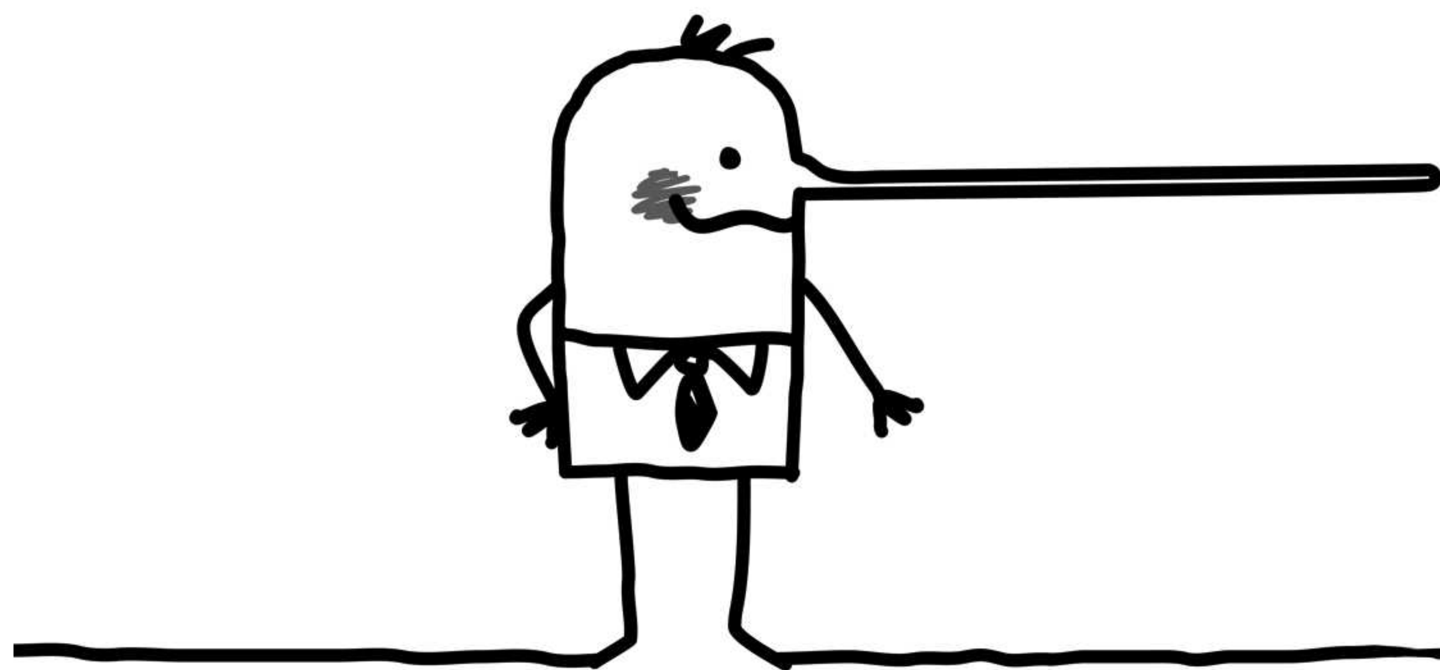
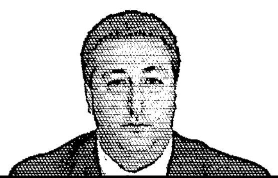
ON THE MONEY



ISTOCK

What caused the financial crisis? The Big Lie goes viral



BARRY RITHOLTZ
On Investing

I have a fairly simple approach to investing: Start with data and objective evidence to determine the dominant elements driving the market action right now. Figure out what objective reality is beneath all of the noise. Use that information to try to make intelligent investing decisions.

But then, I'm an investor focused on preserving capital and managing risk. I'm not out to win the next election or drive the debate. For those who are, facts and data matter much less than a narrative that supports their interests.

One group has been especially vocal about shaping a new narrative of the credit crisis and economic collapse: those whose bad judgment and failed philosophy helped cause the crisis.

Rather than admit the error of their ways — Repent! — these people are engaged in an active campaign to rewrite history. They are not, of course, exonerated in doing so. And beyond that, they damage the process of repairing what was broken. They muddy the waters when it comes to holding guilty parties responsible. They prevent measures from being put into place to prevent another crisis.

