ARE WE ON THE VERGE OF A FINANCIAL CRISIS?

As we close out 2018, remember that this past year marked the 10th anniversary of the last financial crisis. The economic recovery from that time has been slow but remarkably sustainable. And although today's economy remains quite sound, rising U.S. interest rates and ongoing trade tensions with China have many experts pondering if we are on the verge of the next financial crisis or at least a downturn.

Overview

The year started out on a high, as tax cuts were expected to fuel corporate capital spending and job expansion. While corporate profits increased, so did government spending – a bane that continues to increase the federal deficit.

As we turned the corner in autumn, October 2018 was much like many Octobers of the past. Stocks experienced a sharp drop, spurred by selloffs in the technology and energy sectors. Crude oil plunged precipitously. The Dow Jones Industrial Average (DJIA) experienced its biggest monthly drop since October 2008, and the S&P 500 marked its sharpest monthly descent since September 2011. During November, the volatility continued with stocks further losing ground.[1]

The question now becomes: Is the United States in such an unsettled state that another economic crisis is now in our crosshairs?

Warning Signs

Most financial downturns are precipitated by warning signs. An economic crisis can be sparked by any one factor or a series of factors that contribute to a downfall. For example, the 2008 crisis was triggered by what has traditionally been considered a reliable, long-term growth asset: residential housing. However, the subprime mortgage debacle led to a variety of domino effects, from bank failures to corporate cutbacks to home foreclosures when residents could no longer pay their mortgages.

Historically, U.S. economic crises have been sparked by stock market crashes, spikes in inflation or unemployment, or a series of bank failures, which usually result in an economic contraction. To examine if we are currently poised for another recession, let's review some of the current factors.

Reduced Bank Capital Requirements
Last May, President Trump signed bipartisan legislation that loosened parts of the Dodd-Frank Act, specifically for U.S. banks with less than $700 billion in assets. The move relieved smaller financial institutions from stricter federal oversight, leaving the capital requirements passed after the 2008 crisis for larger banks intact. However, a recent study from the Department of the Treasury reported that the U.S. financial system still would be in significant peril if one or more large banks fail.[2]

Soaring Debt
As is human nature, once jobs returned and consumers got back on sounder financial footing, they began to spend money again — in many cases, money they didn't have. Hence, over the last 10 years, credit card debt, subprime auto loans, loans that finance corporate leveraged buyouts, and general corporate debt have been on the rise. Worse yet, the new tax law and spending subsidies have ballooned the federal budget deficit.

A new component to this problem is massive student loan debt, now logged at $1.3 trillion. Much like what happened in the past with subprime mortgages, students have been awarded college education loans that they are unable to repay given the job market and stagnant wages upon graduation. In short, student loans are easy to get but hard to pay off.

The fallout has long-term consequences. Not only do young adults start out life under the weight of crushing debt, but many who would otherwise start their own businesses are less inclined or simply incapable of doing so.

The Federal Reserve

The Federal Reserve recently issued its inaugural financial stability report. In it, the Fed appears to be most concerned with corporate debt, which, relative to GDP, is historically high and marked by increased lending to higher-risk borrowers.

Despite these findings, the Fed recently voted on a proposal to further loosen liquid capital requirements among mid-sized banks. Specifically, firms in the $100 billion to $250 billion asset range would be subjected to stress-test requirements every two years instead of annually. They also would be exempt from holding a liquidity coverage ratio of high-grade assets that easily convert to cash.

The new oversight rules would divide U.S. banks into four tiers:[3]

- Globally systemically important banks (GSIB) — subject to the most strenuous stress-testing and capital holding requirements because they are considered "too big to fail"
- Banks with more than $700 billion in assets
- Banks with between $250 billion and $700 billion in assets
- Banks with between $100 billion and $250 billion in assets

The new Fed stance on stress-testing and capital requirements implies a higher degree of confidence in today's financial system. The committee has further indicated:[4]

- The increase in household debt is generally aligned with the rise in household income
- The nation's largest banks are strongly capitalized with a high level of liquid assets
- Leverage among broker-dealers is currently below pre-crisis levels
- The nation's insurers have strengthened their financial position

The Fed has indicated it is still on target to gradually increase interest rates in an effort to curb exuberant growth in exchange for long-term stability. However, if there is fear of a pending financial crisis, the alarm is not being set off by the Fed.

"Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy — that is, neither speeding up nor slowing down growth."[5]

— Jerome Powell, Chairman of the Federal Reserve

Ways to Prepare

The overall assessment appears to be that no one is pushing the panic button just yet. However, retirees and near-retirees tend to have a different set of concerns than younger investors. In short, they don't have time to make up for any missteps.

Fortunately, much of the advice given to help prepare for a financial crisis is the same whether the economy is strong or weak. In fact, it is generally easier to deploy such recommendations during times of economic strength, so now would be a good time to get your financial ducks in a row.

The following are some tips worth considering:[6]

- Pay off all credit card debt.
- Have up to three to six months' worth of living expenses saved in a liquid account to help cushion the prospect of losing your job.
- Consult with your advisor to see if your current plan is "stress-tested" to meet your specific financial needs, both now and in the future. This includes a diversified portfolio with a strategic asset allocation.
- Remember to rebalance your allocation periodically to ensure that gains or losses do not tilt your portfolio to be too risky or too conservative for your long-term goals.
- Work with a financial advisor you trust for more preparations tailored to your unique situation.

Final Thoughts

The near-decade-long bull market has increased U.S. household wealth to historic highs. Fortunately, even with recent market turbulence, there appears to be a significant margin of cushion for many households that have diligently paid off debt, increased savings and resumed investments in the securities markets.

Continued vigilance and monitoring is perhaps the best way to pick up on warning signs and weather the next downturn, whether it comes in a year or further in the future.

[1] William Watts. Marketwatch. Nov. 28, 2018. "Why the stock market's autumn tumble raises the odds of a recession by 2020." https://www.marketwatch.com/story/how-the-stock-markets-red-october-raises-recession-odds-2018-11-27. Accessed Nov. 28, 2018.
[2] Mark Kolakowski. Investopedia. March 5, 2018. "4 Early Warning Signs Of The Next Financial Crisis." https://www.investopedia.com/investing/early-warning-signs-next-financial-crisis/. Accessed Nov. 28, 2018.
[3] Sylvan Lane. The Hill. Oct. 31, 2018. "Fed releases plan to loosen rules for major US banks." https://thehill.com/policy/finance/414105-fed-releases-plan-to-loosen-rules-for-major-us-banks. Accessed Nov. 28, 2018.
[4] Steve Goldstein. Marketwatch. Nov. 28, 2018. "Fed flags concerns over corporate debt in first-ever financial stability report." https://www.marketwatch.com/story/fed-flags-concerns-over-corporate-debt-in-first-ever-financial-stability-report-2018-11-28. Accessed Nov. 28, 2018.
[5] Thomas Franck. CNBC. Nov. 28, 2018. "Short-term yields slip after Powell says rates are 'just below' neutral." https://www.cnbc.com/2018/11/28/bonds-and-fixed-income-fed-chair-remarks-and-gdp-in-focus.html. Accessed Nov. 28, 2018.
[6] Kimberly Amadeo. The Balance. Nov. 20, 2018. "US Economic Crisis, Its History, and Warning Signs." https://www.thebalance.com/u-s-economic-crisis-3305668. Accessed Nov. 28, 2018.