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The New Normal: Fundamental Changes And The New Face Of Finance

After two years of turbulence in the global economy and financial markets, it appears that nearly everyone—from corporate leaders to heads of state to regulators and individuals—is searching for clues about what will fundamentally be different in the future. While this search for a “new normal” may be fraught with uncertainty, Standard & Poor’s Ratings Services believes that it’s useful to contemplate what may be to come, with clearer hindsight into the events that led to the recent financial crisis.

The credit crunch and subsequent economic turmoil that began in the U.S. in 2007 and spread quickly around the world exposed what we believe are a number of fundamental flaws in financial-market regulation, plus underlying assumptions about the behavior of lenders and borrowers that didn’t pan out.

On the broadest scale, we believe that it will be difficult for the world and U.S. economies to grow as fast over the next decade or so as they have in the recent past. Even as consumers and corporate finance officers become increasingly frugal, governments will likely borrow more, ultimately pushing interest rates higher. Amid this, Standard & Poor’s expects a shift in global economic dynamics—among them a somewhat diminished position for the U.S. (and the dollar), while countries such as China and India become more prominent on the world economic stage.

Already, Asian economies have rebounded more quickly than those of the U.S. and Europe. In fact, they continued to expand while Western economies contracted. The International Monetary Fund has forecast that China will overtake Japan as the world’s second-biggest economy this year. At the same time, India’s young and growing population, expanding middle-class, and high savings rate may help it regain and sustain its precrisis annual GDP

growth of about 9%. By contrast, we're expecting U.S. GDP to grow by about 2.6% annually over the next decade—more slowly than it increased, on average, for the previous 47 years.

Aggressive government stimulus packages that boosted domestic demand and intra-Asia trade have, in our opinion, helped to offset many developing countries' large dependence on exports. But the world may be a long way off from seeing oil priced in China's renminbi instead of dollars. While China has opened its doors to international trade and investment, the government's strict capital controls mean that the renminbi is used almost exclusively for domestic transactions. This puts the Chinese currency at a disadvantage in global trade to currencies such as the dollar, the euro, and the yen—all of which are more used in international markets.

We believe the euro is the only possible alternative to the dollar for a reserve currency. However, any move in this direction carries with it some risks for countries with large dollar holdings, since moving significant reserves out of dollars into euros would hurt the value of the dollar, and thus their existing reserves. In turn, it would raise the value of the euro, making the new reserves more expensive and exports more difficult for Europe.

The Changing Face Of Regulation

More predictable than any change in the world's reserve currency, at least in the medium term, is the prospect of more sweeping financial regulation. Relaxed lending standards (both corporate and consumer), bubbles in housing and equities markets, and the expansion of structured finance and other complex derivatives have all drawn the attention of regulators. In our view, the ramifications of increased and inconsistent regulation could take years to play out.

In the U.S., we're seeing a swing toward more regulation, as banks, borrowers, and various government agencies try to strengthen a financial system that became laden with leverage in the years leading up to the credit crisis. Global financial market regulators also are in the process of creating a system that may result in higher capital requirements for banks, limits on the use of capital instruments such as some derivatives, and greater emphasis on managing liquidity.

We believe that the increased interdependence of national markets has rendered the current regulatory system dysfunctional in some respects. Regulators frequently look only at those areas for which they are directly responsible, in many cases ignoring the interplay with outside institutions. No single regulator, or group of policymakers, has authority over the world market. Clear, consistent international financial regulation will become more and more important as memories, which can be all too short in the financial world, begin to fade. As governments and regulators contemplate all this, we expect that a recovery in the world economy will serve as a bridge to a more tightly regulated financial system that will look quite different than the one of the past decade or two.

Reassessing Risk

We think that banks will generally be among the entities most affected by this changing landscape. We expect financial institutions, especially those in the U.S., to return to building solid, sustainable sources of deposit funding as they reduce continued reliance on complex structured securities. This will reduce banks' leverage, we think, while fostering more reliable, albeit lower, returns.

