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MACROCOSM

Thoughts After a Very Rough Week

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Two weeks after all-time highs, panic-stricken stocks are almost as cheap as they were at the very bottom.

A month ago when the current subprime crisis first emerged, we expected it to blow over quickly and for stocks to move to new highs (see "The Subprime and the Banal" June 25, 2007). We were half right, at least at first -- stocks did indeed go to all-time highs. But we were caught flat-footed by the longevity and intensity of the subprime crisis, and by the violence of the correction in stocks from their highs. And our characterization, last Wednesday, of the reaction in equity markets as a "consolidation" was certainly too mild (see "Bill Gross Shoots, But Can't Hit" July 25, 2007). This is a full-blown correction, driven by the unpredictable dynamics of panic -- but we emphasize that we believe the panic will burn itself out, and that a correction is all this is.

Following is a montage of thoughts on where we're at, and where we're heading.

EXPANDING EQUITY RISK PREMIUM Risk premia of all types have expanded over the last week. We noted just two weeks ago that the *equity risk premium* (the difference between the forward earnings yield of the S&P 500 and the coupon yield of Treasuries) had contracted to its lowest level in two years (see "The King Is Dead, Long Live the King" July 9, 2007). Even then, the equity risk premium was quite wide by historical standards, and strongly supported expectations of excess returns from stocks relative to bonds. But now, with stock prices and Treasury yields falling and consensus forward earnings rising, the equity risk premium has widened out dramatically. It has returned to the elevated range it had occupied for most of the last two years (during which stocks generally outperformed bonds), and is approaching the levels seen at the panic bottoms of October 9, 2002 and March 11, 2003 (both of which were stellar opportunities to buy stocks and sell Treasuries).

Update to strategic view

US STOCKS: Panic dynamics are in control, but falling stock prices and Treasury yields are making equities extremely attractive again. We continue to wait for a signal of the unlocking of frozen credit markets, which will catalyze a stellar entry point in stocks.
US RESOURCE STOCKS: US resource stocks have been babies thrown out with the bathwater in the panic. With growth intact and the Fed now having more reason to stay on pause indefinitely, when stocks turn around these sectors should lead the upside.
FED FUNDS: Markets expect the Fed to cut rates again, and that expectation itself is providing liquidity that will ease the present panic. We don't think the Fed will in fact cut rates, because it won't have to -- but the panic is more reason for the Fed to stay on hold indefinitely.

[see Investment Strategy Dashboard]

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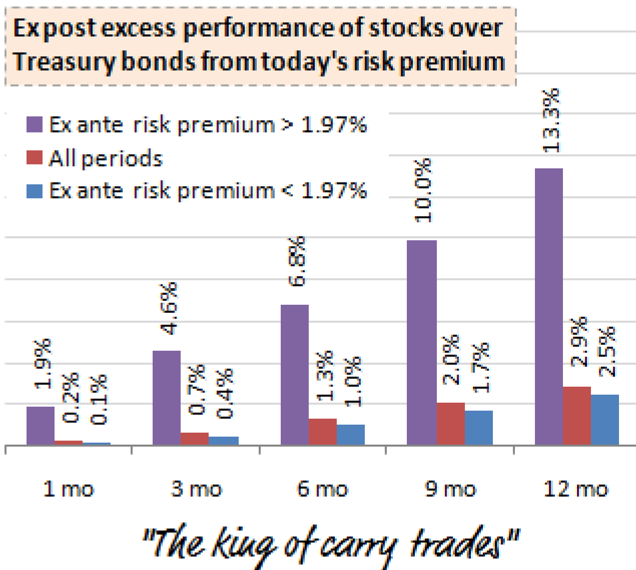
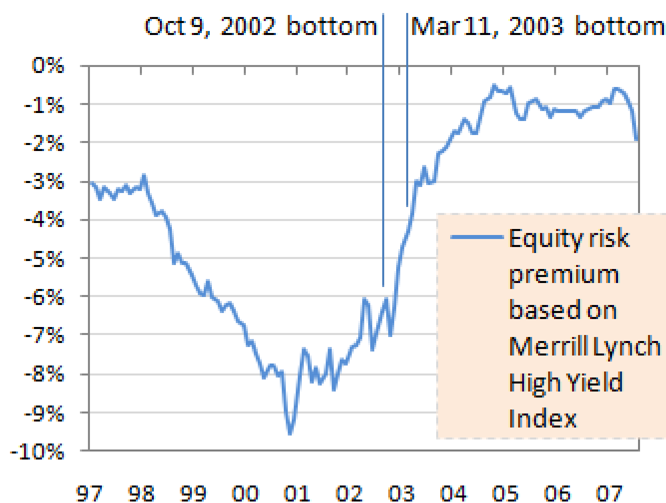


"The king of carry trades"

CREDIT SPREADS AND THE STOCK MARKET The sudden expansion of credit spreads in high-yield corporate bonds adds a special dimension to our consideration of the equity risk premium. It is the case that the equity risk premium has not expanded at all over the last couple weeks -- *if we calculate it using the yield of high-yield corporates* (which has risen) rather than the yield of Treasuries (which has fallen). In fact, using junk yields, the equity risk premium has fallen to its lowest level in over three years. Thus over the last two weeks, despite falling prices, stocks have become less attractive to private equity firms who make acquisition decisions based on the cost of high-yield bond issuance.

