TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

THOUGHT CONTAGIONS

Subprime Time

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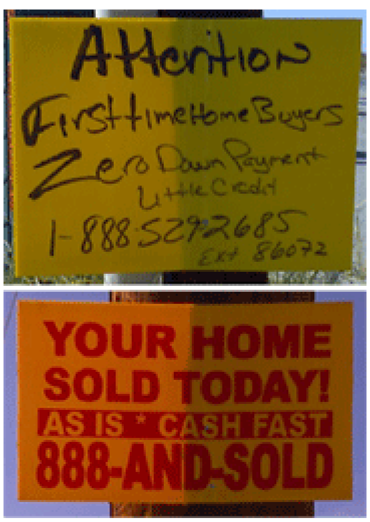
Donald Luskin

Excess liquidity will absorb subprime's problems -- a Fed bailout would only add to inflation.

Throughout this economic expansion that we believe began in early 2003, we have stood against a series of purported threats to growth that, for a while, capture the conventional wisdom -- among them deficits, high energy prices, hurricanes, rising interest rates, and the bursting of the housing bubble. The latest purported threat is the increasing default rate in the subprime lending market. Like all the others -- and like all delusional structures capable of seizing the public imagination -- this one begins with a kernel of truth: obviously, there really are losses being taken in the subprime market. But this one, like all the others, fails the "so what" test. We believe that the magnitude of potential losses in subprime -- both direct losses by lenders, and indirect losses by speculators in subprime-linked derivatives -- is small in comparison to the immense pool of liquidity available to absorb such losses, and to prevent them from infecting the financial system as a whole.

Update to strategic view
FED FUNDS: Distress in the subprime market has given new life to expectations that the Fed will cut rates by year-end. While the environment of excess liquidity will absorb any subprime problems, the Fed is likely to stay on pause to be sure. But stronger than expected growth and inflation will keep the Fed from cutting rates, and should lead to renewed rate hikes.
[see Investment Strategy Dashboard]



PALM SPRINGS, CA:
LIQUIDITY MARCHES ON

When the dust clears, and the conventional wisdom moves on to a new crisis to worry about, our guess is that not only will losses in the subprime market not have become a contagion to the wider economy, but that the subprime market itself will continue to function. Given the liquidity that can be brought to bear, the trillion dollar subprime market is too little to fail.

The pool of available liquidity was able to absorb the Amaranth failure -- involving the largest losses ever taken by a single hedge fund -- without a ripple. In fact, it might be better said that the Amaranth failure was an opportunity -- an opportunity for distressed assets to fall into strong hands, serving to absorb excess liquidity that was otherwise unemployed. That liquidity is the result of the Fed having been ultra-accommodative from 2002 to 2004, and remaining somewhat accommodative even today after 425 basis points in rate hikes. Without some use, that liquidity merely drives inflation as holders of excess dollars

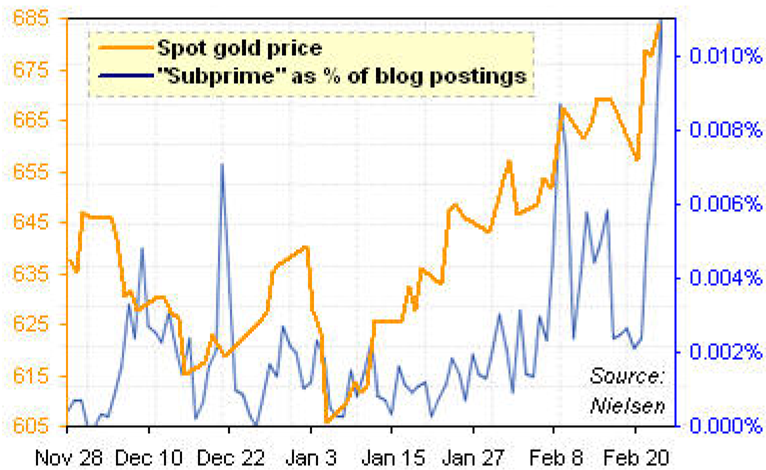
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

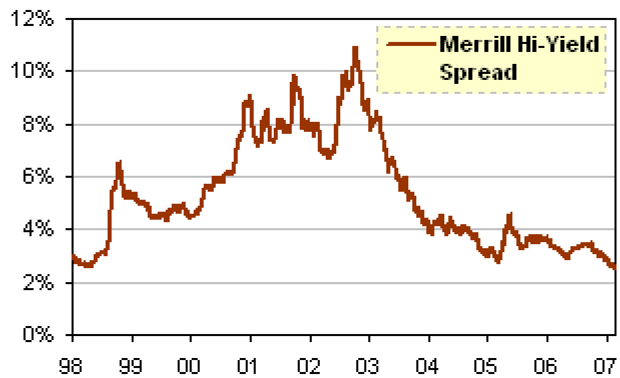
seek to exchange them at higher and higher prices for goods and services. This process is seen first and most clearly in the prices of fungible and storable commodities such as gold and oil, which have soared since the Fed first became excessively accommodative four years ago.

The latest move up in gold, more than 13% in the less than two months since the lows of early January, has corresponded to increasing buzz about problems in the subprime market. This suggests to us that subprime has now become a new factor in the inflation risk equation -- the possibility that the Fed will seek to engineer an unneeded bail-out of the subprime market by adding more liquidity on top of the excess that already exists.



GOLD TRACKS THE BUZZ ABOUT PROBLEMS IN THE SUBPRIME MARKET

Such bail-outs were necessary from time to time during Alan Greenspan's Fed chairmancy. During that era of scarce liquidity -- tight money -- his various bail-outs became known as the "Greenspan put." Today, the "Bernanke put" works differently. We're in an era of abundant liquidity --easy money -- in which the bail-out is in effect before the problem even happens. Exercising an additional put by cutting interest rates -- or even by staying on pause at today's somewhat accommodative 5.25% -- would be entirely redundant from a risk-management point of view, and would aggravate pressures that have already lifted reported inflation above the Fed's comfort level.



NO ILLIQUIDITY IN THE JUNK MARKET

If more liquidity were necessary to deal with subprime problems, we'd see some signs of distress in other liquidity-driven markets. But just the opposite is the case. For example, in the high-yield bond market, spreads have fallen to within handful of basis points from all-time lows. At some point in the future, once the Fed has raised rates to levels sufficient to sop up today's excess liquidity, the "Bernanke put" will no longer be in effect 24 hours a day, and problems like those in the subprime market will lead to substantial distress with significant risk of spillover into the general economy. That world will be very different from today's -- with normal credit spreads, and normal levels of S&P 500 volatility. But for the moment we live in a world in which risk is low, and can be effectively priced at zero. Today adding liquidity to this already excessively liquid environment would be the worst mistake the Fed could possibly make.

BOTTOM LINE: The Fed paused its rate-hiking cycle last August out of concern that the housing slowdown could infect the entire economy. The Fed has conceded that housing is stabilizing, and shows no signs of having had any deleterious effects on other economic sectors. Correspondingly, expectations in the fixed income markets for Fed rate cuts in 2007 have significantly lessened. But those expectations have come back off their lows as problems in the subprime market have come to light. We expect the environment of excess liquidity to absorb any subprime problems, but it will take some time to play out -- and the Fed is likely to stay on pause while it does, just to be sure. But stronger than expected growth and inflation will keep the Fed from cutting rates, and -- once the subprime problems are behind us -- should lead to renewed rate hikes. TM