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MACROCOSM

2007 and the Ghosts of 1998

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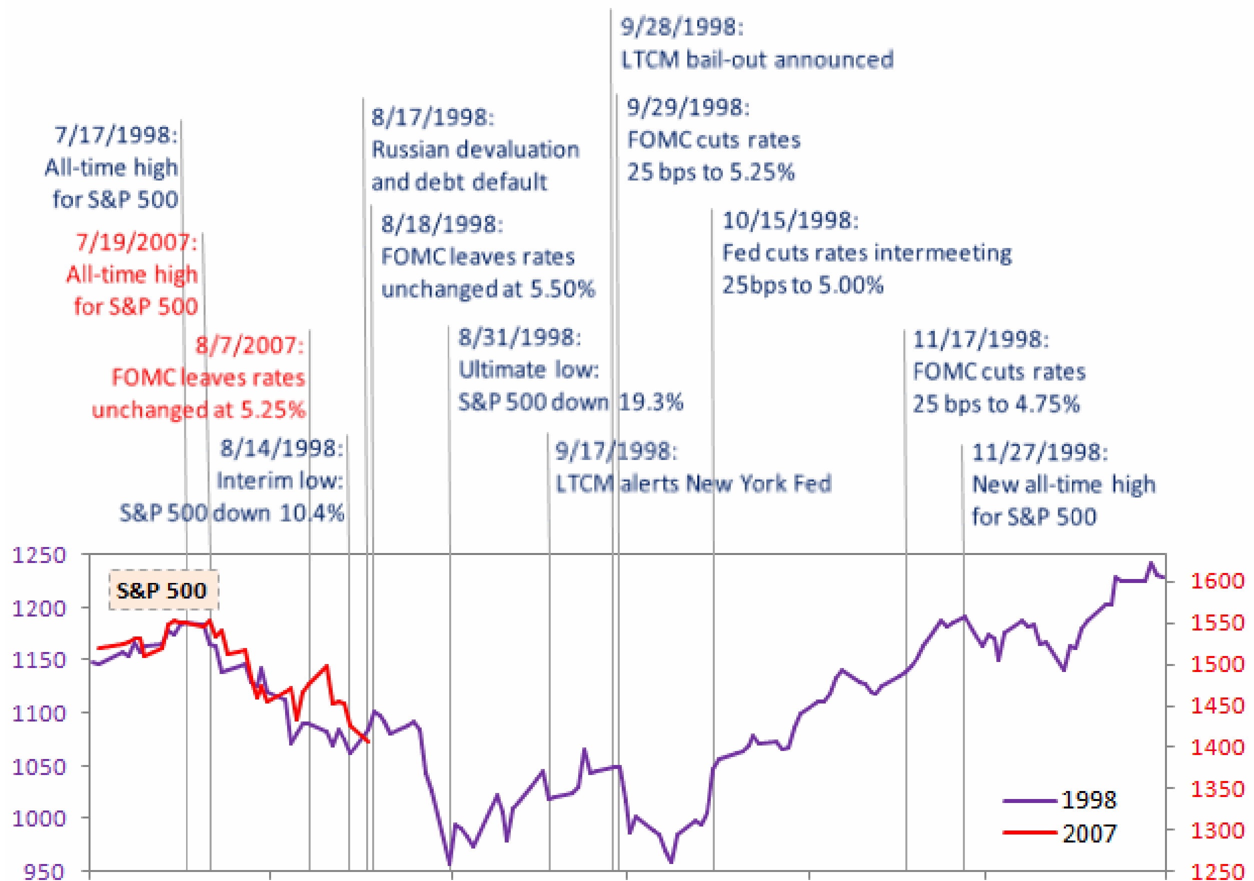
The current crisis isn't a repeat of Long Term Capital Management, but it rhymes.

