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800-319-9533

A Recession or a Full-Blown Financial Crisis?

- Carol Roth

In this informative newsletter, Carol covers A “lowlights” recap of the last big financial crisis as a benchmark for today; Why we may only be in the “early innings” of a broader financial catastrophe; Why commercial real estate is creating red flags; What CLOs are and how those could also create systemic financial issues; How to prepare for what’s ahead; and more.

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A Recession or a Full-Blown Financial Crisis?

Looking to the recent past for benchmarks, the US economy may be far from out of the woods

Some of the folks who told us that the economy was doing just great are starting to admit signs of weakness. Of course, they are not taking any of the blame for causing it nor admitting that they were stupid, untruthful or both with their litany of past economic statements, starting with "there will be no inflation," continuing to "inflation is transitory" and most recently, from US Treasury Janet Yellen, who said earlier this month, "The US economy is obviously performing exceptionally well, with continued solid job creation, inflation gradually moving down, robust consumer spending…I'm not anticipating a downturn in the economy."

We know that the second phase of the double dip recession that entered phase one in the first half of 2022 and then had a small recovery (on the back of massive government spending and consumer spending that turned individual's balance sheets upside down and saw the government racking up bigger deficits) could be here sometime this year.

A recession is one thing, but a broader financial crisis is something else entirely. We have already seen the real implications and crisis for many people from the substantial inflation we have been enduring for more than two years. We have had a small meltdown in the banking sector. So, is the recession the only thing ahead or is this something bigger?

I thought it would be helpful to look back to the Great Recession Financial Crisis to revisit the timeline. In the rearview mirror, it is sometimes hard to remember the way things unfolded and the duration of the meltdown.

In addition to the information discussed below, at the bottom of the piece I share some information on Goldline, who can be a resource for any hedging you are doing in terms of precious metals in your preparations for what's ahead.

GRFC 2.0?

Below is a timeline with the highlights, well, rather, the lowlights, of the Great Recession Financial Crisis ("GRFC"). The list is made up of select key happenings; it is not meant to cover every single event, but rather give us an easy to digest set of benchmarks and timing for that economic period. This data was sourced from the St. Louis Fed, as well as History.com, both of which have more granular detail if you wanted to dig more deeply.

US Great Recession Financial Crisis "Lowlights" Timeline

February 27, 2007: Federal Home Loan Mortgage Corporation aka Freddie Mac announces "tighter standards" for purchasing subprime mortgages/mortgage-related securities

April 2, 2007: Subprime lender New Century Financial declares Chapter 11 bankruptcy

June 1, 2007: Rating agencies downgrade more than 100 second-lien subprime mortgage-backed bonds

July 2007: More than 600 securities backed by subprime residential mortgages put on credit watch; Countrywide Financial Corporation warns of “difficult conditions”; Bear Stearns liquidates two mortgage-backed security-tied hedge funds

August 6, 2007: American Home Mortgage Investment Corporation declares Chapter 11 bankruptcy

September 18, 2007: Fed starts its reduction of interest rates (50 bps)

October 9, 2007: Dow hits a record high

December 2007: Technical beginning of Great Recession, per NBER

January 11, 2008: Bank of America buys Countrywide

March 16, 2008: Bears Stearns collapses, purchased by JPMorgan for $2/share, after tumbling from the $30 range days before

July 11, 2008: Mortgage lender IndyMac collapses

September 15, 2008: Lehman Brothers goes bankrupt

September 16, 2008: AIG bailed out by US govt

October 3, 2008: TARP bailout is announced

October 6-10, 2008: Dow goes into freefall, worst week in history for points decline

November 23, 2008: Government does a direct bailout of Citigroup

November 25, 2008: Fed initiates QE1

December 2008: TARP funds make their way to bailout the large automakers

December 16, 2008: The Fed reduces its target rate to 0 for the first time in history

January 16, 2009: Government does 2nd largest bailout of the recession (Bank of America)