This evolution may yet be in its early stages, since the recent stabilization in the financial markets remains fragile. The weak economy itself amounts to a continued assault on the balance sheets of U.S. banks. Sustained high unemployment, for instance, conceivably could cause another surge of consumer

defaults, this time in previously insulated sectors such as prime mortgages. We think that commercial real estate, to which many banks are exposed, will generally be vulnerable for a while, as borrowers make interest payments on properties that may have lost value and have become harder to refinance.

It remains to be seen how well U.S. banks will adjust to the loss of lending capacity they suffered after the securitization bubble burst. We expect that accounting changes will make the practice of transferring risks off balance sheet much less common, if not obsolete. With use of securitization currently reduced, we think banks will have to rethink the way they do business. But ultimately, we believe that securitization provides a valuable source of funding for lenders and that in the end it will return, albeit on a more limited scale.

We believe that improving stability in the financial sector will depend on improving economic conditions and a return to robust and resilient capital markets as government support wanes. Standard & Poor's bank ratings are extremely sensitive to economic conditions, and any severe deterioration in these conditions could bring about a repeat of 2008, with multi-notch downgrades and perhaps some defaults on smaller, regional banks. At the same time, improving conditions would help banks to continue to trim leverage and maintain margins to the point that we could see a stabilization in the industry's outlook.

Nonfinancial U.S. corporations also are likely to try to limit their leverage for the next few years, we believe, although investors' demands for returns may make it difficult for some companies to do so by funding growth out of earnings. The most creditworthy nonfinancial borrowers may continue to be highly leveraged, we think, even as regulation may force financial firms to curb their leverage.

Still, the level of credit available to speculative-grade borrowers in the wake of the financial crisis has been better than we expected. And the quick return of debt issuance for these companies may cement the ongoing decline in corporate credit quality that dates back nearly 30 years. In our view, hedge funds and alternate lenders and investors will still be major suppliers of debt capital in the future—though perhaps not at the levels of the recent past.

As hedge fund investors more closely examine the liquidity of their funds' investments, regulatory pressures and balance sheet constraints may force some financial institutions to constrain their lending to hedge funds. Because of this, returns on some investment strategies may decline but become more stable, and may motivate some fund managers to look to consolidate. Many that don't may ultimately have to close. And while new hedge fund managers may fill the void that is left, they are likely to find it difficult to raise capital unless they can show successful historical performance.

In any event, speculative-grade bond issuance, which dried up during the financial market crisis, has rebounded smartly. Companies' ability to find long-term funding in the bond markets, instead of relying on bank loans, has been notable. Meanwhile, more and more rated companies are positioning themselves more aggressively for shorter-term financial returns. In many cases, this includes a significant amount of leverage, leaving little room for error and making these companies vulnerable to unforeseen obstacles that could jeopardize their financial health. This may mean that higher than average default rates will persist into the near future.

Meanwhile, government borrowing will likely boost borrowing costs in the long-term as more "vanilla" transactions—such as bank loans and corporate bonds—fill the void left by complex securitizations. All in all, many borrowers, especially those with lower credit ratings, probably will have to absorb increases in their cost of capital, we believe.

Whither The Consumer?

In addition to its effects on corporations, higher government borrowing may be needed for a while to offset declining borrowing by American households. But we believe the projected deficits for the U.S. are unsustainable, and we expect a combination of tax hikes and spending cuts over the next few years to reduce them.

The one-two punch of high household debt and lower wealth has made Americans more discriminating consumers for the moment. Thanks to sharply declining house prices and stock-market volatility that has reduced retirement savings, many Americans have suffered a crisis of confidence—more than offsetting the so-called wealth effect created during the boom times. Add this to banks' increased caution in making loans, and it's easy to see why consumers' ability and willingness to take on debt has waned. In this more conservative new world, we think the U.S. economy—which for now remains the world's biggest—may begin to resemble that from 1960 to 1990, when the domestic saving rate was more robust than now, and when consumer spending was significantly less than today's 71% of GDP.

Consumer sentiment is also clearly tied to the housing market, and we believe the U.S. residential mortgage market may be entering the second phase of a credit downcycle. In this environment, the role of government-sponsored entities (GSEs) Fannie Mae and Freddie Mac will likely become ever more important to the U.S.'s housing policies. In fact, it's difficult to see how the \$11 trillion residential-mortgage market will be able to attract enough private capital to fill the void if the GSEs, which account for nearly all of the current market, were to take on a smaller role.

