It’s Been 10 Years Since the Collapse of Lehman Brothers: 3 Lessons for Investors Today

Description

On September 15, 2008, the financial services firm Lehman Brothers filed for Chapter 11 bankruptcy protection. This still represents the largest bankruptcy filing in the history of the United States, as Lehman held over $600 billion in assets at the time. The event triggered a domestic and global sell-off and ushered in a period of financial panic unseen since the Great Depression. Weeks later, the Emergency Economic Stabilization Act of 2008 was passed and authorized the U.S. Treasury to spend up to $700 billion to purchase distressed assets.

Fortunately, the United States and much of the developed world managed to escape the carnage of the financial crisis, and markets have thrived in the decade since. Canada stood out at the height of the financial crisis and received praise for the stability of its banking system. It was not unaffected, however, and the Bank of Canada moved quickly to drop interest rates to historic lows to avert catastrophe.

Today, we are going to explore some of the lessons of 2008 and determine whether investors can take measures to avoid missteps during periods of crisis.

Central bank flexibility has waned over the past 10 years

Central banks were forced to use many of the munitions at their disposable at the height of the financial crisis. This was not limited to dropping interest rates, but also included bold asset-purchasing programs in the United States, Europe, and Japan. The United States followed up its bailout package with two more rounds of quantitative easing, the last of which was announced in September 2012. In an 11-1 vote the Federal Reserve elected to launch a $40 billion per month, open-ended bond-purchasing program.

With economic growth picking up in the developed world in recent years, central banks have vowed to taper asset-purchasing programs while also gradually raising interest rates. Plunging liquidity is just one reason for investors to be cautious going forward.

The Canadian financial system is more vulnerable

After the financial crisis many Canadians boasted that the stability of their financial system protected them from being exposed to the worst elements of the crisis. Unfortunately, Canadians may not be able to say the same in 2018. I'd recently discussed a research note from **Goldman Sachs** that drew attention to private-sector financial balance, a metric that has been an accurate predictor of crises in the past. Canada joined the United Kingdom as two countries showing red flags, as both "are running sizable deficits and appear vulnerable to higher interest rates and weaker asset markets."

Canada was forced to deal with what some referred to as a "mini-Lehman" back in the spring of 2017 as **Home Capital Group** (TSX:HCG) narrowly averted collapse. The company has managed to recover in the months since with the help of public and private funds, but the crisis highlighted the precarious status of the Canadian housing market. Since then, Home Capital has climbed back into profitability, but mortgage origination growth has come in much slower than before.

In the second quarter, Home Capital posted diluted earnings per share of $0.37 compared to a $1.73 per share loss in Q2 2017. This also came in slightly below analyst consensus at **Thomson Reuters**. Mortgage originations were up 10% year over year to $1.23 billion in the second quarter, as the company has settled into new internal practices. Home Capital still stands as an example of how quickly the contagion from one company can spread in a short amount of time. Fortunately, its management team has been successful in bringing it back from the brink.

Be cautious in a late cycle

This may be the most important lesson of all. We have passed through one of the longest bull-market runs in history in the United States, while Canadian stocks have also performed very well over this stretch with some hiccups in between. U.S. economic growth has surged since the passage of tax reform, but there are concerns that this is a short-term fix in the face of lingering fundamental problems. Canadian GDP growth is also projected to drop below 2% by the beginning of the next decade. Investors should prepare accordingly, as all signs point to economies in the developed world entering a late cycle.

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