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Has Financial Innovation Undermined the Global Economy?

The pooling, repackaging and sale of debt to investors through securitization have provided many benefits to the capital markets, from distributing risk more broadly to increasing sources of liquidity. But they also have given rise to many of the excesses behind the recent market volatility and to concerns about global recession. We examine how these results came about, and where we see the global economy headed from here.

Lewis A. Sanders
Chairman and Chief Executive Officer

JUNE 2008

About the Author

Lewis A. Sanders

Chairman of the Board of Directors and
Chief Executive Officer

Mr. Sanders became AllianceBernstein's Chairman in January 2005; he became CEO in July 2003. He had been Vice Chairman and CIO since October 2000. Before the combination of Alliance Capital and Sanford C. Bernstein & Co., Inc. in October 2000, Mr. Sanders served for seven years as CEO of Bernstein. In his 32 years at Bernstein, he also served as president and chief operating officer, with senior responsibility for all research and investment-management operations (1981–1993); executive vice president (1979–1981); and research director (1972–1981). Mr. Sanders joined Bernstein in 1968 as a research analyst, establishing credentials that would lead to his being named to the *Institutional Investor* All-America Research team four times. Before joining Bernstein, Mr. Sanders worked at Oppenheimer & Co. for two years as a research assistant. He holds a BS in operations research from Columbia University. He is a CFA charterholder.

Has Financial Innovation Undermined the Global Economy?

Securitization contributed to a broadening of market liquidity, helping finance transactions that may not have been possible in the past. Not all of these transactions ended well, however, with subprime mortgages being a clear case in point. Where does this leave the global economy?

About this time last year, I published an AllianceBernstein white paper with the proposition that the world had become a less risky place. During the next several quarters, stock and bond prices fell sharply, volatility surged, risk premia widened substantially and illiquidity literally shut down important parts of the capital markets, conditions that hardly qualify as less risky. Indeed, some commentators describe the setting as the worst since the 1930s.

Many see the recent turbulence as having been caused by financial innovation, expressed in a series of securities that are poorly understood, hard to value and inherently unstable. Worse still, these new securities are thought to have made possible dangerous things like subprime mortgages, the damaging effects of which will not be easily absorbed.

An alternative view of this period is that it will go down as yet another example of how smart, knowledgeable people can overreact to circumstances that have a kernel of truth to them but carry nowhere near the consequences they fear.

So which vision of the world is right? Are we in the eye of a Category 5 hurricane, as some still believe, or is it now dissipating into a tropical storm that will soon pass altogether? At the risk of resurrecting the details of my prescient forecasts of last year, a review of the dynamics described then is important to understanding what side to take in this debate.

The Case for Stability

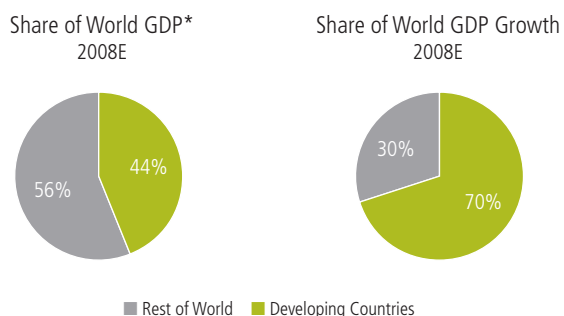
Last year I made much of the fact that economic volatility in the US had fallen sharply over the past 25 years, and that this drop in volatility was mirrored in other developed-world countries, including the UK, Japan and Germany. I pointed out that this newfound stability stemmed from lasting factors:

- A shift in GDP away from volatile categories like defense spending and toward stable categories like services;
- Improved inventory management, which cut sharply the volatility that this asset has historically imparted to GDP;
- Globalization, which has the effect of distributing economic dislocations in any one country, at least in part, to its trading partners, reducing its local impact;
- Flexible exchange rates, which naturally shift competitive advantage to the countries that need it the most; and
- Increasingly activist monetary policy that has become more effective in leaning against the economic tide.

