The fundamentals of market crises: Avoiding a financial black hole

Discussions with clients

Prevention, rather than cure, is key to averting another market crash

Dr Quintin Rayer 29 JUNE 2017

Advisers should be forming judgements about the likelihood of developing market crises and discussing them with clients, writes Dr Quintin Rayer, head of research at P1 Investment Management.

Although markets regularly have periods of falling prices, it seems easy to focus on the upside, directing relatively little effort towards spotting the next crisis.

Press coverage seems short-term, with negative events rapidly forgotten. While discussions with managers tend to concentrate on the positives and the potential for downward market moves can seem neglected.

Recent events show that political events often impact markets (for example Brexit and the US Presidential Election), with outcomes differing from mainstream opinion.

In this context, it seems strange that financial advisers do not spend more time discussing the potential for future financial crises. One might expect these discussions to extend both among themselves and also to client conversations.

This article explores some fundamental causes of financial crises, and sketches a possible approach for better managing investments in the face of this uncertainty.

Financial crises

Advisers know that stockmarkets are prone to bear markets. For investors, these are a source of great concern since stockmarket crashes can result in declines of 25% or more.

Markets often appear driven as much by sentiment as by economic reality and, as suggested by former Federal Reserve chairman Alan Greenspan, can suffer from "irrational exuberance".

Market values are perceived to be linked to economic cycles - but, since participants seek to anticipate investment opportunities ahead of competitors, are forward looking.

Investors must forecast economic and investment outcomes with incomplete information. This can result in decisions coloured by human behavioural biases. With many market participants, many views are generated -not all of these can be correct.

Even if 'normal' economic cycles could be predicted from interest rates, unemployment and other data, national economies are subject to influences from foreign countries via trade, government decisions and wider geopolitical events.

Countries may be 'serial defaulters' on their debts; tending to over-borrow during good times leaving them vulnerable during downturns.

Governments can treat favourable shocks as permanent developments, fuelling a spending and borrowing spree that eventually ends badly.

Financial innovations can permit illiquid assets to command higher values than previously, such as during the US subprime mortgage crisis of 2007.

The **complexities of financial markets may make them prone to instabilities**, making them capable of amplifying small events with potentially catastrophic consequences.

Long periods of stability can lead to debt accumulation until dangerous levels of leverage are reached.

Secular trends

Meanwhile, secular trends can change the investment landscape, creating new opportunities while undermining others. Some investors may correctly anticipate trends and others, not.

Election results or national referendums may turn slight popular biases into outcomes, which can overturn the consensus view.

Examples include:

- **Rising nationalism**, including Brexit, with potential for protectionist trade policies in contrast to previous eras of increasing free trade.

- New technologies, such as the internet dotcom stocks bubble in the late 1990s (although this is hardly a recent phenomenon, considering the 1840s railroad and 1793 canal building manias).

- Ageing populations, increasing demand for healthcare and pension drawdown.

People and politics

Human nature may lead to over-anticipation of future developments and exaggerated valuations. People prefer simple explanations, and prefer any explanation rather than none. Unfortunately, that does not mean they are correct.

Financial sector leaders may believe that innovations have genuinely added value while underappreciating new risks. Product providers may be responding to inappropriate incentives in less-well-regulated areas.

Governments may maintain a balance between producers and consumers to assure fair market prices. However, other forces are present, with constituencies attempting to influence governments including by polling (the 'will of the people').

Governments respond to political influences to silence critics and to help them stay in power.

Market events can provoke responses from authorities, which although intended to address present difficulties, may **sow the seeds of future problems (such as quantitative easing)**. The outcomes can lead to financial bubbles, as governments create artificial criteria to achieve political goals.

What to do?

Advising on investments with these uncertainties is challenging. Conventional risk measures are unlikely to capture these risks, however stress-testing portfolios may help.

With support from managers, advisers can identify issues and construct scenarios of possible outcomes that attempt to quantify risks.

If test results impact portfolios unacceptably, they can be restructured to make them more robust to the scenarios considered.

Anticipating market crises is not easy, advisers have to overcome their human biases, and political and economic systems that can leave markets vulnerable.

Advisers should be constantly on alert, particularly during periods when markets appear sound and are generating consistent returns.

Although difficult, advisers should be forming judgements about the likelihood of developing market crises and discussing them with clients.

These conversations should help ensure clients have a more complete understanding of the risks of their investments, and facilitate a better discussion around portfolio investment allocations.

© Incisive Business Media (IP) Limited, Published by Incisive Business Media Limited, Haymarket House, 28-29 Haymarket, London SW1Y 4RX, are companies registered in England and Wales with company registration numbers 9177174 & 9178013