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LEADING THOUGHTS

A Recipe for the Next Financial Crisis

It may not come soon or deliver the same shock, but the ingredients that triggered so many predecessors are already coming into view.

As the world's economy lurches towards recovery, manufacturing looks healthy, trade volumes are picking up and financial markets are as buoyant as ever. The natural question for savvy investors, though, is whether the good news will last long enough to justify high multiples and tight spreads. If a mob storming the U.S. Capitol doesn't roil markets, what will?

The next crisis may be years away, but the elements that usually cause trouble are already here: financial innovation that leads to a surge in liquidity; excess that isn't initially apparent until it suddenly becomes blindingly obvious; and a slow shift in relative prices that threatens to trigger a cascading series of bankruptcies.

Ballooning central bank balance sheets and easy credit have averted a greater disaster, and the recovery is real. But beneath the surface there are also tectonic shifts in technology, climate policy and post-pandemic patterns that are changing the relative prices of labor, energy, and just about anything you can buy online. These are the forces that will slowly erode long-standing business models until they suddenly catch markets by surprise.

In the 1860s, U.S. Treasury Secretary Salmon P. Chase began marketing U.S. bonds to middle-class investors while Emperor Louis Napoleon blessed the first universal investment banks that channeled French household savings into large-scale projects. There were plenty of railways, steamships, and telegraphs to underwrite. There were also wars, strikes, and con artists along the way, but ultimately there was never enough demand to fill the massive capacity that was built. Prices changed, balance sheets sagged and the 1873 crash of the Vienna Stock Exchange tipped Europe and the United States into years of depression.

More than a century later, a financial innovation called the Eurodollar market drew money from U.S. bank accounts, where interest rates were tightly regulated, and from Middle East governments whose oil profits soared. These vast sums were ultimately channeled to developing countries, mainly in Latin America, on the premise the loans could be financed with export revenues. Again, the story is complicated, but the cozy arrangement unraveled spectacularly with massive spikes in the price of energy, with the oil embargo, and the price of dollars, as Paul Volcker's Fed tackled inflation with sharply higher rates.

The Global Financial Crisis in 2008 can trace its roots to a perfectly benign financial instrument called "securitization," which helped pull money from around the world to finance flawed U.S. mortgages. Among many forces at work, technological advances and globalization dampened household incomes, housing prices started to sag, and it wasn't long before some of the world's largest banks found they couldn't bear the strain.

In January 2021, the financial innovation that supplies abundant liquidity comes unexpectedly from the world's stolid central banks, which were forced to pump in money that boosted prices and growth for much of the last decade when their governments were preoccupied with balancing budgets. When the pandemic hit, the banks doubled-down to prop-up collapsing markets, ramping up their balance sheets to stave-off disaster.

So far, so good. Bankruptcies have been limited and firms have tapped credit markets with little trouble. Pent-up demand should give revenues a nice boost as lockdowns end, but when shoppers resume their regular patterns it's hard to see how growth over the next decade will be much higher than the last. Aging populations mean less consumption, ramshackle infrastructure means higher costs, and trade friction means rising uncertainty.

There will be further pressures on overextended balance sheets from shifting relative prices. Before the pandemic, cloud computing and artificial intelligence were already shaping new business models from finance and health care to telecommunications and manufacturing. For all the differences, the common theme was a further erosion of wages. Once lockdowns end, new living and working patterns will likely further disrupt the prices of real estate, transportation and entertainment.

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Additional shifts in demand will come from expanding rules, subsidies, and taxes to mitigate climate change. Flood-prone properties will probably lose value, clean energy sources will gain it in all likelihood, and everyone will be forced to contemplate their risk of holding stranded assets—whether it be an oil field or an internal combustion engine—that no one wants to buy.

Most crises erupt from the unexpected, so the more investors are watching for these changing patterns and prices, the easier it will be to evaluate the risks to firms that appear to be awash with liquidity for now. But successful investing is rapidly shifting from assessing macroeconomic factors or even predicting government policy to the nitty-gritty of understanding just how resilient balance sheets may be in a world of fluctuating prices.

Ultimately, the recipe for crisis is little more complicated than that.

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