But that doesn't mean that stocks will be beached for lack of support from private equity deals. With the equity risk premium versus Treasuries expanding, stocks have become *more* attractive to plain vanilla institutional investors who make asset allocation decisions between equities and Treasuries. Moreover, private equity firms will not likely be out the stock market at today's wider credit spreads and narrower equity risk premium. The glory days of virtually free high-yield financing are over for the time being, yet credit spreads and the absolute level of high-yield interest rates are *still extremely low* compared to historical norms. Thus the equity risk premium from the standpoint of a private equity firm isn't really especially narrow. In fact, today it is far wider than it was at either of the panic bottoms of October 9, 2002 or March 11, 2003.



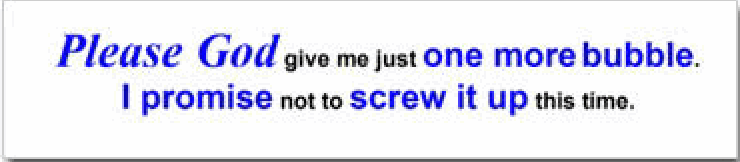
The edge for private equity has narrowed -- but stocks are even cheaper than at the panic bottoms of 2002 and 2003

DEBT MARKET DYSFUNCTION We're aware that valuation arguments like the ones above won't make any difference until the present dysfunction in the credit markets resolves itself. The CDO and CLO markets are frozen while participants reassess the myriad risks in these highly complex securities. Not very liquid in the best of times, these markets are now virtually totally illiquid -- and nothing panics market participants more than an endogenous breakdown in market structure that impedes liquidity (just as the sound of a door being bolted from the other side gives rise to a burning urge to get that door open -- even when there is nothing objectively to be feared).

The last time we saw this particular kind of panic was in October 2005 in the natural gas market, just after Hurricane Rita wiped out Louisiana's Henry Hub, the delivery point for NYMEX gas futures. At the time we suggested selling gas into a panic that we saw was driven by

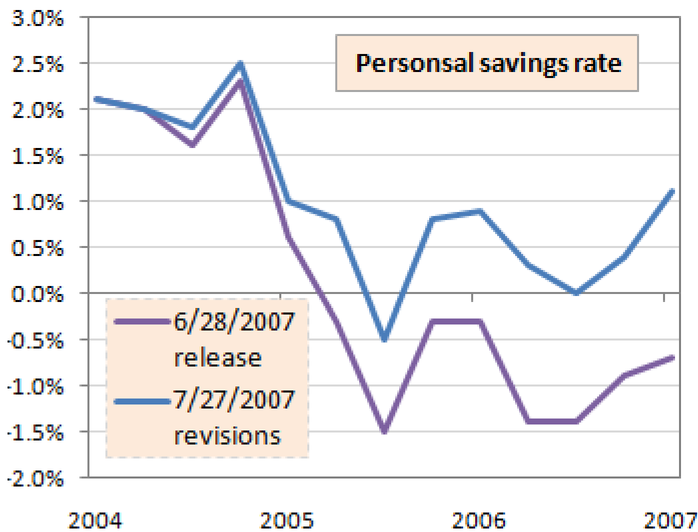
endogenous market failure, not exogenous fundamentals -- and just a month later, the price of gas had fallen by about half (see "Played Out" October 5, 2005). We see the present hurricane in the credit markets as being not terribly different. It's impossible to know if we're at the climax of panic at this exact moment, but we can be pretty confident that things will look a lot better a month from now. Could they look worse? We can't recall a weekend in which we saw more news stories about "global meltdown," "contagion," "collapse," "crisis" and the like. *They don't print stories like that at tops.*

WHAT WILL THE FED DO?
Expectations for Fed rate cuts have come back into the futures markets, having been virtually eliminated several weeks ago (see "Doves Eat Crow" June 6, 2007). One full 25 bp rate cut is now expected by year end, and two are expected by mid-2008. We think it's highly unlikely that these expectations will be fulfilled. As we regard the present credit panic to be substantially an endogenous market phenomenon, we don't expect any particular effects from it on employment or consumption that would motivate the Fed to ease. In that sense, we feel no different about the possibility of rate cuts today than we have felt over the last three years of persistent consensus recession fears, all of which have turned out to be false.



