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Beware When Everyone is On the Same Side of the Trade

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Everybody was on the same side of the trade.

If you have not read Michael Lewis' book, *The Big Short*, about the U.S. financial crisis, I recommend you do so. It is enjoyable and instructive reading from a number of angles. One interesting, but disturbing chapter tells about how low-rated subprime bonds were packaged and magically transformed into AAA-rated bonds.

I've always thought bond ratings mattered, but now I pay even closer attention. A lot of AAA-rated corporate bonds had no business being rated that high in 2007-2008.

As government balance sheets in the West continue to deteriorate, is it possible that some of the current AAA-rated sovereign bonds will not belong in that category? What then will investors do? Will they demand higher interest rates to compensate for the additional risk they are assuming? Or will they make the final move to equities as they conclude that they are being asked to take equity-like risk in the government bond markets without the opportunity for equity-like returns? Why not buy a corporate security such as stock and, at least, have a shot?

One of the takeaways I had from the book is that the subprime collapse/credit rating failure, which caused the 2007-2009 crisis, was containable in the sense that taxpayers could back up the losses.

Essentially, that is what has happened as the U.S. government, backed by taxpayers, bailed out AIG, several investment banks, and commercial banks that had strayed into trading esoteric instruments. Next time, the taxpayer may not have sufficient capacity to do so.

Often, the market's mispricing of some asset is so great, and therefore the profit potential so high, that waiting for a few years can be well worth it for investors. In the case of the subprime mortgage market of the mid-late 2000's, the hedge fund managers betting against it knew they

were going to be right eventually; they just weren't sure if they could convince their investors to ride it out long enough to see the upside.

They all recognized the flaw in the market's pricing was the assumption that housing prices never went down. Moody's and S&P built an assumption into their ratings models, and Goldman, Bear Stearns, and Lehman all built it into their business structure and pricing models.

After all, housing prices in the recent past did have a tremendous track record of upward growth. Home prices rose steadily in all economic conditions. However, with analyzing the market we often have to go much farther back than the recent past if we are truly going to learn from history to avoid its mistakes.

History is cyclical. Modern generations easily lose the first-hand experience of bygone lessons. Therefore, they are prone to make the same emotional mistakes in reaction to traumatic events and logic flaws when trying to problem-solve.

The largest shocks to the system come when everyone is on the same side of the trade.

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