I emphasized, too, that the less-developed world had accomplished a stunning transformation of a different kind, led by China and, to a lesser extent, India and some other countries. The foundation for sustained, rapid economic growth had been put in place, principally by embracing Western technology and know-how. This produced a surge in productivity on a scale unknown at any time in history, involving literally hundreds of millions of people.

Display 1

Developing Countries Are Now Driving World Economic Growth



As of March 31, 2008

*Developing countries are defined as constituents of the MSCI Emerging Markets Index. GDP weights were calculated using purchasing power parity.

Source: International Monetary Fund (IMF), MSCI and AllianceBernstein

I noted then this process had many years left to run, implying that the developing world would become an increasingly important source of global GDP growth. Indeed, such countries now account for nearly 50% of global economic output, and will source at least 70% of global growth in 2008 (*Display 1*).

Making this trend more secure is the fact that the developing world, with few exceptions, has also put its financial house in order. High local savings rates are financing high growth in capital investment while permitting surging current account surpluses, the accumulation of trillions in surplus foreign exchange reserves and falling external debt in relation to GDP (*Display 2*).

In short, the less-developed world has transitioned from being a source of volatility to a source of strength.

And yes, innovation in finance played a role too. Whatever their defects, securitizations and credit default swaps did make possible the diversification of credit risk for companies and for countries, while turning idiosyncratic risk to systemic risk, at a time when the system itself had become far more stable. By virtue of these features, these financial innovations contributed to a sharp decline in the cost of capital and increased its availability, becoming a potent force in terms of lubricating economic activity and stimulating growth.

Too Much of a Good Thing

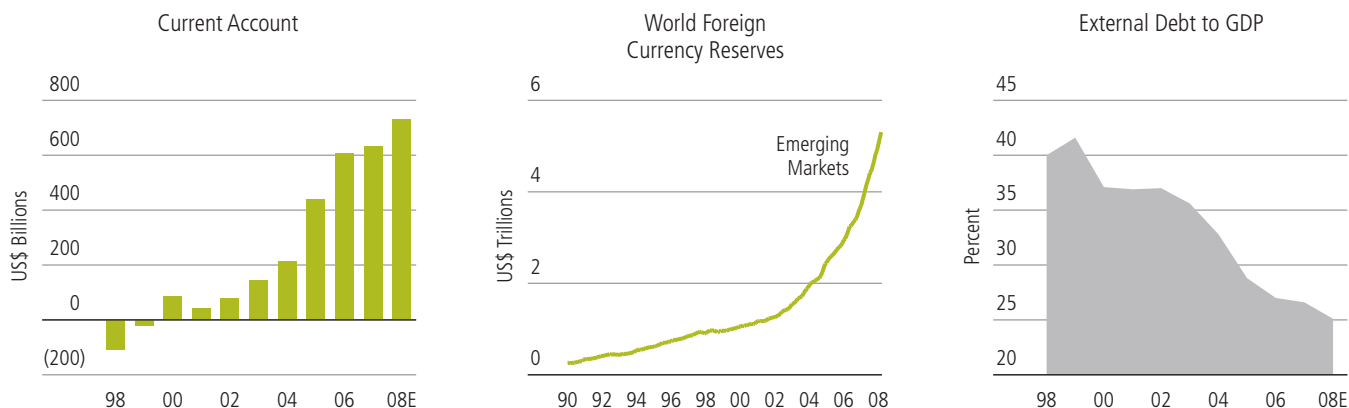
As noted in last year's paper, however, these accomplishments were vulnerable to being undermined—not by their lack of staying power but, ironically, because of it. Stability changes people's attitudes, in particular their attitudes about leverage. It makes people comfortable with more of it. It lulls people into thinking that it can be taken on safely—until it rises to a level that undermines the very stability that brought it on.

And until things blew up last year, leveraging was indeed on the rise. Mortgage finance was the clearest example. Speculative mortgage products gave rise to excess debt and a housing bubble, the aftermath of which we are now contending with.

