

“Minsky Moment” Risks are Rising

July 2020

In response to the COVID-19 crisis, an unprecedented amount of leverage has entered the global economy, particularly as a percentage of GDP. While financial companies are typically leveraged, the amount of debt being held by non-financial companies and individuals has ballooned just as incomes have declined. This combination of rising debt and falling income may be setting the stage for another financial crisis.

The good news is that the central banks have acted quickly to add liquidity into the system, so we believe bank crises are, at the moment, unlikely. But we may still have a severe amount of deleveraging feeding back into the real economy in a manner akin to 1990 or 2000. This short paper addresses this rising risk and introduces the FQ Financial Instability Indicator. First, we will briefly describe the background and follow with the current state and possibility of a rare “Minsky moment.”

The Financial Instability Hypothesis

Hyman Minsky wrote many times about his hypothesis, but perhaps the most concise version is in Minsky (1978). According to Minsky, the financial system carries the seeds of its own destruction through increasing leverage. It has three phases:

- 1) Hedge Finance: Assets are equal to or greater than liabilities
- 2) Speculative Finance: Liabilities are greater than assets through leverage, but not “excessive”
- 3) Ponzi Finance (the “Minsky Moment”): Leverage is so high that a drop in asset values causes mass deleveraging

This hypothesis came to the fore after the Global Financial Crisis (GFC), which was a textbook Minsky Moment. Academic research has shown that the financial instability cycle lasts from 8 to 20 years and is longer than the typical business and market cycle, which is 4 to 6 years. But when these cycles coincide, the resulting recessions tend to be longer and deeper than recessions caused by issues in the real economy or a stock market decline. The GFC, again, was a textbook example of this phenomena. So, it would be useful to know when an approaching recession is tied to the financial system as opposed to the business or stock market cycle.

The FQ Financial Instability Indicator (FII)

The FII is a combination of the FQ Market Risk Indicator (MRI)¹ and a measure of non-financial leverage in the economy. The MRI anticipates when markets are resilient and the risk of asset price declines is low, versus periods of fragile markets where the risk of asset price declines is high. Non-financial leverage measures when the level of leverage in non-financial companies and consumers is trending higher or lower.



Market Insight: “Minsky Moment” Risks are Rising

Combining these two measures together creates four states:

- 1) Normal liquidity: leverage is low and markets are resilient
- 2) Normal leverage: leverage is high and markets are resilient
- 3) Excessive leverage: leverage is high and markets are fragile
- 4) Excessive liquidity: leverage is low and markets are fragile

Normal liquidity equates to Minsky’s Hedge Finance state. Normal leverage equates to his Speculative Finance state. Excessive leverage maps to the Minsky Ponzi Finance state. Excessive liquidity is not in the Minsky cycle, but would relate to early recovery when deleveraging has been completed but market risks remain high.

Where are we now?

The FII last entered the excessive leverage state in late 2007 and then moved to excessive liquidity in mid-2009. In early 2010, as market conditions stabilized and economic growth resumed, the FII moved to normal liquidity where it remained until recently.

Unfortunately, the level of non-financial leverage has risen. This increase, combined with ongoing market fragility, indicates that we are clearly in a state of excessive leverage for the first time in 11 years. This means that the conditions exist for substantial deleveraging if asset values decline significantly. Deleveraging in this context

would likely involve a reduction in debt, mostly through defaults, putting pressure on the lenders who are stuck writing off bad loans. It also could result in further sales in the stock market to meet margin calls. Deleveraging is dangerous because, as we saw in 2008-2009, it results in a downward spiral in wealth and assets. However, like a tornado warning system, dangerous conditions do not mean that a Minsky Moment will actually happen. This environment does, however, signal that the risks of such an event have risen significantly. Given the uncertainties in the global economy from the COVID-19 economic shutdown, the Brexit negotiations, and global trade wars, the possibility of a Minsky Moment is a risk that should not be overlooked. If any of these market risks causes a significant asset price decline, then the leverage in the non-financial sector (which includes consumers) could trigger a financial crisis.

The good news is that unlike 2008, the central banks have acted quickly to supply liquidity to the financial sector in anticipation of weakness. Their adept response may be enough to avert a crisis in the banking system. But a market crisis with high leverage in non-financial companies and consumers could still cause a more significant economic decline than many investors are currently prepared for. The possibility of a Minsky Moment should not be ignored.





Endnotes and References

Endnotes

¹The FQ Market Risk Indicator ("MRI") is designed to indicate the current phase of the market cycle and the level of macro uncertainty, from resilience (MRI=0.00) to high fragility (MRI=1.00) in increments of 0.25 for a total of five levels.

References

Ladekarl J, Peters E, Ye J, "Risk Cascades: Anticipating Fragile and Resilient Markets" FQ Perspective, August 2019
Minsky, H P, "The Financial Instability Hypothesis: A Restatement" (1978). Hyman P. Minsky Archive. Paper 180

This material is for your private information. The views expressed are the views of First Quadrant, L.P. only through this period and are subject to change based on market and other conditions. All material has been obtained from sources believed to be reliable, but its accuracy is not guaranteed.

FIRST QUADRANT, L.P. | 800 E. COLORADO BLVD. SUITE 900, PASADENA, CALIFORNIA 91101
MARKETING SERVICES INFO@FIRSTQUADRANT.COM | OFFICE 626 683 4223 | WEB FIRSTQUADRANT.COM
Copyright © by First Quadrant, LP, 2020, all rights reserved.