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A better way to anticipate downturns

Credit markets, though harder to follow than equity markets, provide clearer signs of looming economic decline.

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What executive isn't challenged by the daily barrage of conflicting economic reports attempting to clarify the question of the hour: will the global recovery build or lapse into another recession? Indeed, executives around the world are evenly split on the topic.[1] And while the savviest executives and investors know better than to get caught up in the short-term fluctuations of the economy, many others, looking for evidence of longer-term trends, still fixate on movements in the equity markets.

They shouldn't. The fact is that those markets, well analyzed as they are, don't predict downturns effectively. Credit markets are a better place to look for signs of impending trouble, in no small part because they have been at the core of most financial crises and recessions for hundreds of years. Parsing the credit markets isn't easy—there's no single number remotely like a share price to monitor, and there are many moving parts. But for executives willing to take the time to understand the relationship between the financial and real economies, the credit markets can provide clearer indicators that a recession is on the horizon.

Collective wisdom falls short

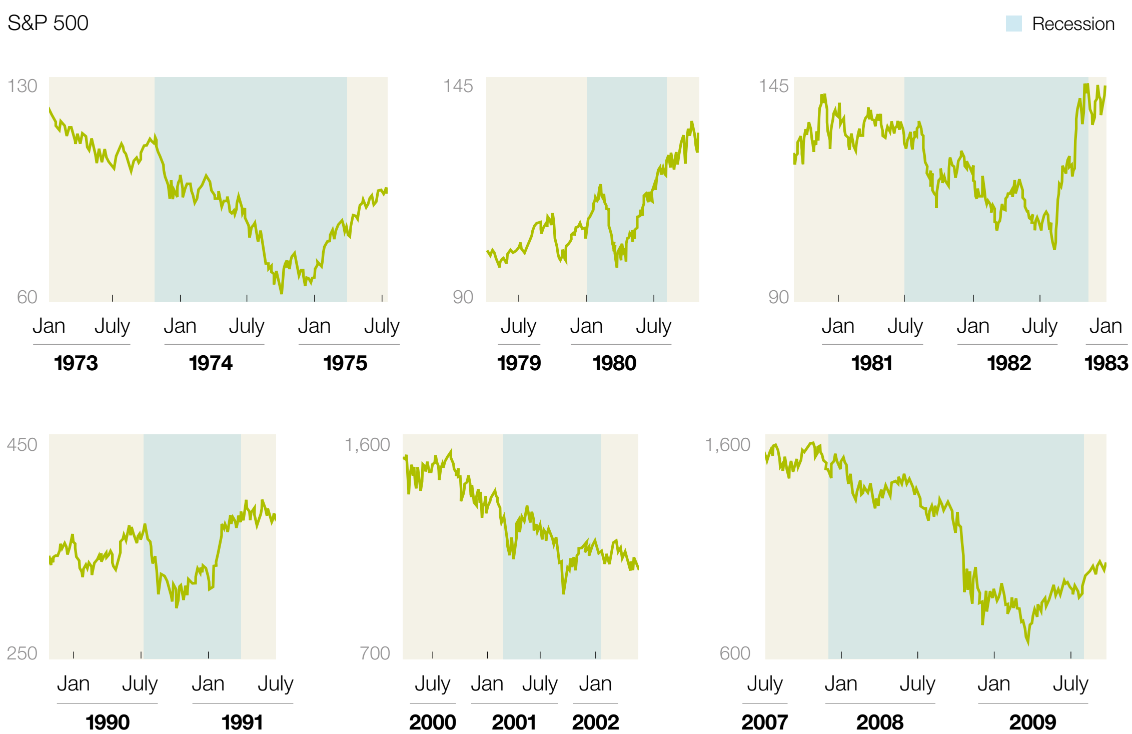
Subscribers to the theory that markets process all information efficiently would argue that equity investors should be in very good shape to recognize early indications of a looming downturn. If that were indeed the case, current market valuations might inspire confidence. Our model of the equity

markets suggests that their current levels in Europe and the United States are reasonably consistent with the intrinsic value of equities, given long-term profit trends and current rates of interest and inflation. And since equity markets do a reasonably good job of tracking long-term economic fundamentals,[2] investors can expect longer-term returns—dividends and share price appreciation—that are in line with historical real returns, in the range of 6 to 7 percent.

