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The 15th September will mark ten years since Lehman Brothers filed for Chapter 11 bankruptcy protection, a cataclysmic event which reverberated throughout financial markets and led to the “Global Financial Crisis”. This laid the foundations for an extraordinary period for central bank activity and therefore financial markets. It’s still not clear if lessons from the GFC have been learned. In our 2017 Long Term Study “The Next Financial Crisis” we argued that the global financial system post Bretton Woods remains vulnerable to financial crises, and their frequency has been higher in this period than across all prior financial history. The GFC was clearly an extreme case and likely a once-in-a-lifetime event. However, in solving this crisis we have added more debt to an already heavily indebted system and our central banks have imposed a decade of extraordinary measures, from which most still struggle to withdraw.

So with the anniversary nearing, we examine how the financial world has changed and why, in many ways, we solved one problem by creating others. We end with a post-Lehman performance review of assets. Although there are some clear losers, it’s generally been a very good decade to own financial assets thanks mainly to central banks.

Global Debt - higher than before the GFC

Increasing debt has been a feature of the post-GFC recovery, and while all sectors have become more indebted, the government and non-financial sectors have either been forced to borrow or feasted upon cheap financing. If you believe that the GFC was a debt crisis, then while the composition of debt might be ‘safer’, the world hasn’t made much progress on tackling leverage. Lower bank leverage and higher capital ratios should mean that it will be much harder for subsequent crises to spread through the financial sector to such devastating effect. But fragilities remain.

Although the developed countries have seen government balance sheets take the strain of the last decade, in EM countries the non-government sectors have seen the bulk of the post-GFC debt rises. In China, the ratio of private nonfinancial debt to GDP has seen one of the most rapid climbs in leverage around the world post the GFC. It responded to the crisis by massively loosening policy, so the leverage increase is a GFC by-product. This bears



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striking similarities to previous credit booms seen in the US, Japan, Thailand and Spain – all of which led to a crisis.

How did we save the financial system and fund the additional debt accumulation?

Central banks have played a big role in facilitating the post-GFC workout. The real adjusted cumulative size of the balance sheets of the Fed, ECB, BoJ and BoE is nearly three times as large it was ten years ago. There has been no precedent for such activity across so many central banks in history.

An additional consequence of the huge central bank QE and monetary policy loosening has been the collapse in bond yields and an increasing proportion of negative yielding debt. Ten years on from the GFC, and it's hard to argue that the global bond market is functioning in a normal manner consistent with hundreds of years of history.

Cheap debt has made it easier for governments to finance themselves, but this has caused pain for other parts of the economy (outside of the obvious debt buildup), most obviously in the financial sector. Negative rates are a huge challenge to the financial system. While US banks steadily outperformed their European counterparts through the 90s and into the 00s, European banks have underperformed notably post GFC.

ROEs for US banks still hover around low-double-digit percentages whereas European banks average around 7% compared to high double digits pre-Lehman. The flip side is that banks are significantly better capitalized thanks to much stricter regulation. However, the negative rates that the ECB feels are required for the wider economy still leave a big mark on profitability, and with it the medium- to long-term stability of the economy, as banks still play an integral part in the success of economies and lending is often based on past profitability and share price performance.

Did the GFC cause populism?

The causes of populism are still being debated and largely revolve around inequality, globalisation, depressed wage growth and immigration issues. Did the GFC also contribute?

Perhaps the workout from the GFC contributed, insofar as after the initial shock global policy makers opted for a mix of extraordinarily loose monetary policy and tighter fiscal policy (especially in Europe). This reinforced the trends of the previous decades when capital won out over labour. Profits soared again but wages stayed low and public services were cut. Austerity somewhere has been a permanent feature of the past decade. So although the roots of populism had been building for a few decades, policy post GFC has arguably attracted the more extreme politics of our day in many countries. Support for populist parties is now at the highest level since before WWII. At the same time we've seen global policy uncertainty surge, with the US currently at the extremes.

So if you believe that the GFC contributed to populism, then it's possible that the full impact of the crisis and its workout are yet to come as populist movements appear to retain momentum around the globe.



Annex: Performance Review Since the Crisis

One great irony of the period since Lehman is that returns have been healthy – albeit with some exceptions. At the top is the seeming bullet-proof rally for US equities, with the DAX's comparatively lackluster return leading the way in a generally underperforming European equity story. So the huge intervention and general asset price inflation over the last decade haven't been universal. But with commodities making up a good proportion of negative-return assets, the hunt for yield has proven a prudent strategy. The big question is, Will this be the case for the next ten years?

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