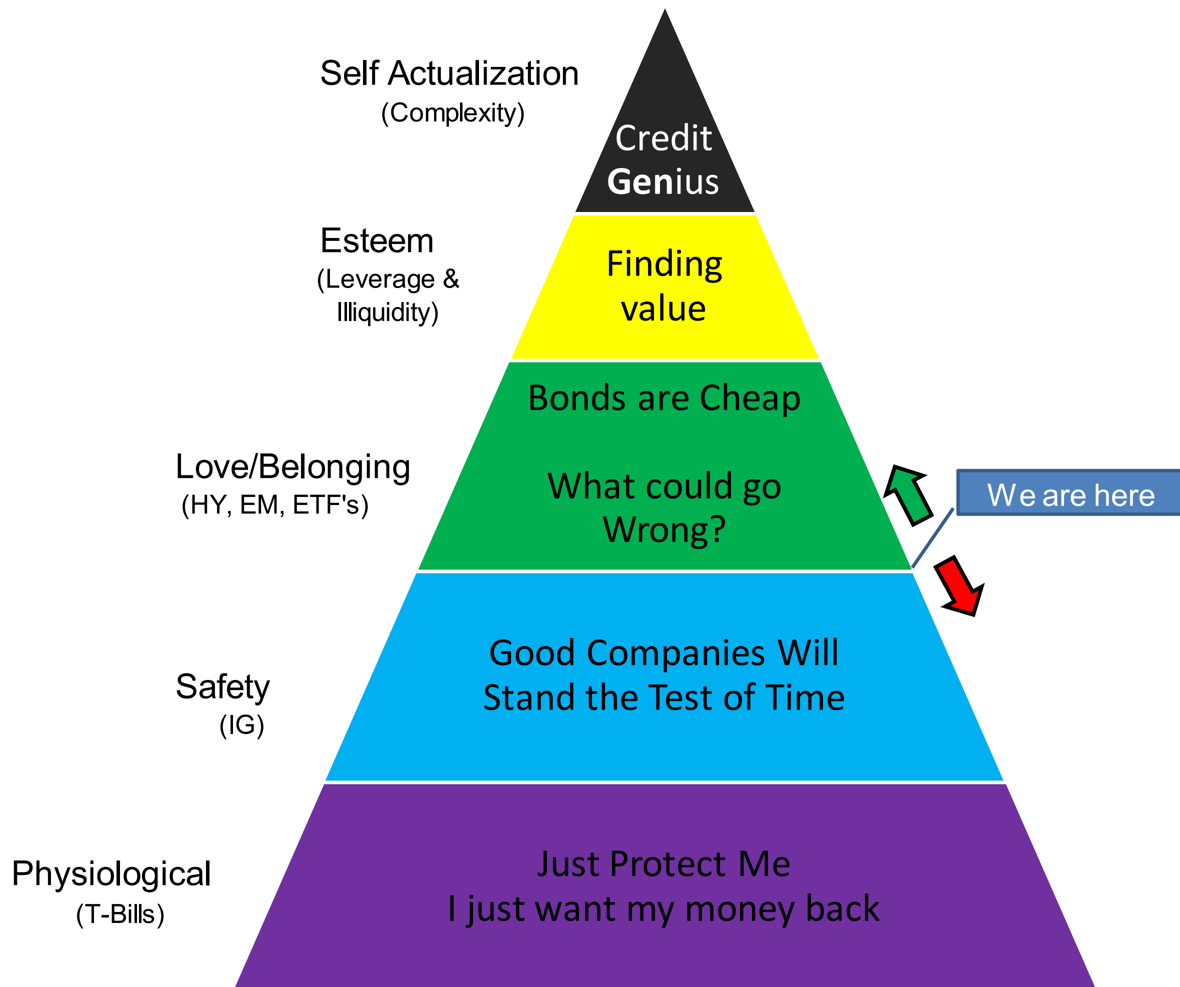
Credit and Financial Bubbles

Suddenly, there is a lot of talk about bubbles. So, I wanted to share these two pages from my current presentation deck. I think they are both relevant.

Maslow's Hierarchy of a Credit Bubble

I think we can all agree that at least some part of a bubble (both the creation and the popping) have a large psychological component. So, I like to use psychology to create an image of where we are and what could happen next.