Of course, the fact that the stock market is currently in line with the long-term trend doesn't rule out the possibility of major fluctuations on the way to the longer term. The performance of equity markets shows that they have not been a good predictor of past recessions. Indeed, during every major recession since the early 1970s, most of the decline in the S&P 500 index occurred *after* the economy had already slowed (Exhibit 1). For example, the major decline in the S&P 500 index during the 2007–09 recession didn't occur until the third quarter of 2008, although the recession officially began in December 2007, and clear signs of problems appeared in mid-2007. Our analysis suggests that the equity markets give too much

Exhibit 1

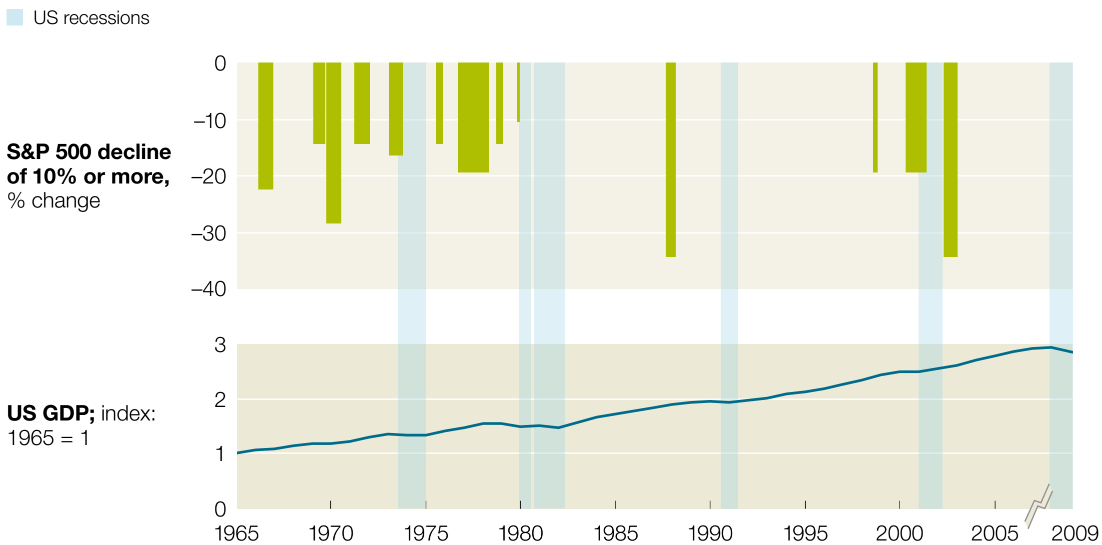
Most of the decline in equity markets comes after a recession has already begun.



Source: S&P 500; McKinsey analysis

Exhibit 2

Stock market declines do not indicate economic downturns.



weight to current economic activity rather than to the situation likely to materialize in a couple of months or even a year.

Moreover, when the index's value does drop during nonrecessionary periods, this rarely signals a coming downturn. In the past 30 years, there have been few major declines in the market outside of recessions (Exhibit 2). Even an extreme case, such as the 20 percent drop during a couple of days in 1987, didn't portend a systemic downturn, and the index was back to normal a mere two months later. In the past, such market fluctuations have been caused mostly by forces that didn't have anything to do with the real economy—and any effect they had dissipated very quickly. Equity markets played the more typical role of bystander, buffeted by and reacting to economic events rather than anticipating them.

While the equity markets may not predict economic trends well, their depth does provide investors with liquidity, so they generally continue to function smoothly even in difficult times. Investors were able to go on buying and selling shares in most companies at reasonable prices throughout the crisis. During that time, the S&P 500's long-term trend value—the value you would expect to see if you were confident that the economy would recover to its long-term trend within several years—stood at about 1,100–1,300. Therefore, no one should have been surprised to see a drop to the 900–1,000 level, given uncertainty about the depth and duration of the recession. Although the S&P 500 index eventually dropped below 900 in the first quarter of 2008, it didn't stay there long; investors realized that a broad market level below 900 reflected unreasonable pessimism.

Exhibit 3

Most major downturns in the past 30 to 40 years have been driven by some sort of credit crisis.