March 9, 2009: Market hits Great Recession low point, Dow 50+% off its all-time high

June 2009: Supposed “official” NBER end of the Great Recession in the US

June 1, 2009: GM files for bankruptcy

October 2009: Unemployment hits 10% in the US

December 2009: Housing foreclosures hit record levels (2.9 million for the year)

August 5, 2010: Standard and Poor's lowers US govt credit rating from AAA to AA+ for the first time ever

August 2, 2012: Dow hits a new record high, 3+ years after the official "end" to the Great Recession

You can see that the unraveling of the various financial and economic components took quite a while to happen, with the market hitting a high a couple months prior to the recession beginning. If the current scenario is anything like this, we could be in the first third to half of this type of a timeline.

Obviously, the environment today is different, so the timeline won't be entirely apples to apples, but given the scope and duration of negligent, indulgent monetary and fiscal policy, it is very possible that there are more severe implications to ponder.

Given that the residential housing market is in much better shape today than in the mid-late aughts, somewhat based on lessons learned, somewhat based on the undersupply in the market leftover from the crisis, that is less likely to cause a systemic issue.

Corporate real estate, particularly the office building component, however, is causing substantial concerns. Various analysts and investors are starting to sound the alarm bells, including Morgan Stanley. The CIO for Morgan Stanley Wealth Management, Lisa Shalett, published a recent report saying, "Commercial real estate, already facing headwinds from a shift to hybrid/remote work, has to refinance more than half of its mortgage debt in the next two years."

In terms of the office sector, CNBC reported that "Almost a quarter of mortgages on office buildings must be refinanced in 2023, according to Mortgage Bankers' Association data."

This is an issue for the industry, whose participants have to deal with the one-two punch of substantial vacancies, which drives down property values, and higher interest rates (assuming with the degrading conditions of both office buildings and banks, that debt even can be refinanced).

It becomes a potential vicious cycle. If building owners cannot refinance and their loans "go bad", that will be another drag on the banking sector.

In terms of broader economic impact, CNBC said, "The primary way real estate could cause problems for the economy is if an extended decline in the value of commercial mortgages made deposits flow out of banks, forcing them to crimp lending not just to developers but to all customers. In extreme cases, that could threaten the banks themselves."

Of course, derivatives played a substantial role in terms of the scope and duration of the Great Recession Financial Crisis. In terms of the corporate real estate industry, that derivatives market is smaller than the residential real estate derivatives market, with office buildings comprising just a piece of that market. However, it is hard, without rigorous and deep analysis, to know what that exposure looks like. Moreover, even if such an issue impacts just a few banks, that could cause a domino effect.

Speaking of derivatives, Collateralized Loan Obligations (CLOs) are also an area to keep an eye on. These are pools of corporate loans, with exposure to risky loans with lower investment gradings, that have been packaged into securities. If that sounds familiar to the mess of securities backed by pools of

mortgages at the center of the Great Recession Financial Crisis (CDOs), it is because it is the sister product with a different set of underlying loan products (corporate loans vs. mortgages).

There are many other issues that could create an economic contagion. All of the cheap and available debt was certain to cause issues. Looking at history, including recent history, there is a decent probability that we will see more fallout above and beyond the inflation we have seen to date, a few bank closures and a recession.

How do you prepare?

For a lengthy recession or financial crisis, you want to make sure you have more access to funds on demand. Keep your spending tight, build up an emergency fund, and take any overage and consider investing that into hard assets where you can.

If you haven't had an opportunity to hedge your own portfolio, or haven't hedged enough, consider giving my friends at Goldline a call to help you (they are the only place from which I personally get my precious metals). And don't wait on this; hedges should be continually evaluated and adjusted on an ongoing basis, dependent on your current portfolio, your risk tolerance, your objectives and of course, the changing economic backdrop.

Only time will tell how bad the fallout will be. As I have said before, hope for the best but prepare for the worst, as history doesn't necessarily repeat but, as Mark Twain allegedly said, it often does rhyme.

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