Financial players were increasing leverage too, both explicitly and implicitly. For example, the notional

Display 2

Emerging-Market Fundamentals Remain Strong



Historical analysis and current estimates do not guarantee future results. Data, including estimates through 2008, are subject to change.

Source: IMF, World Economic Outlook, as of April 2008, and International Financial Statistics

amount of credit default swaps outstanding had grown to seven times the value of underlying instruments to which these securities made reference, promising to amplify the impact of any given movement in perceived credit risk. The earnings assets of leading investment banks were growing far faster than their equity, driving leverage ratios up. Hedge funds, which use leverage liberally even if their net positions don't appear aggressive, were growing at a breakneck pace. And, of course, there were the public-to-private recapitalizations that measured in the hundreds of billions of dollars, reflecting the fact that equities had not yet been repriced to a lower degree of risk. Equities were, to quote the title of last year's paper, "the last risk premium standing." It was a logical arbitrage to take the equity holder out with inexpensive debt.

Our conclusion then was that this recapitalization process had some distance to run. Leverage did not yet seem high enough to trigger trouble. Indeed, privatization notwithstanding, leverage was actually near a modern-day low for corporations around the globe. It still is today.

The message of last year's paper was to enjoy the ride while it lasted.

That ride lasted roughly another two months.

We know all too well what followed. Instead of the subprime excess being contained, as we thought probable, it engendered a viral response as it broke into the fore with the collapse of two hedge funds exposed exclusively and excessively to this type of securitization. Illiquidity and rising risk premia quickly spread to all forms of securitizations, which—given the fact that these instruments accounted for more than half of private-sector debt creation in 2006—quickly became highly disruptive. The pressure focused on banks, which were now hung with loan commitments, both on- and off-balance-sheet, for which they were ill prepared.

Mark-to-market accounting, a feature of securitizations, made things still worse, since valuation was no longer merely an issue of credit-related markdowns, as in the old days, but was now also affected by additional markdowns for illiquidity, opaqueness and the surge in risk premia generated by the turbulent times. The hit to capital from mark-to-market accounting turned out to be huge—measuring in the tens of billions for some institutions.

Declining capital and rising volatility led to widespread actions to deleverage, some voluntary and some forced, adding pressure to the markets. All of these forces caused many institutions and investors to husband liquidity. A distrust of counterparties then surfaced, bringing us to the very brink of systemic failure with the run on Bear Stearns, averted only by the deft action of the Federal Reserve Board. It was then, in mid-March, that the Cassandras became the most vocal—it was then that risk premia reached their highest levels.

Cushioning the Blow

But the worst fears of the bears have not yet materialized. So far the disruption in the capital markets has not produced the widely expected US economic downturn, just a pronounced slowdown. So far, the world, especially the developing world, has continued to grow robustly. Why? Because the factors that have dampened volatility over the last 25 years continue to operate and, in the case of a few, to operate more powerfully than ever.

Consider globalization and flexible exchange rates. The improvement in trade that these factors have made possible in the US has completely offset the collapse in housing. It's no wonder that the unemployment rate has hardly risen despite the free fall in housing.

Consider inventories. This downturn/slowdown was so well advertised that companies preemptively moved to reduce inventories from levels that were already well controlled. Instead of amplifying the downturn as they have in the past, inventories are actually helping to moderate it.

Consider the increased fluidity of the global capital markets, the dislocation in securitizations notwithstanding. Nearly \$300 billion of new equity capital has been raised in just the first five months of 2008, replacing all of the capital lost (after tax recoveries) by major financial institutions in the mortgage meltdown (*Display 3, next page*). And it's not just from sovereign wealth funds, which got the ball rolling, but from private equity and institutional investors too. This is without precedent and contrasts with the last credit cycle around 1990. In that period, 2,300 financial institutions failed in this country, including the largest bank in New England, and nearly every bank in the state of Texas. In this cycle, no important institution is likely to fail.

