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Where is the next financial crisis developing? How can investors protect themselves? Answers from two crisis experts, Robert Aliber, Editor *Manias, Panics, and Crashes* and *Global Shocks* author, Nicholas Sargen.

Robert Aliber
Editor, *Manias, Panics, and Crashes*

Nicholas Sargen
Author, *Global Shocks: An Investment Guide for Turbulent Markets*

CONSUELO MACK: This week on WEALTHTRACK, two experts on financial crises tell us where the next trouble spots could be developing and steps we can take to survive them. Noted economist and author Robert Aliber and veteran strategist and global shock author Nick Sargen are next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK. I'm Consuelo Mack. We live in turbulent economic times. As the latest edition of the classic, *Manias, Panics And Crashes* puts it: "*The years since the early 1970's are unprecedented in terms of the large changes in the day-to-day and month-to month prices of commodities, currencies, bonds, stocks, and real estate relative to their long-run average prices.*"

Also unprecedented in recent history are the 40 some odd banking crises that have occurred around the world in the last three plus decades. According To *Manias, Panics And Crashes,* they have tended to come in waves.

The first wave was in the early 1980s with the $800 billion dollar default of U.S.- dollar-denominated debt by Mexico, Brazil, Argentina and ten other developing countries.
The early 1990s saw a second wave engulfing Japan and two Nordic countries, Finland and Sweden. The third wave identified began in mid-1997, the Asian Financial Crisis that started with Thailand, Malaysia and Indonesia and spread to impact South Korea, Russia, Brazil and Argentina. And the fourth wave was the most recent, the Great Recession which began with the failure of Fannie Mae and Freddie Mac, the giant government sponsored mortgage lenders, followed by the collapse of Lehman Brothers, engulfing the entire developed world

Why are we experiencing so much financial turbulence? That was the focus of WEALTHTRACK last week with our two guests who are experts in the field. You can see the program on our website wealthtrack.com.

In part two this week we are turning our attention to where crises might be developing and how to invest in the meantime. And we are continuing the conversation with noted economist Robert Aliber, Emeritus Professor of International Economics and Finance at the University of Chicago Business School, the editor of the last three editions *Of Manias, Panics, And Crashes*, and a prolific author in his own right on international finance as well as the author of the personal finance books *Your Money and Your Life*.

Once again he is joined by Nick Sargen, Chief Economist and Senior Investment Advisor for Fort Washington Investment Advisors, who has had similar roles at major financial institutions over the years as well as working at the Federal Reserve Bank of San Francisco and the U.S. Treasury Department. Sargen's recently published book is *Global Shocks: An Investors Guide For Turbulent Markets.*

I asked them to identify the financial trouble spots they see developing now.

ROBERT ALIBER: I see two large imbalances. One is the imbalance in the U.S. bond market. Bond prices are much too high for an economy that is fully employed when the inflation rate is pushing up toward two percent and maybe above two percent. The other large imbalance is in China. So China has been experiencing a significant slowdown, and it has a housing stock in its major cities that is greatly overpriced. People had been buying houses in China because it was a safe store of value and a profitable store of value, and that game was very profitable for 20 years, but that game is over. Chinese growth rate is slowing, and as the growth rate slows, investment in housing will fall further. So we have a slowing Chinese economy and a U.S. economy whose growth is accelerating.

CONSUELO MACK: What are the signs of a bubble developing?

ROBERT ALIBER: A traditional bubble in real estate or in stocks is one in which the rate of increase in the price is much higher than the interest rate and, as a result, some smart guy investors borrow as much as they can in order to buy either real estate or stocks because their revaluation profits are so much higher than their interest costs. That's what we saw in the late 1990s. That's what we saw in the U.S. housing market in Nevada and in Florida in 2004, 2005, 2006. That's what had been happening in China for much of the period from the mid-1990s until 2013.

CONSUELO MACK: So apply that standard of identifying a developing bubble to today. What is it about the U.S. bond market?

ROBERT ALIBER: I don't think I've said that the bond market is in the bubble, but the prices of bonds are too high given the inflation rate and given that the economy is at full employment. So we might ask the question, if we were at full employment in a zero inflation world, what would be the interest rate on long-term U.S. government bonds? Probably ...

CONSUELO MACK: So a ten-year bond you mean or 30?

ROBERT ALIBER: Either a ten-year or a 30-year, but that bond interest rate should be three and a half or four percent, more or less approximate, slightly more rapid than the U.S. rate of economic growth. Now we have an economy that is growing at two and a half or three percent a year. We have an inflation rate of one and a half or two percent, and we have interest rates on the ten-year bonds that kiss two percent. There's just a massive imbalance in the bond market, and one day we will wake up and there will be a surge in the inflation rate, and there will be a panic in the bond market.