A bumper sticker observed in midtown New York

But in another sense, today the consensus for rate cuts has a rationale it's never had before -- a liquidity crisis in the financial system of as yet unknown significance. In the past, liquidity crises have been sufficient to motivate even a deflationist like Alan Greenspan to cut rates for at least a short period, so it's not too much of a stretch to think that Ben "Helicopter Drop" Bernanke would do the same thing. But we should be careful of how we compare today's situation to its seeming precedents. We've already noted that the present crisis is fundamentally different than, say, the Long Term Capital Management crisis of 1998 (see "Fever of Fear" July 26, 2007). That crisis was precipitated by an excessively *tight, deflationary* Fed -- easing then was an appropriate and effective solution. But today's crisis was precipitated by an excessively *easy, inflationary* Fed. We think that enough money has already been dropped out of enough helicopters so that the present crisis will be able to resolve itself. Indeed, the very fact that markets now expect the Fed to cut rates itself contributes an important form of liquidity to the market -- expected liquidity. Between the already plentiful real liquidity and increasing expected liquidity, we think the Fed won't cut rates simply because it won't have to.



Savings crisis revised away, just like that!

FRIDAY'S GDP REPORT Somewhat militating against the idea of the Fed cutting rates is the second quarter 2007 GDP report released Friday morning. At 3.4% -- and 4.0% ex-housing -- the economy grew well above what the Fed now sees as its "potential," no doubt exacerbating the Fed's concerns that recent downticks in reported inflation won't be sustained. Revisions of the last three years of national accounts announced Friday downgraded previous growth rates a bit, probably lowering the Fed's

estimate of "potential" growth and making the second quarter's strong performance all the more worrying. At the same time, core personal consumption expenditure inflation was revised higher for the last three years. Also noteworthy, disposable personal income for the past three years was revised higher by $185 billion cumulatively, an amount equal to the annual GDP of Norway, North Sea oil and all. This revision was sufficient to wipe out the negative personal savings rate that has been the subject of so much hand-wringing over the last three years.

OMINOUS POLITICAL BACKGROUND Markets do not live by subprime alone. On Thursday, last week's worst day for stocks, the Senate Finance Committee approved the Baucus/Grassley bill to impose various forms of administrative reprisals against China, to punish it for allegedly keeping the exchange rate of the yuan too low. The Committee approved the bill by a vote of 19 to 1, with only Maria Cantwell, the Democrat from the state of Washington, opposing. This bill is a long way from becoming law. The Senate Banking Committee is protesting it on jurisdictional grounds, and under the Constitution tax bills have to originate in the House anyway. Even if this bill were to become law, it is vague enough so that it's not at all clear it would have any real effect. But it can't be a good thing for markets to have Washington fiddling with protectionism while credit markets burn. It's not the main event right now, but don't let it fall off your radar.

SECTOR DYNAMICS All eyes were on the financial sector last week, down 5.7% while the S&P 500 was down 4.9%. But financials were not the worst performing sector. Basic materials (down 8.5%), utilities (down 7.1%) and energy (down 6.7%) all did worse. Basic materials and energy are our two favorites, being at the intersection of the themes of robust global growth and persistent inflation. They, and utilities, have the distinction of being by far the three best performing since the beginning of the present bull market. Financials, on the other hand, have underperformed the S&P 500. So it's probably the case that, in last week's panic atmosphere, the compulsion to sell was least humiliatingly satisfied by selling those things in which one has the greatest profits (allowing one to tell one's self that he is simply "taking a little of the table" rather than panicking). We don't expect the current credit market crisis to have any long term impact on growth -- and yet it serves to keep the Fed on hold longer, which will only exacerbate the persistence of inflation. When the present crisis passes, the themes of growth and inflation will thus be very much alive and possibly even strengthened, and very supportive of a very strong rebound in materials and energy. Crude oil making all-time highs amidst a credit crisis is definitely a clue.

BOTTOM LINE: Panic dynamics are in control, but falling stock prices and Treasury yields are making equities extremely attractive again. We continue to wait for a signal of the unlocking of frozen credit markets, which will catalyze a stellar entry point in stocks. US resource stocks have been babies thrown out with the bathwater in the panic. With growth intact and the Fed now having more reason to stay on pause indefinitely, when stocks turn around these sectors should lead the upside. Markets expect the Fed to cut rates again, and that expectation itself is providing liquidity that will ease the present panic. We don't think the Fed will in fact cut rates, because it won't have to -- but the panic is more reason for the Fed to stay on hold indefinitely.