Here is the surprising takeaway: They are winning. Thanks to the endless repetition of the Big Lie.

A Big Lie is so colossal that no one would believe that someone could have the impudence to distort the truth so infamously. There are many examples: Claims that Earth is not warming, or that evolution is not the best thesis we have for how humans developed. Those opposed to stimulus spending have gone so far as to claim that the infrastructure of the United States is just fine, Grade A (not D, as the we discussed last month), and needs little repair.

Wall Street has its own version: Its Big Lie is that banks and investment houses are merely victims of the crash. You see, the entire boom and bust was caused by misguided government policies. It was not irresponsible lending or derivative or excess leverage or misguided compensation packages, but rather long-standing housing policies that were at fault.

Indeed, the arguments these folks make fail to withstand even casual scrutiny. But that has not stopped people who should know better from repeating them.

The Big Lie made a surprise appearance Tuesday when New York Mayor Michael Bloomberg, responding to a question about Occupy Wall Street, stunned observers by exonerating Wall Street: "It was not the banks that created the mortgage crisis. It was, plain and simple, Congress who forced everybody to go and give mortgages to people who were on the cusp."

What made his comments so stunning is that he built Bloomberg Data Services on the notion that data are what matter most to investors. The terminals are found on nearly 400,000 trading desks around the world, at a cost of $1,500 a month. (Do the math — that's over half a billion dollars a month.) Perhaps the fact that Wall Street was the source of his vast wealth biased him. But the key principle of the business that made the mayor a billionaire is that fund managers, economists, researchers and traders should ignore the squishy narrative and, instead, focus on facts. Yet he ignored his own principles to repeat statements he should have known were false.

Why are people trying to rewrite the history of the crisis? Some are simply trying to save face. Interest groups who advocate for deregulation of the finance sector would prefer that deregulation not receive any blame for the crisis.

Some stand to profit from the status quo: Banks present a systemic risk to the economy, and reducing that risk by lowering their leverage and increasing capital requirements also lowers profitability. Others are hired guns, doing the bidding of bosses on Wall Street.

They all suffer cognitive dissonance — the intellectual crisis that occurs when a failed belief system or philosophy is confronted with proof of its implausibility.

And what about those facts? To be clear, no single issue was the cause. Our economy is a complex and intricate system. What caused the crisis? Look:

1 Fed Chair Alan Greenspan dropped rates to 1 percent — levels not seen for half a century — and kept them there for an unprecedentedly long period. This caused a spiral in anything priced in dollars (i.e., oil, gold) or credit (i.e., housing) or liquidity driven (i.e., stocks).

2 Low rates meant asset managers could no longer get decent yields from municipal bonds or Treasurys. Instead, they turned to high-yield mortgage-backed securities. Nearly all of them failed to do adequate due diligence before buying them, did not understand these instruments or the risk involved. They violated one of the most important rules of investing: Know what you own.

3 Fund managers made this error because they relied on the credit ratings agencies — Moody's, S&P and Fitch. They had placed an AAA rating on these junk securities, claiming they were as safe as U.S. Treasurys.

4 Derivatives had become a uniquely unregulated financial instrument. They are exempt from all oversight, counter-party disclosure, exchange listing requirements, state insurance supervision and, most important, reserve requirements. This allowed AIG to write $3 trillion in derivatives while reserving precisely zero dollars against future claims.

5 The Securities and Exchange Commission changed the leverage rules for just five Wall Street banks in 2004. The "Bear Stearns exemption" replaced the 1977 net capitalization rule's 12-to-1 leverage limit. In its place, it allowed unlimited leverage for Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns. These banks ramped leverage to 20-, 30-, even 40-to-1. Extreme leverage leaves very little room for error.

6 Wall Street's compensation system was skewed toward short-term performance. It gives traders lots of upside and none of the downside. This creates incentives to take excessive risks.

7 The demand for higher-yielding paper led Wall Street to begin bundling mortgages. The highest yielding were subprime mortgages. This market was dominated by non-bank originators exempt from most regulations. The Fed could have supervised them, but Greenspan did not.