CONSUELO MACK: Now this is something of course that economists such as yourself have been predicting is going to happen for a long time, and yet it really hasn't. So Nick, why hasn't it happened what you normally would expect to have happen?

NICK SARGEN: I think the mistake a lot of people made was when the Fed went on its bond-buying program. What were they doing? They're basically creating reserves at commercial banks. So that's how they're paying for it. So the market says, well, I remember taking my money and banking course, and you create reserves. That money gets lent out, and then that's the actual process of money supply creation. So what the market didn't realize is banks couldn't find or were afraid about lending risk. So they just are sitting on tremendous holdings of excess reserves.

CONSUELO MACK: The borrowers didn't show up.

NICK SARGEN: The borrowers did not show up and as a result ...

CONSUELO MACK: Or they didn't qualify.

NICK SARGEN: ... we didn't really get the money supply creation that a lot of ... So that's the simple answer to the mistake that was made, but coming back I think to your point, Consuelo as you say, it's been a long time, and most economists including myself had expected that the rate increases would have already at least begun. So what I find amazing, the Federal Reserve actually made mistakes contributing to the bubble. I do give Ben Bernanke and the crew tremendous credit for stabilizing the financial system with the first initial round of quantitative easing.

CONSUELO MACK: Do you agree, Bob? Credit for that?

ROBERT ALIBER: The first round of quantitative easing and the second round of quantitative easing, and then ...

NICK SARGEN: After that it was overkill. What did we have to show for it other than extraordinarily low… So now, though, the Fed has been on record since mid 2013, three years. We wanted normalized interest rates, and what have they given us? One lousy 25 basis point hike last December. They came out of the gate this year. Be prepared for four moves.

CONSUELO MACK: Three or four.

NICK SARGEN: Then midyear. Be prepared for two moves. Be prepared for a move in September. That doesn't happen. So what is the bond market pricing in about the Fed? The bond market is pricing in one move every December for the next few years. So as Bob says, for an economy that's growing, this is it? To me there must be a mispricing in the market that it's too low. Yet the Fed has done the worst job of forecasting its own behavior, and that again is the dilemma situation I think we find ourselves in.

CONSUELO MACK: But the Fed doesn't control long-term interest rates. Right?

ROBERT ALIBER: It may not control them, but its policies have a very large impact on long-term interest rates.

CONSUELO MACK: A very large impact. So they do.

ROBERT ALIBER: Yes. This week as we speak, I have refinanced my Hanover home, a fixed interest rate mortgage for 15 years at three percent. The inflation rate is two percent. That's free money. It's just free money, and if you think of it sort of after tax, I've been lent a very large amount of money at a zero interest rate again.

NICK SARGEN: You're the father of international capital flows contribute to these excesses. So what do you do, though, in addition to what the Fed has done? Guess what. Mrs. Watanabe in Japan is saying, "But Professor Aliber, I'm getting negative interest rate on my Japanese government bond yields. So I'm better off earning your lousy two and a half percent yield." So here's an example again of international capital flows pouring into this country. Is the problem the U.S. or is the problem Japan, Europe?

ROBERT ALIBER: It is a global problem because the IMF does not fully understand the domestic consequences of the sharp variability in cross-border investment flows. But we should not experience significant increases in the unemployment rate in our tradable goods industry simply because Mrs. Watanabe wants 40 basis points more on her U.S. dollar securities.

CONSUELO MACK: This is the famous Mrs. Watanabe in Japan.

ROBERT ALIBER: Yes, exactly.

CONSUELO MACK: Who's making these decisions as an individual that are in her best interest but that can be very disruptive.

NICK SARGEN: She was the first carry trader, so she loved yield. Loved yield.

CONSUELO MACK: So, I'm hearing two things here. One is that the Fed has a large influence on long-term rates, but so do foreign investors and, therefore, when you've seen these large flows of funds coming in to the U.S. Treasury market, the U.S. dollar securities because they even with low rates are much more attractive than the $10 trillion worth of negative rates that you can get in other countries, you can understand that. Is that creating a possible bubble in the U.S. Treasury market with these flows that are coming in that again could cause a real problem in the U.S. bond market?

ROBERT ALIBER: U.S. bond prices will be lower a year from now than they are.

CONSUELO MACK: Have you said that before, though?

ROBERT ALIBER: Not in this room.

CONSUELO MACK: Maybe a year ago? Or the year before that? What's going to do it, Bob? What's going to make the difference?

ROBERT ALIBER: With the economy at full employment we're going to see further increases in the inflation rate, and the Fed will take the initiative eventually of allowing interest rates to increase. There will be momentum in the inflation rate, and then we will have the bond market vigilantes who will come and will essentially short bonds because they believe that they have more ammunition than the Fed and that the Fed will have to cave and accept that interest rates will be higher.