Display 3

Financial Institutions Have Replaced Lost Capital Where Necessary

	Subprime/ CDO Write- Downs	Income Tax Benefit	Net Write- Downs	New Capital Raised
Citigroup	\$43 Bil.	\$17 Bil.	\$26 Bil.	\$44 Bil.
UBS	38	15	23	29
Merrill Lynch	37	15	22	18
AIG	32	11	21	20
HSBC	20	8	12	4
IKB Deutsche	16	6	10	13
Royal Bank of Scotland	15	6	9	24
Bank of America	15	6	9	20
Morgan Stanley	13	5	8	6
JPMorgan Chase	10	4	6	8
Credit Suisse	10	4	6	2
Washington Mutual	9	4	5	10
Crédit Agricole	8	3	5	9
Deutsche Bank	8	3	5	3
Wachovia	7	3	4	11
HBOS	7	3	4	8
Other (Less than \$7 Bil. per institution)	132	53	79	70
Total	\$419 Bil.	\$166 Bil.	\$253 Bil.	\$296 Bil.

As of May 31, 2008

Source: Bloomberg, company reports and AllianceBernstein estimates

Consider the role of the central banks in moving against the tide, in providing liquidity backstops and preventing counterparty failure. In another era, a systematic financial accident would have almost surely occurred. It was averted this time.

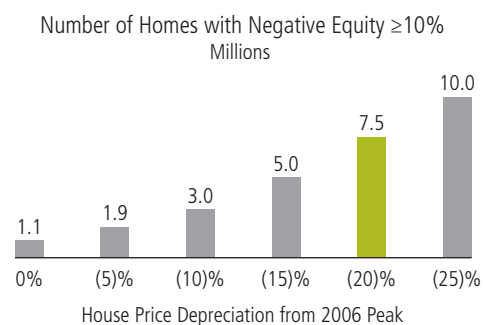
May Not Yet Be Out of the Woods

In all these ways, the shock of the subprime debacle has been absorbed so far. It is quite a story. Perhaps the world is actually a less risky place. Certainly as measured by the sustainability of global economic growth, it would appear to be.

But the last chapter on the US housing dislocation has not yet been written. Yes, so far, we have adjusted well to a vision of defaults and foreclosures in residential mortgages, but the reality of the actual defaults—the turbulence associated with dealing with them—may be another matter.

Display 4

Of 50 Million Homes with Mortgages, Many Will Soon Have Seriously Negative Equity



As of March 31, 2008

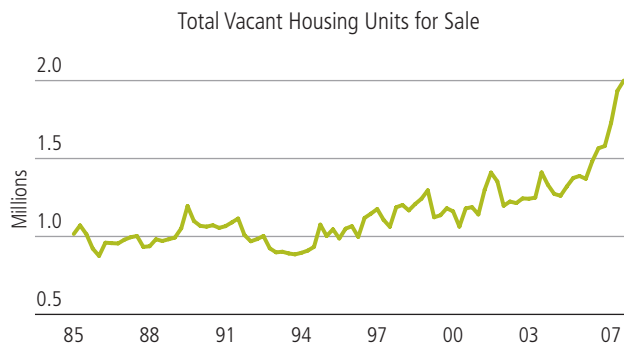
Source: Federal Reserve Bank, National Association of Realtors and AllianceBernstein

By late this year, we estimate that housing prices in aggregate will be down by roughly 20% from their peak in 2006. Based on our analysis of the impact of various levels of price declines, a 20% drop would mean that something like seven to eight million homes in the US will have mortgages at least 10% greater than the homes are actually worth (*Display 4*). The borrowers will then be in possession of a valuable put option exercisable by defaulting on the mortgage, by which they would be effectively selling the house to the lender at an attractive premium to its market value.

