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SOMETHING NASTY HAS HIT THE PROVERBIAL FAN

What is it that Americans say about a certain substance hitting fans ? I can't quite remember, but it seems that the loose lending policies of the world's banking community, together with the "sophisticated" financial engineering of financial market boffins and the generous interpretation of "ability to pay" by the ratings agents have all combined to produce the most volatile financial market environment since early 2003.

When US subprime mortgage borrowers and their lenders first revealed the stresses in this corner of the global capital markets the fear was that a widespread credit crunch might ensue. A credit crunch is a widespread and indiscriminate tightening of lending standards which has the potential for affecting real economic activity such as consumption and investment plans. However, the problems seemed to remain confined to the subprime market. Most concluded that the problem was "well contained" and equity markets recovered. In early July the S&P500 breached 1,550 while the FTSE 100 breached 6,700.

Then came the hedge fund failures, the admissions of potentially large losses for some banks and investment banks, followed by further embarrassing admissions that the bankers responsible for structuring and selling complex credit derivatives had no idea how to value them. Unsurprisingly government bond prices rallied, credit spreads widened, volatility rose and equity prices fell.

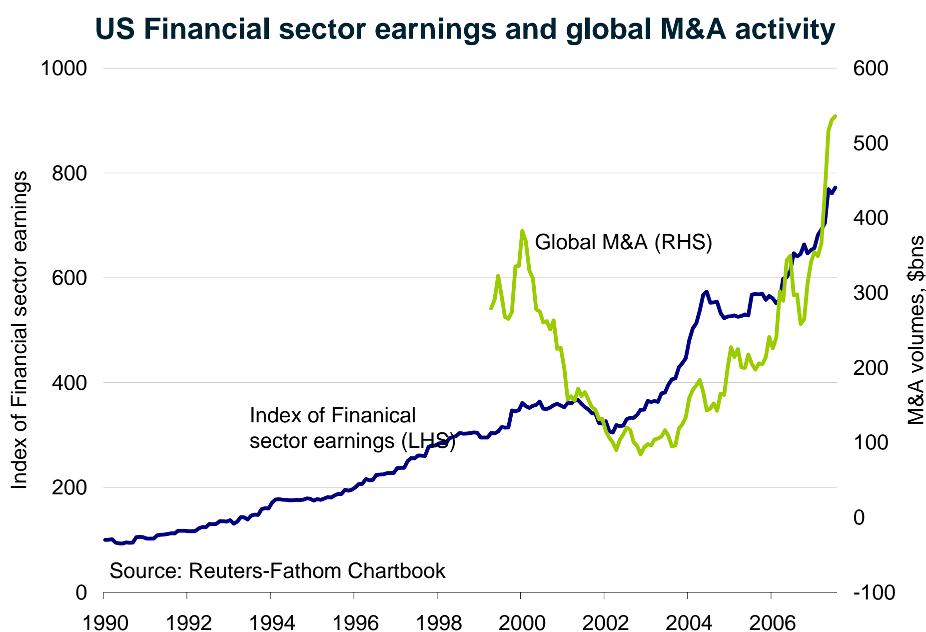
The first signs of really serious difficulties came when the world's central banks found that they had to pump huge amounts of cash into money markets so that financial market participants could cover margin calls and basically de-risk their positions. Contagion took hold. Because it was impossible to tell which institution would be next to reveal large losses, banks refused to lend money to one another, hence the central banks' willingness to fulfil their role as lenders of last resort. This is known as a liquidity crunch, which can be solved as long as central banks make it clear that they are willing to lend as much cash as required; a willingness that the central banks have been at pains to emphasise.

But what if this turns out to be more than just a liquidity crisis ? At the time of writing equity markets are falling sharply again. This probably indicates that equity investors do now see a real potential for the credit crunch that seemed to have been avoided earlier in the year, that is, tighter lending standards and a commensurate decline in real economic growth.

However, let's try and look on the bright side. Suppose that the central banks manage to solve the liquidity crisis, that the feared failures of sizeable financial institutions do not materialise and that both consumers and corporations both manage to continue to borrow to finance their activities. In fact, in the case of the corporate sector many firms are cash rich and do not have a great need for borrowing anyway. What might the outlook be for global equity markets in this relatively benign scenario ?

Unfortunately even in this situation equities may struggle if firms in the financial sector experience lower earnings growth as a direct result of a cessation of the LBO, IPO and M&A activity that has been so important for the sector's revenues over the past few years. This is particularly true in the US equity market where financial stocks make up almost 20% of the S&P500's market value. In fact, if you stripped out Financials from the S&P500 index it would be over 10% lower today. Financial sector earnings growth has outstripped earnings growth in the rest of the index, by around 120% since the start of 2006.

The blue line in this week's chart represents an index of the nominal earnings of the US's financial sector, while the green line represents global M&A activity, measured in billions of US dollars. The correlation looks strong. The sharp increase in corporate activity has played a big part in the financial sector's good times since 2003.



If all this corporate activity dries up, then financial sector earnings, a huge part of total US equity market earnings, will fall. After all, investment bank fees can be as high as 5% of these billion dollar restructuring deals. Other providers of professional, financial sector services such as law and accounting firms will also experience lower revenues. And with falling revenues some banks will start to ask why their deal teams need to be so large, which would clearly have implications for financial sector employment levels.

The bottom line is that even without the dreaded credit crunch there could still be a direct, and longer lasting, negative impact upon equity market valuations going forward.

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