8 These mortgage originators' lend-to-sell-to-securitizers model had them holding mortgages for a very short period. This allowed them to get creative with underwriting standards, abdicating traditional lending metrics such as income, credit rating, debt-service history and loan-to-value.

9 "Innovative" mortgage products were developed to reach more subprime borrowers. These include 2/28 adjustable-rate mortgages, interest-only loans, piggy-bank mortgages (simultaneous underlying mortgage and home-equity lines) and the notorious negative amortization loans (borrower's indebtedness goes up each month). These mortgages defaulted in vastly disproportionate numbers to traditional 30-year fixed mortgages.

10 To keep up with these newfangled originators, traditional banks developed automated underwriting systems. The software was gamed by employees paid on loan volume, not quality.

11 Glass-Steagall legislation, which kept Wall Street and Main Street banks walled off from each other, was repealed in 1998. This allowed FDIC-insured banks, whose deposits were guaranteed by the government, to engage in highly risky business. It also allowed the banks to bulk up, becoming bigger, more complex and unwieldy.

12 Many states had anti-predatory lending laws on their books (along with lower defaults and foreclosure rates). In 2004, the Office of the Comptroller of the Currency federally preempted state laws regulating mortgage credit and national banks. Following this change, national lenders sold increasingly risky loan products in those states. Shortly after, their default and foreclosure rates skyrocketed.

Bloomberg was partially correct: Congress did radically deregulate the financial sector, doing away with many of the protections that had worked for decades. Congress allowed Wall Street to self-regulate, and the Fed the turned a blind eye to bank abuses.

The previous Big Lie — the discredited belief that free markets require no adult supervision — is the reason people have created a new false narrative.

Now it's time for the Big Truth.

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STEVEN PEARLSTEIN

This time, we're headed for a commodities bubble

PEARLSTEIN FROM G1

linked to those things.

Maybe they thought we wouldn't notice that the financialization of the economy brought with it higher prices and a more volatile economy, along with higher profits for the financial services industry.

The latest example is the market for commodities: corn, wheat, cotton, silver, copper, oil, natural gas. In the past decade, hundreds of billions of dollars have flooded into the market, largely through swaps contracts and commodities index funds, ETFs and mutual funds.

These markets have long since outgrown their original function of providing producers and consumers of these commodities with a way to hedge their risks by guaranteeing supply and locking in prices. All futures markets require a certain number of "speculators" to take the other side of the contracts from commercial users and producers. Typically, these speculators would represent 30 percent of the participants in a healthy futures market.

But today, because of a sudden desire to earn higher returns and diversify investment portfolios, there are more people wanting to invest in corn and copper and oil than there is corn and copper and natural gas produced and consumed. But no problem. The financial wizards on Wall Street have magically conjured up synthetic corn and copper and West Texas oil so that speculators can provide hedging opportunities for other speculators. Instead of 30 percent of the market, these "passive investors" typically account for 70 percent or more.

Who are these new passive investors, as they are politely called? They are pension funds and university endowments whose overpaid consultants tell them that if they want to earn big returns like Harvard and Yale, they have to put money into "alternative" investments such as private-equity funds, hedge funds, real estate investment trusts and commodity pools. More recently, however, they have been joined by individual investors turned off by the stock market and looking for higher returns than they can get from money market funds. While in the past, small, unsophisticated investors have been unable to invest in risky and volatile commodities, the financial services industry has rushed in to satisfy the new demand with exciting products.

Because most of the new investors hope to ride the commodities boom caused by a weak dollar and a strong China, there is an imbalance in the futures and swaps market — more people are betting prices will go up than down. That asymmetry has the effect of driving futures prices even higher, bringing even more investors into the "long" side of the market — the herd effect common on many financial markets.

The strong demand for commodities futures also put upward pressure on the actual prices paid for those commodities by real producers and consumers, if for no other reason than many private sales contracts are settled at a price linked directly or indirectly to futures prices.