Based on studies of prior consumer choice when faced with this option (Texas in the late 1980s, California and Massachusetts in the early 1990s), default rates appear to increase exponentially as the gap between the mortgage and the value of the house widens into double-digit territory. With this experience as a guide, we could be looking at foreclosures reaching as high as five million by early 2009, compared with one million now—a figure that is already double where we were just a year ago. There is no modern-day precedent for a national supply of foreclosed property anywhere near this figure. This new inventory will come on top of more than four million homes that are on the market, two million of which are vacant (*Display 5*), a derivative of excess production during the bubble. To say the obvious, this condition could be highly disruptive. It could regenerate uncertainty about house price declines, and related loss frequencies and loss severities in mortgages, calling into question yet again the adequacy of mark-to-market write-downs and the loss reserves of on-balance-sheet mortgage lenders.

Display 5

The Inventory of Vacant Houses Has Exploded



Current analysis and estimates do not guarantee future results.

Source: Bureau of Labor Statistics, Federal Reserve Bank, National Association of Realtors, US Census Bureau and AllianceBernstein

The seriousness of this matter has not been lost on the regulatory community or Congress. There is a legislative effort under way to avert this looming crisis in the form of the Frank-Dodd bill. That bill has now passed both houses of Congress and we await the final details to assess its likely effectiveness.

It will need to be highly effective because of the sheer scale of the problem and because the problem is being compounded by an externality: a boom in the prices of commodities of all types, a boom that threatens to undermine consumer purchasing power and debt-service

capability. This issue is ripe for intense analysis in and of itself. Suffice it to say for now that we don't expect current commodity price pressure to derail the global economy. However, we are not far away from price levels that would produce a different result.

Some Uncertainty Beyond the Near Term

Commodity price pressures notwithstanding, things should look and feel better in the period immediately ahead. Consumers have received their tax rebates. Although only a one-time boost, these rebates are large by historical standards. If history is a guide, retail sales will strengthen noticeably over the summer, and even mortgage delinquencies might improve for a while.

But we need to stay tuned. The foreclosure problem is a latent threat. If we can lick it with a well-crafted loan-modification approach, which the Frank-Dodd bill may provide, most of the damage from the excesses in US housing and mortgage finance may be behind us. The high risk premia generated by this phenomenon can be expected to continue their fall, generating good absolute and relative returns in all parts of the capital markets, save US treasuries. If we don't fix the foreclosure problem, however, more trouble may well lie ahead. It's rare that a single issue can have a profound impact; we think that this one can. We are watching its development carefully, and our investment strategy will be adjusted accordingly. ■

Recent AllianceBernstein Publications

Research & Strategies Magazine 2008: Defined Contribution

March 2008

The defined contribution world is in ferment. For corporate plan sponsors the US legal and regulatory framework governing defined contribution plans has been radically altered, mostly for the better. But adjusting to the new environment presents many challenges. Some answers to today's vital questions about plan design can be found in this special issue of *Research & Strategies*. While some of this material relates to US legislative and regulatory changes, most of the articles provide an overview of emerging best practices that may be of interest to plan sponsors and fiduciaries everywhere.

The Bubble Bursts: Risks and Opportunities in the European High-Yield Bank Loan Market

Martin A. Reeves

Director of European Fixed Income and European Credit Research

Michael E. Sohr

Director—Private Placement and Bank Loan

March 2008

In the years leading up to the summer of 2007, a bubble developed in the European high-yield bank loan market, fueled in part by the rise of collateralized loan obligations. The global liquidity crisis was the pinprick that deflated the bubble. We do not expect the European market to be back on an even keel until 2009 at the earliest, and even then it will not be restored to its previous form. Nevertheless, we see opportunities in the market for selective investors.

Emerging Markets and the Decline of Exportable Oil

James Barrineau

Global Economist—Fixed Income

March 2008

Emerging-market oil producers are consuming more of their own oil, a trend that is putting upward pressure on prices. As strong economic growth has accelerated consumption in many emerging-market economies with proven reserves, oil production has remained stagnant, even as prices have soared to record highs above US\$100 a barrel. In our view, these trends are likely here to stay until the incentives facing emerging-market oil producers change.

