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The Stock Market Crash of the Great Recession: Who's To Blame?

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During 2008, the first full year of the "Great Recession", the US stock market as measured by the S&P 500 Index went into free-fall, dropping almost 40%. The plunge is generally blamed on the American housing crisis. "Housing" accounts for approximately 25% of the US GDP, reflecting the depth and breadth of the industry for e.g., real estate developers, builders, and architects; brokers, bankers, and lawyers; electricians, plumbers, and roofers; painters and lawn maintenance professionals; and appliance and furniture manufacturers. Since the dark days of 2008-2010, the S&P has gradually (albeit erratically) recovered and now (early 2012) is just about where it was when the recession began more than four years ago. The same is true of the Dow Jones Industrial Average as well most other indices. What has happened to the housing market in the meantime? The leading measure of American residential housing market is the S&P/Case-Shiller Home Price Index. Since dropping some 30% from mid-2007 to early 2009, the 20-city home price index has not regained any ground, remaining locked at negative 30%.

With the housing market still a mess (2.5 million in unsold inventory, one in five borrowers owing more than the value of their homes), but with the stock market reasonably healthy, one needs to ask whether housing was the real culprit behind the stock market's collapse. Those arguing "guilty as charged" would point to the housing bubble, whose monumental collapse in 2007 ushered in the worst economic collapse since the Depression of the 1930's. While the bubble was certainly fueled by many factors, the most blatant was cutthroat mortgage lending by US banks and other mortgage originators. In a frenzy for market share, these entities aggressively competed by creating and offering a variety of suspect products interest only loans, no documentation loans, floating rate option loans, loans with little or no down payment, and automated loan underwriting. These seductive products were aimed primarily at the least credit-worthy, or "subprime," borrowers. As the booming housing market grew, borrowers' appetites were whetted by the availability of cheap and easy credit and by the prospect of seeing their home prices soar, allowing them to flip and buy even more expensive residences.

The housing boom and eventual bust that followed also depended on a mode of financial engineering developed in the 1980's called "securitization". This is the process by which loans (for example, for homes, automobiles, even credit card receivables) are packaged into pools of asset-backed securities that are sold to retail and institutional investors. Lenders like securitization because it allows them to off-load the assets from their balance sheets, keep origination fees, avoid large capital requirements, and then start the process over again by making more loans. In the late 1990's and the early- to mid- years of the first decade of the 21st century, the outfits that packaged mortgage loans into mortgage-backed securities initially the government-sponsored-entities Fannie Mae and Freddie Mac, owned by public shareholders but created by Congress to ensure stable mortgage and housing markets; and eventually also the Wall Street investment banks competed aggressively to buy up and package home mortgages. The investment banks added a twist that Fannie and Freddie could not, extending warehouse lines of credit to mortgage lenders who used the liquidity to make more and more loans. In many ways, it was a veritable Ponzi scheme, earning participants lucrative fees, commissions, and bonuses in the process. In the frenzy, underwriting standards were relaxed and documentation got misplaced, but no one worried because investors paid little heed to how much due diligence had been done or not done on the collateral backing the securities they had bought.

In this increasingly opaque market, mortgage-backed securities became more and more complex, comprising different tranches of widely diverse risk and payment features. Meanwhile, the rating agencies willingly gave their highest ratings on the grounds that the mortgage pools were so large and widely diversified (in terms of geography and types); underlying this faith was the belief that no one defaults on their home. By most estimates, at least a quarter of mortgages made and packaged in 2005-2007 were "sub-prime" (up from 5% a decade prior). To protect themselves from the increasingly toxic assets, astute investors bought credit default swaps, guarantees from insurance companies like AIG that the mortgage pools would not default and, if they did, investors would be made whole. Adding further to the frothing market, an increasingly significant portion of investors were the very banks that packaged the securities; banks like Bear Stearns and Lehman Brothers created off-balance "structure investment vehicles" (SIVs), funded in the short-term commercial paper market to purchase 15- and 30-year mortgage-backed securities.

But to return to the main question posed earlier: was the housing collapse the real cause of the Great Recession's stock market sell-off? Except for 2008, the lack of correlation between stock market indices and the housing market would suggest otherwise. In point of act, while the Great Recession was manifested by the collapse of the housing bubble, the real cause of that fiasco was financial: credit mania fed by easy monetary policy; a long-standing government mandate (carried out by Fannie Mae and Freddie Mac) to assure as many Americans as possible the opportunity to own their own homes; greed-driven financiers flourishing under the eyes of dozing regulators. In other words, the culprit was not a housing crisis per se but, rather, a financial system gone awry.

In the years since, the stock market has gradually recovered as policy makers and regulators have assiduously moved to prevent another such meltdown witness the Dodd-Frank legislation, a more alert and proactive Federal Reserve Board, and the newly energized Securities & Exchange Commission. Foot-dragging and uncertainty still surround the fate of Fannie and Freddie, but as the financial system stabilizes, the next focus must be on restoring the dynamism of the housing market. Although another financial collapse is not beyond question, the American financial system is in far better shape today than anytime during the go-go years of the subprime build-up. This is reflected by the stock market.

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