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MACROCOSM

Fever of Fear

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It's not the end of the world. But the price of risk-bearing has gone up -- to normal levels.

Update to strategic view

US MACRO, US STOCKS, US BONDS: This market downdraft attributable to credit market worries is likely to prove overdone. Debt markets have been forced to reprice for risk after undergoing an unsustainable orgy of low-priced risk-taking. While that has been an unwelcome wake-up call for market participants, we see nothing to alter our view that the fundamentals remain positive for equities and the economy, and negative for long-term Treasuries.

[see Investment Strategy Dashboard]

Amid the mounting market panic over sub prime woes and their broader credit market implications, we would counsel maintaining a measure of calm. The current bout of anxiety bears some surface resemblance to the crisis which struck financial markets in late summer 1998, culminating in the Russian default and collapse of Long Term Capital Management. The signs of stress then were also particularly focused on the debt market, with high risk credit spreads moving sharply higher.

But there's a critical difference between current conditions and those extant in that earlier episode. That crisis was in large measure the consequence of excessively tight Fed monetary policy which put powerful upward pressure on the dollar in forex markets, leading to the wave of emerging market devaluations and collapsing commodity prices. The deflationary tilt to policy magnified the real burden of debt, punishing borrowers and pushing up the risk premium demanded by creditors.

The present freak-out is something entirely different. Far from being tight, monetary policy remains accommodative. On a trade-weighted basis, the dollar remains near record lows against its G-6 counterparts, and while the price of gold is down nearly $20 in the rush to liquidity of the past couple sessions, at about $660 it is still some 75% above its 10-year moving average. And this morning crude oil traded at all-time highs. In fact, the Fed's long-standing excess liquidity posture is the relevant context to any understanding of the angst now afflicting the markets. The easy credit conditions fostered an environment in which no borrower was deemed too risky, giving rise to the subprime mortgage phenomenon and to private equity loans with increasingly lax covenants and repayment terms, thriving in a world of cheap loanable funds looking for a home.

The unraveling of recent weeks can be seen as a reckoning with the reality that even in an easy money environment, there's potential for highly adverse consequences when a rational price is not paid for risk. This has been most vividly illustrated by the subprime meltdown. The difficulty

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now being experienced in other sectors of the credit market are not a matter of a spreading subprime "contagion," as such. It is simply an awakening to the fact that risk was underpriced and so must now be repriced at more normal levels.

The contrast with the 1998 experience could also prove instructive for divining the way forward. In that era of an excessively tight Fed, money was already scarce, so there was little cushion available to absorb the incremental demand for liquidity arising from the market blowout. In essence, the Fed's stance gave rise to a vicious cycle in which its deflationary posture created conditions which further deepened the deflation. Eventually, the markets seized up and the Fed was finally compelled to initiate a series of rate cuts to avoid an all-out financial collapse. Today, we suffer from no such dearth of liquidity. That also points up the sharply different fundamental backdrop between now and then. To be sure, an excessively accommodative Fed is courting the risk of an inflationary breakout that likely will at some future point prove highly damaging. At the moment, however, the policy stance can hardly be considered restrictive, suggesting that while the market's risk preference may be reverting to less exuberant levels, actual credit risk remains quite unthreatening.

In that regard, it's worth noting that the spike in credit *spreads* seen in the last several weeks has considerably outpaced the rise in *absolute yields* being experienced by corporate borrowers. For the most part, the widening of spreads has coincided with the rally in Treasuries seen since the 10-year yield reached 5.3% last month. The Merill High-Yield Index spread has jumped some 130 bps since bottoming at 241 bps last month. But the 10-year Treasury yield has also fallen about 50 bps. The major driver for the Treasury rally has been the altered risk environment shaped by the subprime and credit market woes. This suggests that a restoration of some sense of stability in the credit markets will be met by a renewed sell-off in Treasuries, which is likely to be seen in a narrowing of credit spreads.

BOTTOM LINE: This market downdraft attributable to credit market worries is likely to prove overdone. Essentially, debt markets have been forced to reprice for risk after undergoing an unsustainable orgy of low-priced risk-taking. While that has been an unwelcome wake-up call for market participants, we see nothing to alter our view that the fundamentals remain positive for equities and the economy, and negative for long-term Treasuries.