	Crisis	Start date	Real GDP change after crises, %
US crisis	Federal Reserve Board inflation crackdown	1980	–2
	Savings-and-loan, junk bond crisis	1990	0
	US subprime-mortgage crisis	Dec 2007	–2
Non-US crisis	Latin America (Mexico) debt crisis	1982	–4
	Japan property market burst	1990	3
	Mexico debt crisis	Dec 1994	–6
	Asia (Thailand) debt crisis	July 1997	–11
	Russia default	Aug 1998	–5
	Argentina economic crisis	1999	–1
	Greek/eurozone crisis	Dec 2009	N/A

Incubators of crisis

Unlike equity markets, credit markets don't always function smoothly during difficult times. That, in part, is why they are a better source of clues about where the economy is heading. The credit markets are where crises develop—and then filter through to the real economy and drive downturns in the equity markets. Indeed, some sort of credit crisis has driven most major downturns over the past 30 to 40 years (Exhibit 3). Such crises include not only the recent property debacle in the United States and the 1990 one in Japan but also the crises generated by excessive government borrowing in Latin America in 1980 and by excessive corporate borrowing in Southeast Asia in 1997. So executives who find reasons for optimism in today's equity market levels might be less sanguine looking at today's credit markets. It's still not clear whether prices have stabilized in once overheated real-estate markets. Banks are still somewhat vulnerable. And the level of government debt in the United States and elsewhere is still an issue.

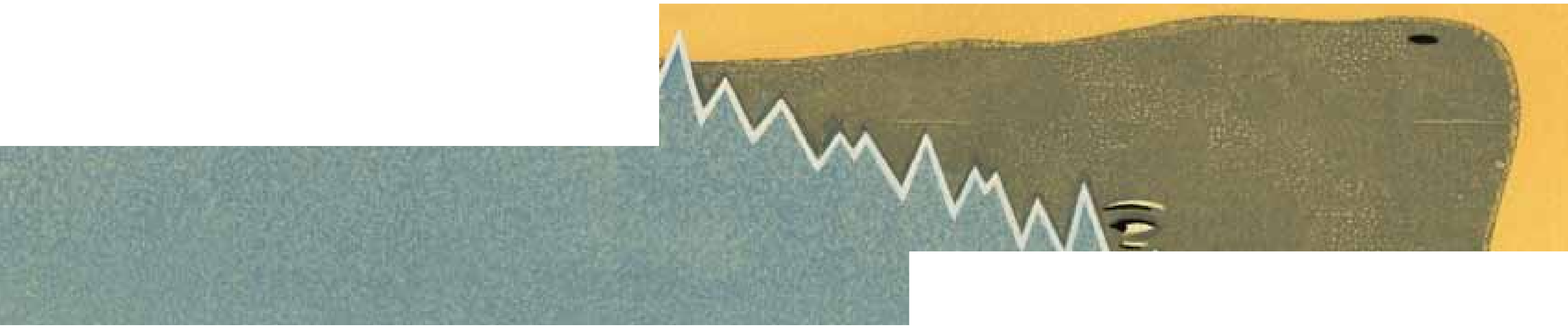
Moreover, the pattern of crisis development shows clearly enough that the one thing we can know for certain is that economic crises will erupt in the future—in part because the credit markets work almost as if designed to cause them. That may be a provocative point, but consider this:

- The credit markets are extremely illiquid. The trading volume of most equities is many orders of magnitude greater than that of typical debt instruments. In fact, you could argue that debt is sold rather than bought. Plenty of investors analyze stocks on their own and call their brokers now and then to buy one. But they buy debt, for the most part, only when a broker calls with inventory to sell. This illiquidity sometimes makes it difficult for banks or other investors to sell credit assets at a reasonable price. In addition, providers of short-term credit—to banks, hedge funds, and other financial institutions—may be simply unwilling to extend new credit when old debt comes due, forcing debtors to sell assets to pay down debt just as they are least sellable.

- The banking system and many investors, particularly hedge funds, earn a significant portion of their profits on the mismatch between their assets and liabilities: they invest in longer-term loans and other investments and borrow with short-term deposits and debt. Banks make attractive returns when (as is normally the case) long-term interest rates are higher than short-term ones. Normally, this formula works well. But two things can happen to disrupt it. Sometimes the yield curve inverts, with short-term interest rates higher than long-term rates; then, normal banking profits disappear. More important, short-term credit markets sometimes freeze up, so banks, hedge funds, or financial institutions can't get short-term debt at a reasonable price, or any price. As a result, they sell assets at distressed prices—if they can find buyers.

