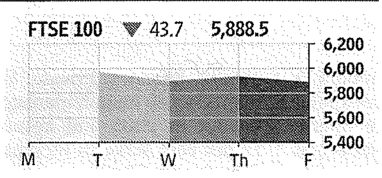
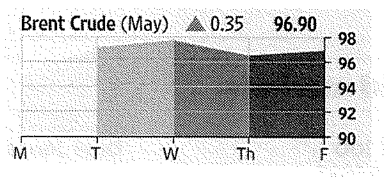
Stock markets

FTSE AIM	▲2.0	997.2
Dow Jones	▲96.72	12381.02
Nikkei 225	▼187.82	13500.46
Nasdaq Comp	▲3.57	2303.35
Eurofirst 80	▼48.44	4828.58



Commodities

Gold London	▼5.55	$944.60
Platinum	▼25.0	$2155.0
Copper	▲41.0	$8321.5
Carbon Dec 08	▼0.22	€21.48
Carbon Dec 09	▼0.22	€21.96



Currencies

$ per £	▲0.0060	1.9673
€ per £	▲0.0025	1.3270
¥ per £	▼0.73	210.41
$ per €	▲0.0005	1.4819
¥ per $	▼0.60	106.97

Bear market? This is the latest buying opportunity

Anatole Kaletsky
Economic view

Is this really the worst financial crisis in decades? The answer may be delivered this week, when we learn whether Eric Dinallo, the New York State Insurance Superintendent, has managed to organise a rescue of the monoline bond insurers, the relatively small and previously obscure businesses that lend their top-notch credit ratings to several trillion dollars of financial obligations issued not only by American municipalities, but also by infrastructure projects across Europe and many of the public-private partnerships that are building hospitals, schools and railways across Britain.

If a bailout for these bond insurers is finalised next week, the deadline envisaged by many Wall Street bankers and recently confirmed by Mr Dinallo's boss, Eliot Spitzer, the Governor of New York, then this announcement could well mark the turning point in the global financial crisis. If not, then credit downgrades among the bond insurers will trigger tens or even hundreds of billions of dollars of additional losses and bank write-offs. But will this really be the worst financial crisis the world has faced, as so many experts suggest?

Looking at what the stock market is actually doing, as opposed to what analysts are saying, the impression is less extreme. Bank shares have undeniably taken a big hit since August, but comparing these movements with the ones that happened in previous financial crises, it is hard to conclude that this is the crisis of a lifetime. US banks are only 20 per cent below their long-term average in relation to the S&P 500, while financial stocks generally are right on their 20-year average — and the fall in relative values has been neither steeper nor deeper than it was in the late 1980s and the late 1990s. The bears can respond, of course, that the present level of bank shares merely proves that shareholders are still in denial about the damage that is being done and far worse losses are still to come. For example, Meredith Whitney, of Oppenheimer, who made a name for herself in the autumn by being the first to predict the demise of Citicorp, argued last week that the stock could fall by a further 15 per cent to 50 per cent because the bank would have to cut its dividend yet again. But there is a different way of looking at such dire predictions.

If the worst that the most bearish of analysts on Wall Street can say about the world's poorest-performing big bank is that it will have to cut, or even eliminate, its dividend to rebuild capital ratios, this amounts to a rather moderate sort of crisis in comparison with what happened to the Japanese and Asian banks in the 1990s or to the US and European banks in the Latin American debt crisis. In those cases, it was not only a few mismanaged banks rebuilding their capital by cutting dividends. In 1982, when Mexico and Brazil defaulted, every leading American, British and European bank effectively became insolvent, with non-performing loans worth more than 100 per cent of equity capital. And most of them, including Citibank, Deutsche, Chase Manhattan, Lloyds and Midland, remained effectively insolvent until 1988. The situation in Japan in the 1990s was even worse.

'It is hardly surprising that people are constantly amazed by each new cycle — and find it difficult to see it in historic proportion'

Why, then, are so many experts describing the present credit crunch as the worst financial crisis in living memory? A typical view is this comment last week by David Rosenberg, the chief economist of Merrill Lynch: "We confess that we have been in the business for 25 years and have never — and repeat never — seen a cycle like this one." Looking back over my own 30 years of experience of financial markets, it strikes me how often I have heard almost identical statements in past financial crises, usually emanating from the finest brains in the business: Alan Greenspan, who described LTCM in 1998 as the worst crisis in his 60-year working lifetime; Robert Rubin, who was not joking when he described his rescue of the Mexican peso as The Committee to Save the World; and George Soros, who reacted to Black Monday in 1987 with a single chilling sentence: "This is 1929."

