TrendMacrolytics

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Just Chill!

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Hedge fund panic mongers are trying to jawbone the Fed into a big mistake.

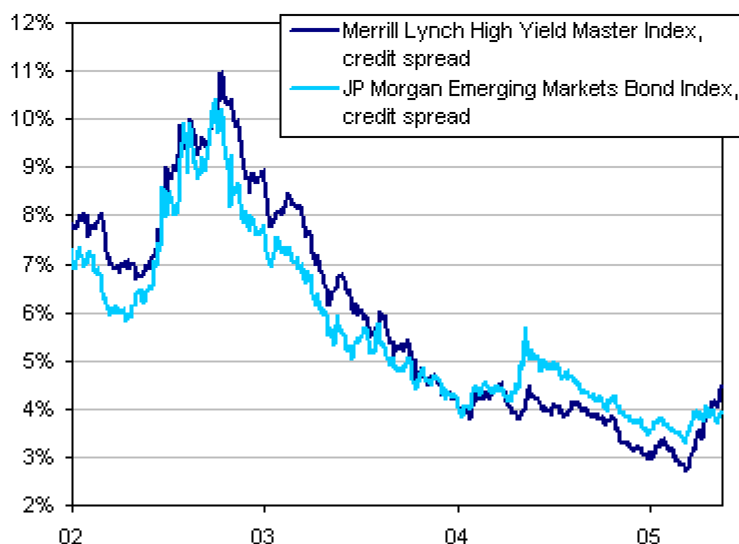
Amid the inchoate rumors about troubled **hedge funds** and anxiety over the systemic risks arising from a potential cascade of fund failures, we'd advise maintaining some perspective on the forces actually at work. It appears that rather than exposing some nascent financial fissures, the spreading sense of apprehension is serving mostly to restrain expectations for sustained **Fed** rate normalization even in the face of growing evidence that the economic expansion is at no significant risk from such policy action. Indeed, from our perspective the bigger risk would be if the campaign of fear and speculation reached its intended target and short circuited the Fed in its task of attaining monetary equilibrium.

To be sure, hedge funds were no strangers to the seemingly free lunch being handed out at the Fed's easy-money trough. Facing the prospect of an end to the Fed buffet, highly leveraged funds are positioning for some blowback, cutting back their heightened risk exposure and unwinding some wrong-footed bets that were placed on the idea that the Fed would remain easier longer. The abrupt pop in the **dollar** and drop in **gold** last week appeared to reflect at least in part the vacating of such positions. But as the dust settles after last week's action, we'd expect to see some retracement of those moves.

That goes as well for a **Treasury** rally fueled in large measure by flight-to-quality flows, supported by the supposition that a hedge fund crisis could keep the Fed from raising rates as much as it otherwise would, or even move the Fed to cut rates for a time in order to keep the system liquid. The 17 basis point rally on the **10-year note** since it closed with a yield of 4.28% on May 9 -- the day stronger than expected April **jobs numbers** were released -- has been matched equally by a move lower in the implied yield of December **Eurodollar futures**. The year-end Eurodollar contract is now moving to price for a **fed funds** rate target of no more than 3.5%, implying that the Fed will refrain from raising the rate at three of its five remaining **FOMC** meetings this year.

In making these bets, market participants appear to be guided by memories of the **Long Term Capital Management** blowup which motivated the Fed to cut rates by 75 basis points over a two month period in late 1998. There's a critical difference, however, between conditions now and those that obtained in 1998. In that event, the LTCM collapse was the culmination of a 14-month conflagration that spread from **Asia** to **Russia**, rooted in a **deflationary** Fed that had countenanced a 25% appreciation of the dollar relative to gold, and only slightly less against major **foreign currencies**.

While we don't rule out the possibility of an entirely different factor coming into play that would pose problems just as great, at this point it's difficult to detect any similar kind of stresses at work. No question, there have been players badly hurt by the **debt downgrades** of **General Motors** and **Ford** and the related repricing of various corporate credit instruments. A shading



towards less risk tolerance has been seen in a recent widening of high yield debt spreads. Although spreads had been relatively stable for several weeks in ranges around 400 basis points, in the rumor-driven trading of the past week the **Merrill Lynch junk spread** has surged by about 45 bps. Still, this response appears contained compared to the debt market downdraft in summer 1998, when spreads blew out by some 250 bps over several weeks even prior to news of the LTCM breakdown. Another sign that high-risk market segments continue to function in orderly fashion: **emerging-market debt spreads** have been stable on net over the past month.

Somewhat ironically, the greatest risk of spreading fund failure and threat to financial stability would come not from the Fed maintaining its policy normalization process but failing to do so. As it is, the Fed remains behind the curve, and all the contemporaneous **inflation** data is trending higher. The recent behavior of market price indicators such as foreign exchange and gold suggests only that a worst-case inflation scenario is unlikely to play out. With gold still nearly 30% above its long-term average, the lagging official price indexes still are only in the early stages of showing the inflationary consequences of the Fed having remained too easy for too long. Were the Fed to pause for a significant period, or signal an end to the rate-raising cycle before equilibrium is achieved, the worst-case outcome would be back on the table, and the Fed would ultimately be forced into an aggressive tightening posture that would pose serious risks to the expansion. At that point, obviously, highly leveraged funds with high risk portfolios would face considerable peril.

Bottom Line: As a consequence of the Fed remaining too easy for too long, many hedge funds took the opportunity to ratchet up their risk exposure in highly leveraged positions, and are now trimming their exposure to adapt to changing realities. Trepidation over the supposed risk that hedge fund difficulties represent a systemic threat, however, is not being borne out in the market. The bigger threat, in fact, is that the Fed pays undue heed to the speculation and fails to maintain its policy normalization program. At this point, though, we have little reason to think that that's a likely risk. TM