Fix one thing, break another. Parallels Between 2001 and 2009. Another Credit Bubble.

The Parallel Stages of the Credit Bubble 2001 versus 2009

Stage 1: An event drives investors into a particular asset class. At this stage the investment thesis for investing in such asset class is likely still sound. When interest rates were cut aggressively in 2001 in the aftermath of the Dotcom bubble bursting investors fled equities and went into fixed income compounding the problem of finding attractive high yielding assets. In the aftermath of the 2008 credit crisis investors fled risky assets such as equities and reallocating into risk free assets like US treasuries.

Stage 2: Valuations in the security asset (that's the asset investor flee into as they exit the distressed asset), in 2001 corporate bonds, and in 2008 US treasuries, rise, causing yields to compress.

Stage 3: In 2001 as valuations of corporate bonds rose and their yields compressed, alternatives had to be found. Investors moved out the term structure as well as down the credit quality curve leading to a yield drought. In 2008 investors diversified out of US treasuries to corporate credit in a similar pattern moving out the term structure and flattening he yield curve as well as moving down the credit quality ranking from investment grade to junk.

Stage 4: Investors sacrifice quality and prudence for immediate gratification. In the 2001 story, investors later piled into SIVs and CDOs because of the higher yields and at times, a favorable credit rating, for whatever that was worth. In 2008, structured credit was at the heart of the crisis and

as a result investors have remained cautious about the asset class. However, investors have managed to pile into everything from emerging market hard currency and local currency debt, junk bonds (or high yield as they are now more respectfully referred to), option writing on any underlying instrument with even a shred of volatility, and dividend paying equites.

Stage 5: When investors seek a specific type of product, regardless of the rationality of that objective, the financial industry always obliges. In the aftermath of 2001 investors sought yield as well as some form of validation in the form of a credit rating. The financial industry packaged assets of varying quality and then issued tranches liabilities of differing claims, often obtaining a credit rating, and a high one at that, in order to satisfy both yield and credit rating criteria. The result were SIVs and CDOs. The perversion of these constructs did not happen immediately but set in when demand for liabilities outstripped the availability of assets and led to serious adverse selection issues in credit markets, most notably the mortgage market. The rest is history. It is also poetic that a construct designed for the dynamics of an earlier crisis should precipitate the second one. We haven't yet seen a construct addressing the insatiable thirst for yield this time but we have seen some questionable solutions. Mutual funds which pay dividends come hell or high water are one example. These funds may be equity funds or bond funds or balanced funds but their defining feature is a promise to pay a frequent (often monthly, sometimes quarterly) dividend. Some of these funds will even pay out of capital when income is insufficient, a practice which simply doesn't smell right. Having squashed bond yields, some funds have specifically targeted high dividend paying equities, creating a surreal bull market in these types of stocks. One can only hope that fund managers do not go so far as to invest in companies who pay dividends out of capital or new debt. That would be too comical. Other strategies involve employing increasing leverage to portfolios of bonds, a stratagem which finds

parallels if not analogues in CDOs and SIVs. Still other desperate measure for yield junkies involve option writing on any convenient underlying instrument within easy reach.

The parallels between the reaction to the Dotcom bust and the reaction to the 2008 financial crisis are remarkable. History doesn’t repeat itself but it does seem to exhibit a consistent autocorrelation.