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MACROCOSM

The Subprime and the Banal

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The global liquidity surplus will absorb the latest speculative crisis. The problem is that everybody knows it.

A second round of the subprime meltdown is upon us, triggered by losses in two Bear Stearns funds. Matters are now arguably worse this time compared to the first round last February, with the closely watched ABX-HE-BBB indices making all-time lows. In one sense this has been a bolt from the blue that has interrupted the slow march of stocks to new all-time highs, despite a reaccelerating economy and resurgent forward earnings, and provided the chance for Treasuries to correct from their mini-crash to five-year highs in yields. And it's been the opportunity for some small measure of Fed easing expectations to slip back into the markets. But compared to the outright panic that ensued last February, the reaction to the latest subprime crisis has been modest. We don't expect the new round of subprime troubles to have lasting impact on the financial system or the economy. Markets may have to continue to correct their larger trends -- stocks higher, bonds lower -- for a short while longer, but the subprime smoke will clear quickly, and those trends will resume when it does.

The economy is stronger now than it was in February during the first subprime crisis, and is better able to withstand shocks (see "Rodney Revisited" May 29, 2007). And for those who thought the weaker economy of last February would surely be tipped into recession by the subprime crisis, the present reacceleration of growth is a sharp rebuke to their "housing contagion" theory -- a theory with which we have always disagreed (see "All Tip, No Iceberg" March 16, 2007).

As to systemic risk, our view today is similar to the one we expressed in February when we said that the financial system would easily weather the subprime storm (see "Subprime Time" February 26, 2007). We argued that the global surplus of dollar

Update to strategic view

US MACRO: Global liquidity is in sufficient surplus to immunize the financial system and the general economy from the latest subprime crisis. But the liquidity surplus is becoming more widely recognized by market participants, and with the Fed now generally expected not to be cutting interest rates, the expected quantity of liquidity is falling. Long term, we caution that the liquidity surplus cannot be relied upon forever to heal all financial wounds.
US STOCKS: Stocks are consolidating while the latest subprime crisis plays out. It will shortly be off the radar, and stocks should move gradually back to the highs.
US RESOURCE STOCKS: Energy and basic materials should continue to be driven higher by global growth and continuing inflation pressures. But with the Fed not likely to cut rates, the strongest bull case is off the table.

[see Investment Strategy Dashboard]

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liquidity -- caused primarily by the Fed's having kept interest rates far too low for far too long -- would easily absorb the consequences of the bursting of the bubbles that it itself caused in the first place. At that time, that was a maverick view -- and it turned out to be right. We still stand by that view today with respect to systemic risk arising from Bear Stearns' subprime problems. But since February, the idea of a global liquidity surplus capable of immunizing the financial system against such contagions has become commonplace. We now hear about it daily in stories in the *Wall Street Journal* and on CNBC. The specifics are often quite mistaken in these stories, but still, as contrarians we have to be concerned about too great an acceptance of the general idea.

It's not that there isn't enough surplus liquidity to handle the latest subprime crisis -- there is more than enough. But when the consensus expects that surplus liquidity is a sure-fire free put, we can be sure that eventually the total amount of risk taken in the market will rise to a level such that the liquidity won't be enough anymore. Call it moral hazard, or just the kind of equilibration of risk-taking behavior observable, say, in the way automobile drivers will tend to go faster when they are wearing seatbelts. It's a corollary of Parkinson's Law: risk-taking expands to use up available risk-remediation. Abstractly, it's a good thing, since growth is a product of risk-taking. But when puts are perceived to be free, the types and quantities of risk that are taken can be quite counterproductive. You don't have to look very deeply at today's credit markets to see examples.

We also note that the conventional wisdom's cognizance of the healing power of surplus liquidity comes, ironically, at the same time as the expected quantity of that surplus is falling. The widespread belief that the Fed was poised to cut interest rates -- when rates were already too low -- led to expectations that global liquidity, already in surplus, would nevertheless be increased to even greater levels of surplus. Some modest rate cut expectations have returned over the last week, but compared to the extravagant hopes of most of the last year, they've now largely been dashed. This means that the *expected* amount of surplus liquidity has fallen. We can see this registering in the current consolidation of liquidity-sensitive markets such as gold and the US dollar.

But the global liquidity surplus story still likely has some surprises in it. The Fed may not be cutting rates, but as the economy continues to accelerate, a 5.25% funds rate gets effectively easier and easier. Staying on pause while the economy accelerates isn't as bad a liquidity mistake for the Fed to make as cutting rates, but it's still a mistake -- it will still add to the global liquidity surplus. We see no near-term scenario under which the Fed is likely to do anything to outright drain the surplus of global liquidity. Best case, they will add to it slowly through the rest of the year by staying on pause -- which, at least, is better than if they had cut rates and added to it quickly.

The global liquidity surplus story may have become banal, but the conventional wisdom has yet to grasp the inflationary implications of it. Inflation is the cost of those "free" puts we mentioned earlier -- its the inevitable result of what might be called too much money chasing too few financial crises. So we are not comforted by the last couple months of seemingly benign inflation data. With rate cuts off the table, we may have avoided the worst-case inflation scenario. But as the economy reaccelerates and the Fed stays on pause, new inflation pressures will be imparted to the economy. At the end of last month, when Fed rate cut expectations first appeared likely to collapse, we sounded a note of caution on the most inflation-sensitive equity sectors, in the context of our overall bullish view on them (see "Inflation Plays Revisited" May 31, 2007). It's telling to observe just how strong they've been since then. The S&P 500 has fallen 1.8%, but energy is the best-performing S&P 500 sector (up 2.3%) and basic materials is tied for second best (up 0.2%). This sector performance is telling a story about global growth to be sure, but make no mistake about it -- there's an inflation story here, too.

BOTTOM LINE: Global liquidity is in sufficient surplus to immunize the financial system and the general economy from the latest subprime crisis. But the liquidity surplus is becoming more widely recognized by market participants, and with the Fed now generally expected not to be cutting interest rates, the expected quantity of liquidity is falling. Long term, we caution that the liquidity surplus cannot be relied upon forever to heal all financial wounds. For now, stocks are consolidating while the latest subprime crisis plays out. It will shortly be off the radar, and stocks should move gradually back to the highs. US resource stocks -- energy and basic materials -- should continue to be driven by global growth and continuing inflation pressures. But with the Fed not likely to cut rates, the strongest bull case is off the table.