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MACROCOSM

All Tip, No Iceberg

Friday, March 16, 2007

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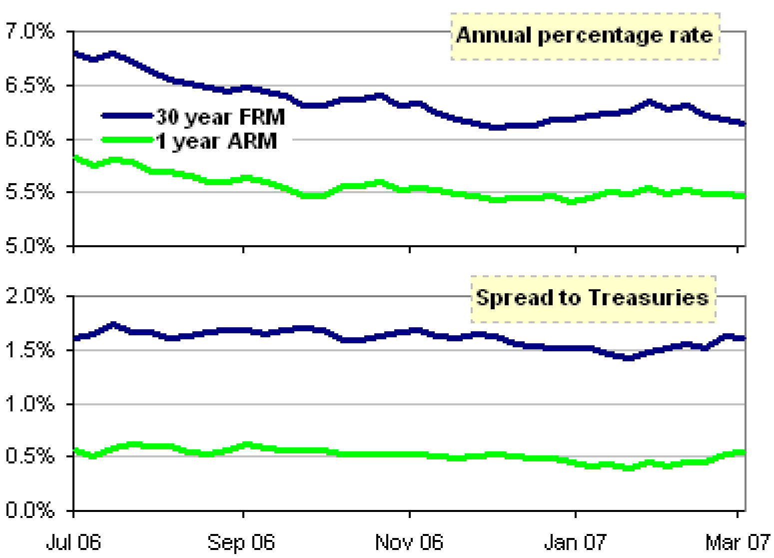
Superabundant liquidity is buffering the economy from problems in subprime.

Update to strategic view
US MACRO: For all the alarm about the subprime lending collapse, markets are showing no evidence of a systemic credit contraction. We believe that monetary liquidity remains super-abundant, and is buffering the overall economy from potential spillover effects from subprime.
[see Investment Strategy Dashboard]

The widespread alarmism about the subprime lending market is beginning to take on the intensity of the oil and gas panics following Hurricanes Katrina and Rita (see "Water In The Streets" September 1, 2005 and "Played Out" October 5, 2005). Seemingly credible fears then about energy prices and shortages and their effects on the economy were so intense -- and turned out to be so wrong -- that we'll bet that most investors who bought into them have managed to erase the memory. When a similar amount of time has passed after the present subprime lending panic -- and it has become clear that the economy successfully absorbed and adapted to any attendant difficulties -- we expect that today's fears will be just as difficult to remember. We believe that investors are exaggerating the dimensions of the subprime problem (see "What Would Say Say?" March 15, 2007), and underestimating the capacity of today's superabundant liquidity to buffer the problem's macroeconomic spillover risks.



SUBPRIME PROBLEMS HAVEN'T EVEN SPILLED OVER INTO THE REST OF THE MORTGAGE MARKET

If the collapse of subprime lending were to have any spillover effects, the first place we'd expect to see them would be in the mainstream mortgage market. Rates should rise to reflect an increasingly scarce supply of funding, as liquidity is soaked up in the process of absorbing losses in subprime. But just the opposite is the case. Since the subprime sector's problems have come to light, mortgage rates have actually fallen. Spreads to Treasury yields have

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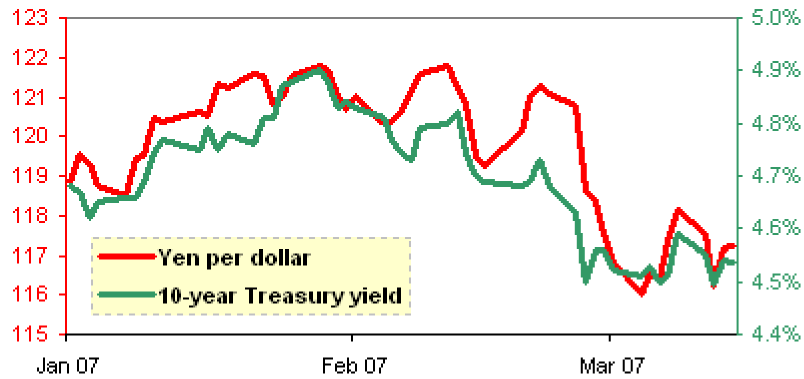
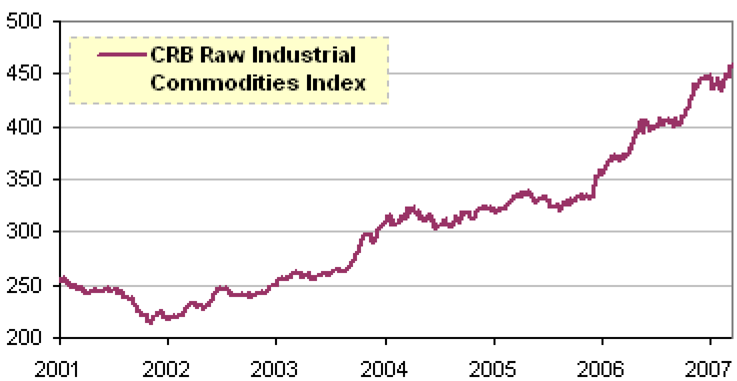
widened slightly over the last several weeks, suggesting a marginally higher risk premium being attached to mortgage lending. But the widening has been miniscule, and spreads are still narrower than they have been for most of the last seven years. Liquidity is so plentiful that financial markets are able to take their lumps in subprime and continue to fund mainstream mortgages at the same time.

