



Mohammed El-Erian: We Have Not Reached Escape Velocity

September 15, 2009
by Robert Huebscher

The US Financial system has not fully emerged from the financial crisis, Mohammed El-Erian told an audience of nearly 1,000 advisors on Sunday night. His remarks kicked off this year's Schwab Impact conference in San Diego.

El-Erian, the CEO and co-CIO of the global manager PIMCO, called the crisis a "sequential contamination of balance sheets" that initially hit the sub-prime and housing markets. In 2007 the contamination spread to the financial services industry, and a year later it hit the global economy. Now public finance balance sheets are strained, creating a new level of concern for policy makers.

Full emergence from the crisis is analogous to a rocket reaching its escape velocity – and the US economy isn't there yet. It won't be, El-Erian said, until balance sheets are no longer contaminated.

Speaking with El-Erian was Larry Fink, the CEO of Blackrock, who generally agreed with El-Erian's forecasts, and specifically seconded El-Erian's assertion that the "New Normal" for the US will be slower economic growth.

Together, El-Erian and Fink addressed a number of issues related to the financial crisis, which I summarize below.

Are we safe yet?

In the narrowest sense, the US financial system is safe, in that El-Erian no longer believes a repeat of the cataclysmic events of last September and October are possible.

In a broader sense, however, the global economy still faces many risks. We are still dealing with the solvency of large institutions and have "inadvertently accelerated redesign of the global economy." What's more, we are doing so in the context of a "shrinking pie" – the global economy is contracting. The government's new ownership stakes in numerous companies has fundamentally changed it's role – once a referee, it's now a player.

Fink agreed that we are much safer than we were, but he did not say with any conviction that we are safe. Prior to the crisis, the source of the market's strength was a "myth" based on leverage, excess capital, and excess production capacity in industries such as automobile manufacturing. "We have a stronger system today than we did three years ago," he said, but many of those fundamental problems remain unresolved.

The failure of diversification and other lessons from the crisis

The biggest lesson of the financial crisis, according to El-Erian, is that diversification is a necessary but not sufficient condition for maintaining adequate portfolio performance. He believes investors need more than just conventional diversification.

Diversification is no longer just about asset classes. Investors must recognize that markets will under- and over-price certain kinds of risk – and they won't necessarily do so at the asset class level. Over the next five years, he said, these considerations will become more important than asset class diversification.

El-Erian did not offer any specific examples of risk factors that he now considers mis-priced, nor did he say whether such a strategy could be employed over long time horizons or, instead, whether it would be useful only for short-term tactical decisions.

Using an analogy to explain the failure of asset class diversification, El-Erian said it was as if the oxygen had been suddenly sucked out of the room. The entire audience would quickly gasp for air – as the global markets did when the deleveraging process began last fall.

Once the oxygen was restored, those who were fit and healthy would recover first, and they would help others to recover – unless they were pulled down in their rescue attempts.

“It did not matter what market you were in when the crisis hit,” he said; all markets collapsed. When markets recovered, however, it mattered greatly where one was invested, as the healthiest markets performed best.

Investors must focus on the “left tail” of the return distribution to insure against extreme adverse outcomes, he said, noting that PIMCO has recently introduced funds with insurance against the worst outcomes.

EI-Erian cited two other lessons of the crisis: that policy makers must recognize that financial innovations (like securitization) will always be “over-produced and over-consumed,” and that we must have a strong infrastructure to support innovation. Financial institutions must recognize that incentives matter – compensation must be structured to reward managers for long-term and not short-term results.

The future of regulation

Two kinds of regulation are likely to emerge from the current crisis, according to EI-Erian: “smart ones and dumb ones.” The smart ones are, like smart parenting, very hard to implement.

The combination of irrational resistance from the financial industry and politicians who just want to say they did something (but not necessarily the best thing) will produce the dumb regulations, he said, as may bad implementation of otherwise good ideas.

Barriers that restrict access to certain activities (such as access to the capital markets for certain types of funding) are ill-advised, EI-Erian said, because they will impede growth. Such regulation is like reducing the speed limit on the highway, he said – “it’s safer, but it carries a cost.”