CONSUELO MACK: And there goes the economy too. Right? Possibly? Or how damaging to the economy?

ROBERT ALIBER: The economy has a lot of positive growth momentum. We are at full employment.

CONSUELO MACK: All right, what do we do as investors, Nick Sargen?

NICK SARGEN: I actually am a believer in the resilience of the U.S. economy. How many times have people predicted the double dip that's never materialized? So that's been one of the lessons, but I believe that once the Fed does raise interest rates, I don't think markets are yet prepared for it. They believe the Fed has cried wolf, and so I don't know that it's the U.S. that is vulnerable. What did we see at the beginning of the year and late last year? We saw the emerging economies come under tremendous strains because the anticipation then was higher interest rates.

CONSUELO MACK: Here.

NICK SARGEN: Here. Weakened commodities hurt the debt servicing capability of these emerging economies.

CONSUELO MACK: Hurt their currencies.

NICK SARGEN: So your other question then on me is, so what do I do in these circumstances? We have a Hobbesian choice. I mean we're sitting here saying we agree with Bob that eventually yields will rise, but we recognize that we can't time it perfectly, and we still may be in a low interest rate environment for a while. So really in terms of our investment positioning, what we are not doing is taking big interest rate bets right now.

CONSUELO MACK: On either way.

NICK SARGEN: Yes. We're just saying ...

CONSUELO MACK: Either for them staying lower longer or for them ...

NICK SARGEN: That's right.

CONSUELO MACK: ... going higher sooner.

NICK SARGEN: What we have been doing is saying we think Bob's right that the U.S. economy is basically resilient. Therefore, we'll take credit risk. So we've been invested in investment grade corporate bonds. We've been invested in high-yield but I'd call it high-quality high-yield. So in our view we are compensated today for credit risk, but we're uncertain about the timing of when Bob's going to be right about the interest rate increases. So we're kind of neutral on the market for the time being.

CONSUELO MACK: So the U.S. bond market being expensive, you agree with Bob about that.

NICK SARGEN: Long term, long term, meaning if you gave me a couple of years, the bond yields, they're going to be higher than they certainly are today. What I don't know is, I've got to manage money to get me through this year into next year. I'm not sure about that time horizon. I'm not convinced that they go up that much in that time horizon.

CONSUELO MACK: What about the possibility of a bubble developing in China and how damaging that could be?

NICK SARGEN: I do agree with Bob that at the top of I think our list, the Bank for International Settlements has done a very good job now creating early warning systems. China is at the top of their list, but that said, there's bubble and there's bubbles. So the market to worry about is the one Bob described. It's the property market because that's where a lot of people have their wealth. That's where the financial institutions have their exposure.

CONSUELO MACK: You are writing a book about monetary turbulence, and my question for you is, are we going to be in for a period of continued monetary turbulence?

ROBERT ALIBER: Yes, yes. It takes a long time for the policymakers at the global level to essentially come to a shared conclusion about the source of the turbulence. So they'll have to agree and then they'll have to figure out, given our analysis, how do we essentially dampen the turbulence? Where do we put the speed bumps to better insulate one economy from the mischief in other economies?

CONSUELO MACK: In the meantime, until those speed bumps – whatever they may be, form they may take – are implemented, as far as the economy is concerned and global economies are concerned, what are you predicting?

ROBERT ALIBER: We will see erratic, large changes in the prices of currencies. The only currency that has not has a major decline is the Chinese yuan, the RMB. So we can expect that the price of that currency will decline, and that means that foreign money will surge into the United States. It means that unemployment in our tradable goods industries will increase.

CONSUELO MACK: Will increase. Right. So the manufacturing sector again will be hurt.

ROBERT ALIBER: Our manufacturing sector will be bleeding.

CONSUELO MACK: What is your outlook for the dollar?

ROBERT ALIBER: The weakness in other currencies means the dollar is strong, in a way too strong given that we are concerned about the impact of an increase in imports on unemployment in our tradeable goods industries.

CONSUELO MACK: Nick, do you concur with Bob about you envision continued strength in the dollar and, if so, what are the investment implications?

NICK SARGEN: No, I think that's the correct call. I think that currencies tend to move in cycles of multiple years, and we had had two very strong years for the dollar. Then we moved a little bit sideways for a while when the market was unsure of the Fed, but if the Fed at some point comes into play and we still have other central banks feeling the need to ease, that's generally a recipe for a stronger dollar.

CONSUELO MACK: You have written a book, *Global Shocks: An Investor's Guide for Turbulent Markets*. Clearly you are predicting that we are also in for more turbulent markets. How turbulent?