At a hearing last week of the Senate permanent investigations subcommittee, Wallace Turbeville, a derivative specialist with Better Markets, a nonprofit research and advocacy group, told the senators that before 2004, the curve showing prices on most commodity futures markets was typically downward sloping — that is, futures prices for the next month were generally higher than those a year or two years out. But with the explosive growth of speculative commodities investing, Turbeville testified, the curves now typically are upward sloping — that is, anticipating a steady increase in prices. Those expectations have become a self-fulfilling reality, as anyone who buys food or gasoline or copper gutters has surely discovered.

> ***The financialization of the economy continues undeterred, creating a bubble in commodities just as it did with houses and office buildings.***

Not that the upward path of commodity prices has been a smooth one. To the contrary, commodities prices have been extraordinarily volatile. A recent paper by Kenneth Singleton, a professor at Stanford Business School, found a strong connection between the flow of investment money into the commodities markets and the boom and bust of oil from $50 a barrel to $145 and back to $35 between January 2007 and March 2009. And since then, of course, it hit $125 a barrel before settling back to $75. You can't explain that by changes in supply and demand.

Paul Cicio, president of the Industrial Energy Consumers of America, told the subcommittee that the increased volatility has driven up the price that its members must pay to hedge their risks on the commodities markets. And that increase eventually makes its way into the price of products produced with natural gas.

Earlier this year, the chief executive of ExxonMobil, Rex Tillerson, estimated that speculation was then contributing an extra $30 a barrel to the price of oil.

And no less an expert on coffee prices than Howard Schultz, chief executive of Starbucks, blames "financial speculators" for driving up the price of your double-skim espresso macchiato.

Chairing last week's hearing was Sen. Carl Levin (D-Mich.), whose committee blew open the scandal of Goldman Sachs and other investment banks creating risky mortgage-backed securities that it sold to unknowing customers while secretly using its own money to bet that they would default. Last week, Levin was focused on the growing role of mutual funds in the commodities market.

By law, mutual funds are supposed to derive 90 percent of their income from investments in stocks, bonds and other securities, under the regulatory supervision of the Securities and Exchange Commission. So to get around that prohibition and offer commodity funds, some clever securities lawyers in the mutual fund industry came up with the idea of setting up shell companies in the Cayman Islands for the sole purpose of investing in commodity futures and swaps. By selling shares in the offshore subsidiary to their sponsoring funds, the mutual funds are able to meet the requirement that they only invest in securities, and can also pass the subsidiary's profits on to mutual fund investors without paying a corporate profit tax. And because these are subsidiaries of mutual funds regulated by securities regulators, they escape oversight of the Commodities Futures Trading Commission.

What's clear from this tale is how little the financial services industry has really changed since the crisis of 2008. The financialization of the economy continues undeterred, creating a bubble in commodities just as it did with houses and office buildings. The industry is still engaged in clever games to circumvent regulation, increase risk and find the cracks between one regulatory agency and another. And when regulators step in to try to restore some sanity to the markets, they inevitably run into a political buzz saw created by the industry and its Republican allies.

A case in point is the recent rule adopted by the CFTC, at the instruction of Congress, setting limits on how much a commodities market can be controlled by one investor or dealer. The industry responded with its litany of explanations for why it's harmful and unnecessary.

There's the one about how futures prices have no effect on market prices. Yeah, right.

There's one about how speculators bring needed liquidity to the market, ignoring the obvious dangers of having too much liquidity.

There are the dire warnings that if any curbs are imposed, the entire industry will simply pick up and move to other countries — an argument made while also waging a furious campaign to prevent adoption of similar rules in Europe and Asia.

Finally, when all else fails, the industry claims the regulation is being rushed through without sufficient data and analysis, citing dozens of academic studies (many of them funded by the industry) that came to varying conclusions.

These were the same hackneyed arguments the industry used to block restrictions on savings and loans before that industry imploded in the 1980s. They were the same arguments used to push back regulators who wanted to tighten corporate accounting and disclosure rules before the Enron and telecom scandals of 2001. And they were the same arguments used successfully to curb reckless and abusive mortgage lending before the bursting of the housing bubble in 2008.

Now you can bet what's left in your 401(k) that there's about to be a commodities bubble — one that will generate big fees for Wall Street and leave a mess for everyone else.

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