From Whence Come Liquidity

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For a good 9 months we've observed an inverted yield curve that seems to indicate nothing other than a curiosity of a new millennia. This is no longer a good predictor of a forthcoming economic slowdown , much less a recession. The new world we live in is attended with so much liquidity that the need to invest it, even at low long term rates, is too compelling to pass up. But what of the banks and their spreads? Well a reasonable assumption would be that they begin to constrict their lending as their margins begin to show signs of stress. There has been somewhat of a disconnect here though. It seems that whatever slowdown we might discern is of small magnitude. Could it be that banks no longer invest in high quality U.S. Treasuries and financially sound businesses and mortgage obligations of the highest order for the bulk of their lending? Possibly opting for more and more low quality credits including high risk credit operations, subprime mortgages and risky business loans? It would make sense in an era where you could simply carve out the risk and sell it to someone for a premium (read hedgefund, private equity, foreign bank, etc) and then believe yourself to be fully protected from the fallout if it should occur. But what if every banker, in his infinite wisdom, decided not to be left out of such a fruitful endeavor? Would the overall risk simply disappear because the added buffer of a derivative contract disabuses the issuer of some risk? If I insure against a hurricane does that mean the hurricane is much less likely to ruin my property? In fact, because of the ability to insure a house against the damage of a hurricane, I might just temp fate and build one where I have a high likelihood of a hurricane doing just that, as I have nothing to fear of a financial loss. Ah, but you say that such insurance would be quite costly and prohibitive! And there you just might be right. However, if where I build is highly susceptible but has *never* experienced such an event then I presume the premium would be quite acceptable.

You may now begin to see my point. The explosive and pervasive use of credit derivatives has emerged so rapidly and with such acceptance that what may be most probable appears as a low probability. ***It** has not happened.* So we build our castles in the sand. Interestingly enough, *it* actually has happened. An historian would wryly point to the South Sea Bubble, Depression era stock margining, or Japan's debt bubble of the early 90's. In each case we find something old, something new, something *borrowed* and something blew (as in blew up!). I've heard the arguments; many, many of the arguments, of how it is different this time. The most common among them is how well the markets have held up under many recent adverse events. The logic is lost on me as one might argue to turn a single story house into a two and then a three story one because the recent hurricane (a category 2 or 3) did very little damage. But as we build, so we increase the risk of loss.