- The system suffers from chronic group-think. Participants in the credit markets tend to pursue the same strategies because it's so easy for banks to monitor what other banks are doing. Banks and investors observe which banks or other investors seem to be making the highest profits and then implement similar strategies. If contrarians in the market were to counterbalance credit excesses, the system should stay in equilibrium. But the system makes it very difficult for investors with contrarian views to apply them. For example, during the recent real-estate bubble, plenty of people were trying to figure out how to bet against the housing market but couldn't, because they didn't have the massive amounts of collateral required.

- Expectations of government bailouts create tremendous moral hazard—certainly in the bailout of US banks after the subprime-mortgage fiasco and most likely in Greece when it was at risk of defaulting on its sovereign debt. If the European Union hadn't been expected to step in and rescue the country, the spreads on its debt would have been much higher, years before the crisis hit, relative to, say, German bonds or other euro bonds, given the enormous levels of government debt and its large social obligations. Instead, investors assumed that the EU or one of



Because the conditions for a crisis are in place several years in advance, it is possible to see the signs of one coming—and to avoid getting caught up in credit market hazards.

its members would bail out Greece and continued to lend to it at rates far below levels that would have reflected the true risk of the debt. And in the end they were right, as the EU stepped in.

Unfortunately, it takes several years for crises to develop, and once the conditions are in place, they are nearly inevitable. The only way to stop one is to anticipate it years in advance; for example, preventing the US subprime crisis would have required clamping down on borrowing in 2005. Avoiding the crisis in Greece would have required something similar in 2005, 2006, or even earlier.

Foreshadowing a downturn

The good news, relatively speaking, for managers of companies is that because the conditions for a crisis are in place several years in advance, it is possible to see the signs of one coming—and to avoid getting caught up in credit market hazards.[3]

Loose lending standards

One clear sign of trouble ahead is a deterioration of lending criteria. In the late 1980s, for example, banks were issuing debt based on wildly optimistic assumptions of earnings growth, even for industries in long-term decline. In the same era, Canada's Olympia & York, the developer of Canary Wharf, in London, borrowed money with virtually no due diligence. And during the 2005 real-estate bubble in the United States, buyers with little or no evidence of their ability to carry a mortgage could purchase houses.

Unusually high leverage

Another warning sign of crisis is unusually high debt levels and mismatches between assets and liabilities, whether by financial institutions, companies, governments, or individuals. For example, in the months leading up to the real-estate crisis that erupted in 2007, the leverage of both banks and consumers in the United States was at unusually high levels. In addition, many consumers were financing their homes—long-term, illiquid assets—with debt in the form of adjustable-rate mortgages that had the characteristics of short-term debt.

In the 1997 Asian crisis, companies financed production facilities—obviously long-term investments—with debt in US dollars. When the dollar strengthened, borrowers needed more local currency cash flows to service the debt. And as hedge funds have grown over the past decade, the importance to their returns of their financing model—short-term debt to finance less liquid assets at very high leverage levels of 90 percent or more—has largely been left unspoken. The general public couldn't see how leveraged these funds were, but the banks lending to them could. And even with full access to their balance sheets, no single bank was willing to give up the business as long as the hedge funds were profitable customers.

Transactions without value

It isn't always easy for casual observers to notice, but subtle signs often indicate that financial transactions are proliferating even when they aren't creating value (for example, by substantially easing the allocation of capital). Indeed, many collateralized debt obligations, such as those blamed for the great credit crisis that resulted in the demise of Lehman Brothers two years ago, fall into this category. Another example, early in the 2000s, was the use of off-balance-sheet debt not just by Enron but also by plenty of others. Whenever a company tries to take debt off its balance sheet, investors would be well advised to wonder why. These transactions generate a lot of fees for bankers but rarely create any value.

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Watching the equity markets for signs of future crises or downturns is unlikely to provide the kind of advance notice that can inform strategic decisions. Executives with the tenacity to follow the many moving parts of the credit markets are likely to be better prepared when the economy does turn sour. ○

[1] "Economic Conditions Snapshot, September 2010: McKinsey Global Survey results," mckinseyquarterly.com, September 2010.

[2] See Richard Dobbs, Bill Huyett, and Tim Koller, *Value: The Four Cornerstones of Corporate Finance*, Hoboken, NJ: Wiley, November 2010.

[3] Indeed, US industrial companies that entered the crisis with healthy balance sheets were able to withstand the crisis reasonably well, precisely because they were not overleveraged and had sufficient cash reserves to be flexible as the crisis wore on.

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