At a time when many Americans owe more on their homes than they could recoup by selling them, we believe the GSEs will play a critical role in cushioning the impact of increasing delinquencies on prime loans, which could be critical to avoiding a “double dip” in home price declines caused by increasing vacancies and foreclosures.

Spanning The Globe

Whatever the speed and depth of change in the near term, the eventual evolution of a global economic environment that is dictated less by the U.S. and more by a surging Asia may be the most profound change that will define the future. To be sure, a still-fragile recovery and shifting dynamics in the financial system mean that a new normal may arrive in fits and starts. Nonetheless, in our view, any diminished role of the dollar, the potential for the globe's financial center to shift to Asia, and what could be a new era for financial regulation could make the next couple of decades a stark contrast to the past decade or two.

The areas listed below have changed in a number of ways after two years of global economic and financial turbulence.

<i>Area</i>	<i>Effect</i>
Global economy	It's unlikely that the world and U.S. economies will grow as rapidly as they have, and continued expansion of Asian economies means that the relative decline in U.S. importance has accelerated. The global financial system may shift its headquarters out of New York and London toward Asia, especially if regulatory changes make Asia more attractive.
India	The rise of India's middle class, its high savings rate, and its large and growing young population will temper the impact of weak export markets. We expect India to regain and sustain precrisis GDP growth rates of about 9% from 2011, provided it hastens policy reforms.
China and the renminbi	Major obstacles stand in the way of widespread international use of China's renminbi, despite the country's greater political willingness to see it through.

The areas listed below have changed in a number of ways after two years of global economic and financial turbulence. (cont. 'd)

<i>Area</i>	<i>Effect</i>
U.S. banks	In our opinion, banks will most likely return to basics, with a reduced use of securitization and an emphasis on attracting deposits. We also expect that accounting changes will likely make "off-balance-sheet" risk transfer obsolete. It remains to be seen whether the banking system can absorb the loss of credit capacity and still thrive.
Fannie Mae and Freddie Mac	The role of the GSEs will likely become more crucial to the government's housing policies as the residential-mortgage market enters what may be the second phase of its credit downcycle.
Bond insurance	The massive transformation of the bond insurance industry in the past few years threatens its existence. With many issuers and investors learning to go without bond insurance, it is possible that the market never fully recovers, leaving little room for new entrants.
Life insurance	In our view, life insurers' concerns about pricing, profitability, product mix, investment portfolio performance, and capital adequacy are tied more to the economic slump and the ups and downs of credit and underwriting cycles, and less to major systemic change.
U.S. equity investment	The post-recession period will likely affect all sectors in the S&P 500, but areas most closely associated with the consumer—autos, homebuilding, retail, and leisure, consumer staples, health care, etc.—may see the most turmoil.
U.S. corporate borrowers	We believe the environment for nonfinancial companies won't be vastly different, as the proportion of lower-rated entities continues to rise and many U.S. corporations keep in place aggressive financial policies in the hunt for short-term returns.
Global corporate credit markets	This year may be a turning point characterized by prudence among market participants amid a tepid recovery in mature economies and guarded optimism among emerging markets. We may see incremental improvement in macroeconomic fundamentals, ongoing repair in the financial sector, and a cautious revival in the nonfinancial sector.
U.S. speculative-grade debt, recovery rates	Continuing credit pressures have the potential to push default rates back up, especially with any stall or reversal in the economic recovery. Post-default recoveries may fall below historical averages for all classes of debt.
Leveraged loans	The investor base for loans may shift more toward relative-value players and, as such, may correlate more closely to other asset classes that rely on these same investors. In addition, the market will likely have less capacity for the type of multibillion dollar transactions that dominated 2005 to 2007.
Hedge funds	Investors are scrutinizing liquidity terms more closely and assessing whether they match the strategy of the fund. Some hedge funds have altered their redemption terms, likely in an effort to better align them with their strategies and to more accurately represent liquidity risks to their investors. Meanwhile, regulatory pressures and balance sheet constraints may force some financial institutions and prime brokers to constrain their lending to hedge funds. This will generally lower hedge fund returns but could make them more stable.

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