Caps on executive compensation fall into the “dumb” category, EI-Erian said, and are like a parent telling a child that he or she cannot go out to play. Instead, regulators must insist on clawbacks in contracts, which defer some portion of compensation to be based on multi-year performance.

Smart regulations will focus on insuring that financial institutions maintain proper capital cushions, and that those cushions are countercyclical. During periods of prosperity less capital should be required, and vice versa, he said.

The big issue in Fink’s eyes – which is really more than a regulatory one – is determining who will be the ultimate buyer of certain types of assets: mortgages, credit card and automobile loans, and other previously securitized assets. Banks can no longer buy them, and life insurance companies, once the largest purchasers of commercial real estate, need greater liquidity and have reduced their exposure to such assets. Endowments face the same problems – the need for liquidity has reshaped their asset allocations.

The buyers of formerly securitized assets will now likely be foreign entities, Fink said. It is critical to maintain the stability of those capital markets in the short term, he said, but that the longer term effects of foreign ownership are uncertain.

EI-Erian recalled his 15 years of experience at the International Monetary Fund, which was constantly managing financial crises. Comparing his experience to airplane travel, he said that when conditions become turbulent and the cockpit door is closed, passengers assume the pilots know what they are doing.

If the cockpit door were open, however, passengers would see pilots banging on the instruments, trying to determine whether the problems were real or whether they were simply instrument failures. They would see the pilots turning the steering wheel, but the plane failing to respond. They would see pilots arguing with each other, as policy makers and regulators do in times of crisis.

As a result, EI-Erian believes, successful oversight requires opaqueness – market participants should not seek complete transparency from institutions like the Fed. And the Fed must maintain its independent status, he added, so it can respond quickly to liquidity needs in times of crisis, wherever they may occur.

The dollar as the reserve currency

“Even though we have abused our privileges,” EI-Erian said, “we are luckily still in control of our destiny,” and the dollar will maintain its status as the reserve currency.

Reserve currency status confers “amazing privileges,” he said, including an enormous ability for an economy to finance growth beyond the means otherwise available to it at a low cost.

In another analogy, El-Erian said the global economy was like a huge airplane driven to high altitudes and high speeds by one big engine – the US consumer.

In the future, though, the global economy will be a plane driven by multiple engines, including the economies of China, Brazil, and other emerging markets. The transition to a multi-engine global economy will take place over the next 20-30 years, and may not be a smooth one.

At the margin, the dollar is losing its status, and eventually other currencies may have lesser roles as reserve currencies, but this process will take decades to unfold.

Will the US experience a Japanese lost decade?

This recession is driven by a process of balance sheet deleveraging, and not by insufficient flows within the capital markets. That distinction, El-Erian said, separates the current crisis from the lost decade that crippled the Japanese economy.

He maintained that an experience like Japan's remains possible, though. We are still struggling to accommodate lower leverage and reduced industrial capacity in many sectors, including automobiles, airlines, and financial services. Slower economic growth, as forecast by the New Normal, will make it difficult to ensure we avoid a lost decade.

Fink noted that US demographics are markedly stronger than Japan's, as we have a much younger population. He believes policy makers should encourage immigration and specifically should allow and encourage foreign students to remain in the US after graduation to help build the workforce.

The New Normal for the fixed income markets – inflation versus stagflation

The bond markets are engaged in a massive tug-of-war, El-Erian said. Low inflation is keeping rates low, but uncertainty as to whether the rest of the world will continue to fund US debts periodically pushes rates higher. These forces, he said, explain the volatility over the last month of 10-year Treasury rates, which fluctuated from 3.3% up to 4% and then back to 3.3%.

Ultimately, yields will be higher, El-Erian said, but he did not offer a specific timetable.

Inflation is not a concern, because the demand for goods is far less than its supply, he said. "It is very difficult to generate inflation under these conditions."

Stagflation – slow growth combined with inflation – may emerge at some point, and El-Erian said it is starting to show up in some industries. For example, as the demand for air travel slackened, airlines cut fares and then cut back flights. Once the supply (number of flights) reaches an equilibrium with the demand for air travel, prices will rise again – creating stagflation within that industry.

Other industries – automobiles, real estate, and financial services – may undergo a similar stagflationary transition, but El-Erian said it is hard to generalize those trends to the overall economy.