Liability-Driven Investing: A Guide to Finding the Right Prescription

Mark A. Hamilton

Senior Portfolio Manager—Blend Strategies

March 2008

Today's pension plans struggle with two objectives that are often in apparent conflict: that of minimizing fluctuations between the present values of assets and liabilities over the near term; and that of ensuring the ability to pay future obligations over the long run at the lowest possible cost. While there's clearly no single prescription that will allow every plan to balance these near-term and long-term objectives, we've created a guide to help plans find the right pair of bifocals.

Equity Extension Research: Improving the Odds of Success

Joseph Gerard Paul

CIO—Small & Mid Cap Value Equities; CIO—Advanced Value Equities;
Co-CIO—Real Estate Securities

Kent Hargis

Senior Quantitative Strategist

February 2008

These three research papers are the culmination of several yearlong initiatives that have not only shaped the development of our new 130/30 equity-extension strategies but also enriched our overall research and portfolio-management processes.

Abating Climate Change: What Will Be Done and the Consequences for Investors

Amy Raskin, Director of Research on Strategic Change

Saurin Shah, Equity Analyst—Research on Strategic Change

Nils Mellquist, Equity Analyst—Research on Strategic Change

Brett Winton, Equity Analyst—Research on Strategic Change

January 2008

Policies aimed at abating climate change are likely to influence trillions of dollars in global capital spending over the next 20 years. Few, if any, policy decisions in our lifetime will have such an enormous impact. We assess the likely implications for companies in a diverse set of global industries.

When Diversification Fails: Implications of the Subprime Crisis

Drew W. Demakis

Co-Head—Alternative Investments

January 2008

The benefits of portfolio diversification are widely accepted. But during market crises, multiple strategies sometimes underperform simultaneously—as happened after June 2007. So what is the point of diversification if it fails when it is most needed? Our research into the behavior of five typical risk-premium-seeking strategies over the past 15 years suggests that short-term failures do not disprove the long-term benefits of a diversified approach.

Capital Markets Turmoil: Risks and Opportunities

Lewis A. Sanders

Chairman and Chief Executive Officer

January 2008

In our view, the recent sharp widening of risk premia throughout the capital markets should be seen as an opportunity, as opposed to a signal that lasting economic dislocations lie ahead. We are adjusting portfolio strategies in both stocks and bonds accordingly, while being careful to act at a measured pace and to balance the opportunity with the risks entailed.

China at a Policy Crossroads: Domestic Stability and the Future of Globalization

Anthony Chan

Global Economist—Fixed Income

January 2008

As the protectionist backlash from the US and Europe intensifies, Beijing faces a difficult policy choice: should it maintain its current business model in the hope of preserving domestic social stability, or pursue a faster revaluation of the renminbi—a path that may help preserve its international relationships and the future of globalization? We analyze the risks and benefits of both strategies and provide insights into the action that Beijing might take and its consequences—not only for China but for the world.

Surveying the Investment Landscape: Perspectives from Our Credit Research Team

Jack Kelley

Director, Global Credit Research

September 2007

This selection of recent work by our global credit research team includes articles on 4G wireless technology, the impact of Russia's resurgence on worldwide commodity markets, the state of the global banking industry, and discretionary spending among affluent US consumers.

The Last Risk Premium Standing

Lewis A. Sanders

Chairman and Chief Executive Officer

June 2007

The US and many other countries have enjoyed a striking decline in economic volatility during the last 20 years and, as a result, fixed-income and real-estate assets have been repriced dramatically but equities have not. This paper looks at the nature and sustainability of this divergence, one of the most important trends now shaping capital-market behavior.

Nowhere to Go but Up: Has the Growth Style's Long-Term Disadvantage Come to an End?

May 2007

While growth has underperformed value over the history of style indices, there are indications that this tendency may have run its course and we've now reached a point of equilibrium, one where growth is no longer inherently disadvantaged. While there would still be style cycles, they would be fundamentally different from those we've known in the past. What type of growth manager would best suit this new scenario?

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