Such extreme reactions might, of course, have been justified. Maybe each successive crisis really was worse than the one before — in which case, this crescendo of chaos may, indeed, be approaching its apocalyptic climax. On reflection, however, two less sinister explanations for the mounting sense of panic seem more likely. The first is that 25 or 30 years, the typical career for even the most experienced investors and bankers, mark a fairly brief period in economic history, covering only two or, at most, three economic cycles. It is hardly surprising, therefore, that people are constantly amazed by each new cycle that comes along — and find it difficult to see it in historic proportion.

Secondly, and more interestingly, when we look back through history — or think about the underlying economics of business cycles — we realise that every financial crisis and bear market in the past has been a buying opportunity because we can see, with hindsight, that the world never did come to an end. Yet if everyone in the market knew that previous financial crises and bear markets always created buying opportunities, then a new bear market could never occur, unless large numbers of investors believed that the latest financial crisis was somehow different — and worse — than any that had gone before. If people believed that this was just an average sort of crisis, they would now be buying instead of selling, and there would be no crisis.

In other words, to create any financial crisis — even a fairly mild one — there has to be a widespread belief that things are much worse than ever before. In terms of market psychology, the view that "this crisis is different from every other" is really just an echo of the cry "this time is different" that is always heard at the top of a bull market.

But although worldly-wise commentators invariably ridicule all suggestions that structural conditions in a bull market are healthier than in previous cycles, they often fall for the belief that structural conditions in a cyclical downswing are worse than ever before. Such structural deterioration may actually be true in certain periods. It happened, for example, in Japan in the 1990s. In general, however, the fear of exceptionally deep and prolonged bear markets is less rational, and more emotional, than the hope that bull-market trends will persist.

Periods of fear are more susceptible to irrationality than periods of hope — and not just because of the obvious psychological link between fear and panic. Experience and economic theory show quite clearly that profit-motivated individuals tend to keep capitalist economies expanding, while nobody (apart from unreformed Marxists or al-Qaeda terrorists) has comparable incentives to push the economy into a prolonged slump. Moreover, governments and central banks in modern mixed economies with a decent understanding of demand management and collective-action problems also have clear incentives to promote growth rather than cause depressions. This does not mean that depressions never happen, because market incentives can temporarily break down and policymakers can make big mistakes.

On balance, however, to bet on a prolonged slump is to bet against economic theory and human nature. "This time is different" is much more likely to be true on the way up than on the way down.

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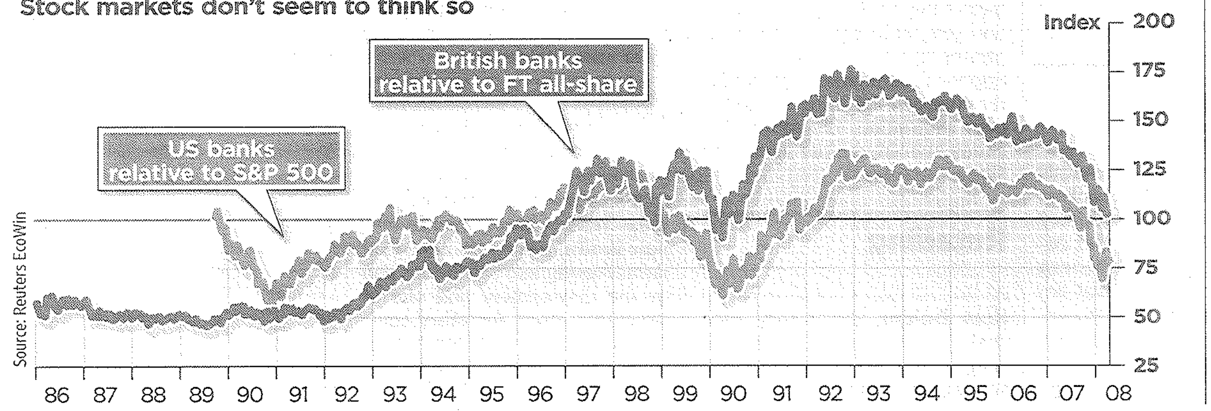
Is this really the worst financial crisis?

Stock markets don't seem to think so



Source: Reuters EcoWin