NICK SARGEN: It remains to be seen. I don't think that we're going to necessarily go through another 2008 financial crisis. That was kind of the mother of all crises, but I think to Bob's point that people just accepted these crises as one-offs, and I think really it was 2008 was so severe that then people said, "What's going on?" and a lot of people I think made the wrong conclusion. It was a mistake in the sub-prime sector. Again you find the specifics. I think I became a believer of what Bob was saying about the increased frequency, and right now again my theme has been that there's disequilibrium in markets that economics profs don't talk about, that finance profs don't talk about.

CONSUELO MACK: Except for Bob Aliber. Right?

NICK SARGEN: That's right. I'm not saying all the time. Most of the time markets function normally. So I have two hats to wear. Is this a normal market? In which case everything I was taught, I pay attention to. Or is this an abnormal crisis-type market in which case I need a new set of guideposts.

CONSUELO MACK: Do you believe there is a crisis developing that could happen in the next year or two?

NICK SARGEN: I would say the risk, yes. As Bob says, to me it’s the potential for something going wrong in China or other emerging economies. Remember one of the points I want to make here too is even when China was everybody’s darling, you couldn’t really invest in China directly. You had capital controls. So what did everybody do? Everybody did the indirect play.

CONSUELO MACK: Hong Kong.

NICK SARGEN: Invest in Brazil, Australia, all the suppliers of resources into China, but once China slowed, what did we see? Huge dislocation in commodity prices. Then these emerging economies come under tremendous strain. So the famous BRICS concept; it looked like a genius in the 2000s. One of the worst performing investment ideas in the current decade.
So my argument isn’t necessarily don’t invest in emerging markets, but I’m basically saying you’re going to have to be more selective in which emerging markets to be in. It’s not going to be a rising tide lifting all boats or sinking all boats. You’re going to have to pick and choose which economies are more vulnerable to developments in China.

CONSUELO MACK: Given what you know about the crises, these waves of crises that we’ve gone through, what would be your one investment for a long-term diversified portfolio?

ROBERT ALIBER: Well, for American investors, this is a time to buy bank stocks, and that’s because the Fed’s policy of keeping interest rates low has crimped bank earnings, but if interest rates are going to rise, then bank revenues will rise, and bank profits will rise. The prices of bank stocks will increase.

CONSUELO MACK: Are these money center banks you’re talking about or just ... ?

ROBERT ALIBER: All of them.

CONSUELO MACK: All of them.

ROBERT ALIBER: All of them, or a fund that invests in regional banks or a fund that invests in community banks. This tide is going to lift a large number of bank stocks.

CONSUELO MACK: Nick, what would your one investment be?

NICK SARGEN: My one investment would be investing in private debt in companies, and you can do that either by investing in illiquid instruments or you can go into the public market in business development companies. The biggest question I get is, "Nick, I just want to earn some interest. My bank isn't giving me anything. I barely get enough even to go into corporate bond markets. So what can you do?" So our own firm, my parent company which is an insurance company, has been making investments in this area but ...

CONSUELO MACK: Western & Southern.

NICK SARGEN: Western & Southern. But I realize not everybody may have millions of dollars to go into these, so what's available to the individual investor? So basically you can go on the stock exchange for some entities. It's called business development companies, BDCs, and you can go buy shares in these institutions that are making loans to smaller, mid-sized companies on a diversified basis. So the appeal is several-fold. Number one, the interest rate is based off of a floating exchange rate. So if interest rates go up, you're not disadvantaged. Two, you get very attractive spreads depending on the level of subordination, but for senior debt you might get five and a half percentage points above LIBOR on that. Not bad in this environment. So we see that appeal, but truth in advertising though. You have to do your homework. One of the disadvantages is they tend to charge high fees. It can be as much as three percent. So read your prospectuses, but again when people come to me and say, "Find me yield with acceptable credit risk," I think this is an interesting to explore.

CONSUELO MACK: All right, we're going to leave it there. Nick Sargen, thank you so much for being here and, Bob Aliber, it's really a treat to have you on WEALTHTRACK.

ROBERT ALIBER: And for me.

CONSUELO MACK: At the close of every WEALTHTRACK, we try to give you one suggestion to help you build and protect your wealth over the long term this week's Action Point is take a cue from Bob Aliber and: Take advantage of still extremely low interest rates. As Aliber told us, he just refinanced his home with a fixed interest rate mortgage for 15 years at 3%. As he said with an inflation rate at 2%, that's free money and after tax it's getting a large loan at a zero interest rate. So wherever you can lower your interest rates to lock in these low rates, do it.

To see this interview again, please visit our website, wealthtrack.com. Also thank you for connecting with us on Facebook and Twitter.

Have a great weekend and make the week ahead a profitable and a productive one.