Fueling the fear these last several weeks has been the idea that liquidity is being rapidly reduced by the Bank of Japan's slightly less easy monetary policy posture, and the demise of the yen carry trade (see "Carried Away" March 1, 2007). According to the conventional wisdom, the yen carry trade has been liquefying the US economy by propping up long-term US Treasuries, and keeping US interest rates anomalously low. If that were true, then we'd expect Treasury yields to have risen over the last few weeks as the yen carry trade has been unwound and the yen has strengthened against the dollar. But just the opposite has been the case.



APPARENTLY THE YEN CARRY TRADE WASN'T PROPPING UP THE TREASURY MARKET AFTER ALL

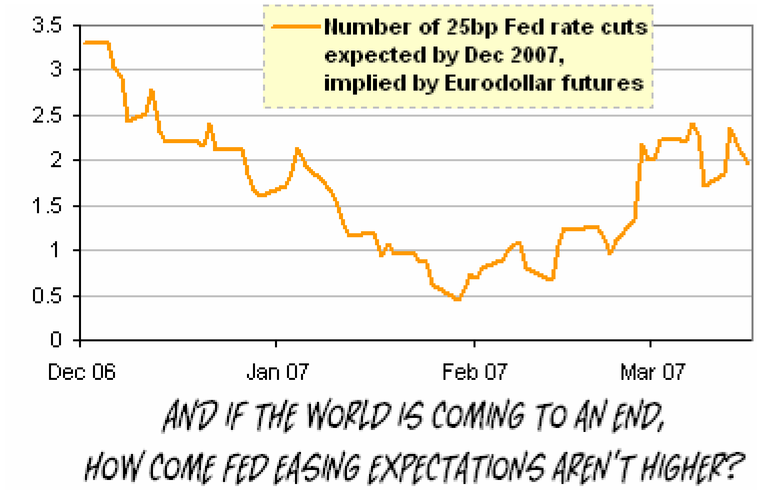


SOMEBODY FORGOT TO TELL INDUSTRIAL COMMODITIES ABOUT THE END OF THE WORLD

If the economic expansion were seriously threatened, and if liquidity were seriously expected to be impaired, then we would not be seeing the strength we are seeing in growth-sensitive and inflation-sensitive commodities. The CRB Raw Industrial Commodity Index has moved to all-time highs. And resource stocks have been among the strongest in the equity market. Since the mid-February top, energy has been the second best performing S&P 500 sector (beaten only by utilities); since the interim bottom, materials has been the best performing S&P 500 sector (see "Something's Survived" March 8, 2007).

The most intriguing evidence from markets that the present panic is overdone comes from the markets for Fed expectations -- markets which have for the last several years gorged on exaggerated notions of the Fed staying hyper-accommodative forever. It's notable that with pessimism about the economy as profound as it would seem to be now, the 10-year Treasury yield has not matched its lows of last December. Similarly, Fed rate cut expectations in the Eurodollar futures markets have not matched their December highs. Then almost three and a half 25bp cuts were expected by December 2007 -- today, less than two cuts are expected. There's still al long way to go, but markets are gradually moving in a pattern that points toward the view that what we've been espousing ever since the Fed paused its rate hiking cycle last August -- that rates are still too low, and will eventually have to move up (see "March to Folly"

August 4, 2006). If liquidity is sufficient to buffer the spillover effects of the subprime problems, and if reported inflation continues to run above the Fed's comfort level, then there's simply no reason to cut rates and every reason to raise them.



BOTTOM LINE: We conclude that the panic about the subprime sector is overdone. There are no doubt heavy losses to be taken by failed speculators in that sector, but we flatly reject the widespread notion that subprime problems will infect the entire economy. Stocks worldwide have corrected sharply in this panic. But our call one day before the top was that valuations and sentiment had set stocks up for a correction (see "Enough Good News for a Correction" February 16, 2007), and since then the subprime issue has simply provided an arbitrary narrative. Liquidity remains superabundant, and the economy is already using it to buffer the consequences of the subprime problem. Of greater long term concern is what will happen when the Fed finally resolves to mop up that liquidity, and the world has to face the next inevitable crisis without it. Or worse, what if the Fed doesn't mop it up at all? Then we can have a legitimate panic -- about inflation.