Viewpoints
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Pipes Are Being Unclogged but the All-Clear Is a Long Way Off

By Mohamed El-Erian

There are many interesting aspects to the crisis that started in the U.S., spread round the world and prompted unprecedented policy responses. One that I have stressed, including in previous Financial Times contributions, is the repeated ability of the crisis to morph.

This dynamic is again in play today and will be an important driver of markets and policies in the weeks ahead. Look for the mix between deleveraging and economic concerns to shift towards the latter; and, on the other side of the valuation tug-of-war, for excessive policy pessimism to lift as measures make the transition from design and execution to the effectiveness phase.

If you look for one indicator that highlights the dramatic October intensification of the crisis, go no further than the yen/euro exchange rate. The rate collapsed from 150 yen per euro to 116 on Monday last week before rebounding to 125. By any standard, this is a massive move; it speaks to the interaction of two distinct yet self-reinforcing elements.

Deleveraging intensified in October as credit-starved entities used asset disposals to stay afloat. With the crisis eating into cash cushions, it evolved rapidly from a largely U.S. phenomenon to one engulfing several banks and sovereigns worldwide; from one affecting levered investors to also causing redemptions in unlevered vehicles; and from one contaminating credit and counterparty risk to a broader contagion that pulled the rug from underneath all risk premiums.

Having said this, deleveraging does not explain fully the latest stage of the crisis. Markets have also started to discount the prospects of a major global economic slowdown driven by lower consumption, investment and trade flows. This is not just about a U.S. recession: a rapidly growing number of countries are experiencing sharp falls in economic growth.

Deleveraging and economic slowdowns are distinct yet inter-related factors. The first speaks to correcting the abuse of leverage as Wall Street's liquidity factories work through a disorderly contraction mode. The second speaks to the need to adjust to new "natural" rates, including the operational specification of Nairu (the non-accelerating inflation rate of unemployment), to reflect a paradigm in which credit lubrication is impaired for years.

Importantly, the two together imply negative feedback loops that lead to valuation overshoots. As a result, expect additional institutional failures and consolidation in the

weeks ahead, particularly among hedge funds. We should also expect policymakers to continue to face complex policy challenges for which there are no "first best" solutions.

Markets are pricing in the morphing of the crisis, but not fully yet. Within the G4 (eurozone, Japan, U.K. and U.S.), they are now correctly signaling two convergence trends. First, that interest rate differentials will narrow further as policy rates converge, but not fully, to (the now even lower) Japanese levels; second, that banking sector policies will become even more encompassing globally, including in guaranteeing virtually any activity deemed systemically important.

Having said this, markets have yet to recognize the cumulative impact of the significant policy measures already announced. This excessive policy pessimism partly reflects the unavoidable lags that exist in the recognition-design-execution-effectiveness chain. It also reflects the hesitancy of market participants whose early optimism has been buffeted by repeated sharp market sell-offs.

These factors will evolve over the next few weeks. Look for an accelerated unclogging of the financial system's plumbing, including the normalization of the commercial paper segment. Look for a measured yet notable recovery in sectors that are embraced by government balance sheets, such as bonds issued by systemically important banks and senior mortgage securities. But do not look for a panacea. There will be no generalized, quick and sustained recovery in all risk assets. Too many have been severely damaged to bounce back any time soon.

The author is co-CEO and co-chief investment officer of PIMCO, and author of "When Markets Collide: Investment Strategies for the Age of Global Economic Change."