I just updated this slide for the first time since the autumn. I moved the "we are here" flag lower but balanced the directional arrows.

In Maslow's theory, you need to complete one level before you can move up or down to the next level. I've been highlighting that the credit market was in the Love/Belonging phase, which I equate to high yield, emerging markets and active ETF strategies. We have seen that crack and if we go much further, it will start to impact IG significantly. I don't think we get there, but it is the next level of risk to get questioned.

One positive thing to note is that in this entire cycle (which I think peaked in 2017), we **never reached the Credit Genius level**. We never saw the complexity, leverage and market value triggers that pervaded the market prior to the financial crisis. We haven't seen LSS (leveraged super senior), or

CPDO (constant proportional default obligations) – both products deserve a special spot in hell. We also haven't the SIV's or conduits, which is where I think the rating agencies made a lot of mistakes because they felt they could rate liquidity instead of credit risk and were spectacularly wrong.

Am I concerned that if this spills over into the "Safety" bucket that investment grade will get hit harder than it already has? Yes, but I think we will find significant **support where we are and drift back to the "bonds are cheap" area.**

Bubbles Only Happen in Safe Assets

This slide always gets some attention (usually with people across the table looking at me like I've lost my mind). But let me elaborate.

Two Conditions Required for a Financial Bubble or Crisis:

- **The banks need to be heavily exposed to the asset.** Banks are the lynchpin of the financial system, so for anything to create a bubble, it needs to hit the banks. And to hit the banks, they need to own a lot of it.
- **The asset has to be owned on a highly leveraged basis.** Leverage is what creates forced sellers. It probably sounds trite, but you have to have a margin account to get a margin call. Forced sellers are the key and that is directly tied to owning an asset on a leveraged basis.

My view is that you need a 'safe' asset, that banks own a lot of, and that both banks and other investors own with significant amounts of leverage.

Some Historical Evidence

Let's take a look at some examples in my lifetime.

- **The S&L Crisis.** At its heart, this was a case of banks failing to hedge (or properly understand) their interest rate risk. That is how I think of that crisis and it ties directly to something that is "safe", owned by banks (who are leveraged by definition).
- **Russia & Long-Term Capital.** Back in the day, many investors, especially European banks viewed sovereign debt as having de minimis default risk. Yes, they might restructure, but they didn't default. Russia proved that wrong. At the other end of the spectrum were a bunch of quant geniuses playing with simply massive exposure in what was viewed as less volatile markets – like swap spreads. LTCM was the single largest counterparty for at least some banks. They were a huge derivative player and banks were comfortable providing them credit on these arcane products, until they weren't. Sadly, this crisis introduced the **Greenspan Put** which has plagued or helped markets ever since (depending on your view).
- **Enron. Worldcom. Etc.** This was a **fraud** problem. You couldn't trust the accounting of many companies. You thought you had IG assets, but what you had was just a complicated accounting fraud. So these bonds, which in theory were "safe" (IG), were a huge problem. Massive direct lending by banks, and in the case of Enron, huge derivative exposures. This rippled through the financial community rapidly. (It coincided with and was linked to the dot.com crash, which, if you are really honest with yourself, was just another asset class that was viewed as "safe" – the only risk you had at the time, was not owning enough 😊).

So what gets my attention?

- **Leveraged Loans or High Yield?** Nope. I think there are risks there and some investors may have losses (though at current levels I'm a buyer of these markets) but nothing so big to hit the financial system as a whole.
- **Vol Selling?** Kind of. It certainly meets one additional criteria, it is an area that has seen an increase in hiring and promotions on Wall Street. So it is probably crowded, at least to some degree and selling vol is a leveraged strategy. The reason I say "kind of" is because I think **it creates short, sharp moves like the ones we've experienced over the past few days**, rather than anything that becomes systemic.
- **CMBS?** Maybe in some specific regions or products, but I don't think problems are big enough or widespread enough to be a threat to the system. Banks are involved. Leverage is used. But, right now I can't get worked up about this. It is on my radar screen but is a far-off ping, not that interesting to investigate.
- **Student Loans?** With 3 kids in or about to enter college, this one is too personal for me to pontificate on objectively.

Bottom Line

I just don't see what turns some current market volatility into anything resembling a crisis.

I'm staying in risk-on mode!

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