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Lehman Bros. II coming soon, says Canada fund manager

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Three years ago, the House of Lehman collapsed like a house of cards. And if you thought the original was scary, just wait until Lehman II comes to a theater near you–in IMAX 3D with digital surround sound.

That's the view of a sober-minded Canadian strategist and money manager, John Stephenson, senior vice-president of First Asset Management in Toronto. He predicts a new, Lehman-like financial crisis in the next six to 12 months, only this time involving the debt of governments and European banks.

He thinks it could drive stocks much lower, to levels at which they traded, well, just after the collapse of Lehman and AIG in fall 2008.

"When it happens, it's going to happen fast, and it's going to be ugly and very deep," he told me in a telephone interview, adding that he expects it to be "worse than the last crisis. Last time around, the governments had some room to bail people out. They don't have that capacity [now]."

Stephenson isn't well-known in the States, but I find him smart and credible. He's been named one of the 50 best money managers in Canada and is steeped in Toronto's conservative Bay Street culture.

Other famous investors agree with him. Investing giant George Soros, for one, said: "This crisis has the potential to be a lot worse than Lehman Brothers."

Taking a page from the work of Carmen Reinhart and Kenneth Rogoff, Stephenson says the financial crisis first hit the private sector and then moved to the public arena, as governments bailed out the banks to "save" the economy.

"A buildup in government debt has been a defining characteristic of the aftermath of banking crises for over a century, " wrote Reinhart and Rogoff in their 2011 paper "A Decade of Debt."

"For the countries with systemic financial crises and/or sovereign debt problems, average debt levels are up by about 134 per cent."

That puts a huge burden on taxpayers, and makes the creditworthiness of sovereign debt shakier. "You've had a transfer of risk to governments," Stephenson said. "The average citizen wonders why they're going to have to suffer for someone else's mistake."

Indeed they do...especially Germans and other solid northern Europeans who balk at helping countries like Greece, which they see as freeloaders.

"Politically, the Germans have no interest in bailing people out," Stephenson said. That puts elected officials like Chancellor Angela Merkel on the spot.

Chancellor Merkel is committed to keeping the euro zone together, but she's very unpopular and her ruling coalition is strained to the breaking point. So, she and other European leaders have consistently been behind the curve, favouring one short-term fix after another rather than telling their electorates what they really think needs to be done. (She and French President Nicolas Sarkozy just announced yet another deal they say will keep Greece from defaulting, causing markets to rally.)

In retrospect, the much-reviled TARP here in the U.S., and the subsequent stress tests, did put our banks in, well, less bad shape than their European counterparts.

"The US has been more proactive," Stephenson told me. "In 2008-2009, U.S. banks started issuing equity like it was going out of style. European banks never took the opportunity to recapitalize."

In fact, the euro made things worse for Europe, because it allowed countries like Greece and Portugal to issue debt at extremely low rates, which European banks then bought to squeeze out some extra yield while taking on the low risks of a sovereign credit.

Or so they thought. To this day, said Stephenson, the banks haven't written down a penny of it.

Now, the big French banks hold nearly $57-billion in Greek debt, €140-billion in Spanish debt and almost €400-billion in Italian debt (all combined private and public) as of last December, Nicolas Lecaussin wrote

in The Wall Street Journal.

The debt of the big three U.S. banks amounted to 39 per cent of U.S. gross domestic product, while the total debt of the three largest French banks comprised 250 per cent of French GDP.

On Wednesday, Moody's Investors Service downgraded the credit ratings of French banks Société Générale and Credit Agricole, and said it may downgrade them again.

A big test may come soon. Credit-default swaps on Greek sovereign debt indicate a 92 per cent chance of default, Stephenson said. "Clearly the market doesn't think it's about to make it."

And rather than stanch the bleeding, a Greek default will lead to further hemorrhaging, he predicted. Spain and Italy are "too big to fail, too big to bail," he said.

And with God knows how many derivatives contracts (remember them?) tied to sovereign and private credit alike in the Eurozone, the effects could be widespread.

"Once the default occurs, it could be very easy to see a banking crisis in Europe will become a banking crisis in the US, Canada, and Australia," he said.

Yes, even Canada, whose banks survived the first crisis because they acted like real bankers and avoided the insane, idiotic risks taken on by their American counterparts.

Stephenson thinks Europe could be in recession again by next year, while the U.S. may scrape by with slow growth.

And emerging markets? "They're going to get trashed in the short run. All the hot money is going to disappear."

That would be good news for the U.S. dollar, which "will be the only safe haven," he said. But in the long run, he's bearish on all paper currencies–especially the euro, which he calls "dysfunctional"–and he likes silver and gold.

He's also a fan of cash, which comprises 60 per cent of his personal portfolio, and favours shorting all the banks–European, American, Canadian, and Aussie alike.

His target for the S&P 500 index is around 800, which is about where it settled in November 2008 (before dropping below 700 by March 2009). He thinks the S&P/TSX composite index will hit the 8,000 range.

I'm not entirely convinced of his Armageddon scenario; I think a long drip, drip, drip of bad news with sudden flare-ups of panic is just as likely. In any event, I lightened up on stocks late this spring because I was worried about these things.

The S&P has held support in the 1,100s very well, but if it breaks below that and heads down to 1,020 or so, we're likely in a new bear market that could go lower still. So, I'd continue to sell riskier assets into whatever rallies the market gives us, and keep watching to see how the crisis plays out.

"The only surprise is that it hasn't happened sooner," Stephenson said. "The pressure builds and the dam can't hold."

If he's right, it might be time to untie the lifeboats and get the life jackets ready. James Cameron never made "Titanic II," but maybe the time is right. Only in the markets and the movies can the same ship sink twice.

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