Update to strategic view
Please see following page

For stocks, the present crisis in markets has so far followed almost precisely the same pattern as that of the Long Term Capital Management crisis of 1998. Then the S&P 500 came off all-time highs reached on July 17, this time the highs were two days later, on July 19. So far the "two days later" pattern continues. In 1998, on August 13 the S&P 500 had lost 9.4% from the highs. This time around, with the same number of days passed, the loss is exactly the same. In 1998, an interim bottom was reached the next day,



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August 14, down 10.4%. Dare we indulge in technical analysis, or downright numerology, by imagining that the pattern will continue? If it does, then today will be an interim bottom on a closing basis, down another 1%. In 1998, on the market day following the interim closing low, stocks traded lower initially on the news of the Russian debt default, but then recovered for two weeks. If the pattern continues, one has to wonder what analogous revelation will come on Friday (or, rather, *which* revelation, from among the many currently being speculated about).

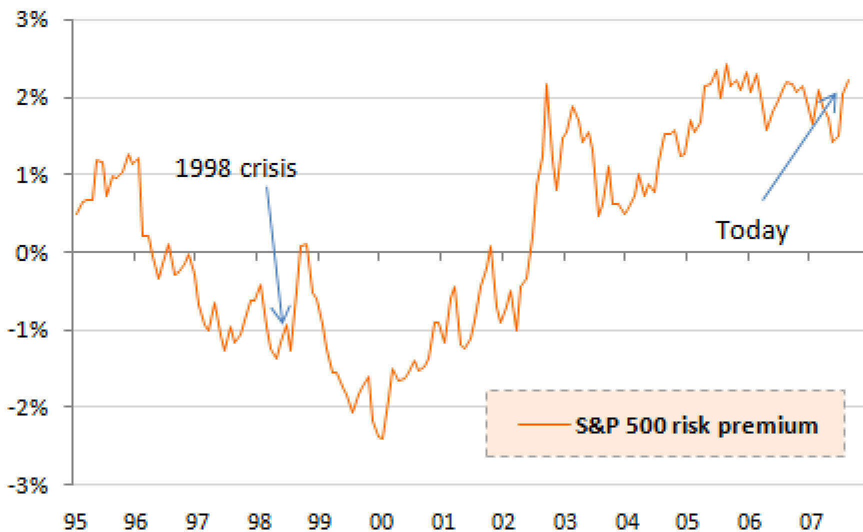
Update to strategic view
US STOCKS: Stocks entered in to the current crisis undervalued, and are now getting absurdly so. Without material damage to the economy, we must be getting close to the limits of what sheer negative sentiment can do on the downside. We look for at least an interim bottom here within days. **FED FUNDS:** There is no material reason for the Fed to cut rates in the current crisis, and important long term reasons why it shouldn't. We still expect no cuts. But the market's urgent expectations for rate cuts could potentially exert an irresistible demand effect on Ben Bernanke.
[see Investment Strategy Dashboard]

Obviously we were wrong when we said last week "the worst is over" (see "Burned Out" August 7, 2007). If we continue now to follow the 1998 pattern, then there is much worse to come after a respite of a couple weeks. In 1998, at this stage in the pattern, the name "Long Term Capital Management" hadn't even come to the surface as the key factor in the crisis (although today, the crisis bears that name). At this stage it was all about the Russian default and devaluation, the risk of contagion in Latin America, and the consequences of similar events the year before in Asia. After LTCM emerged as an issue, the S&P 500 experienced another leg down, ultimately falling 19.3% from its July high. Let's look closer at how the 1998 crisis unfolded, and examine whether today's backdrop of events is or is not truly analogous. While there are many similarities, we conclude that there are many profound differences, and that we are not destined to repeat the extraordinary risks and losses of 1998. We're probably closer to the end of the crisis than to its beginning.

This time around, we have something we didn't have in 1998 -- namely, now we have the memory of 1998, which of course we couldn't have had then. We learned in 1998 that macroeconomic events are one thing, but their impact on the risk-bearing structure of modern markets is another. The current crisis has been characterized by full awareness of the *both* aspects -- both the fundamental macroeconomic issue of subprime mortgage defaults, and the issue of the knock-on effects in today's highly evolved and levered credit markets. So while in 1998 LTCM emerged late in the game as a surprise, this time around markets may well have better discounted the full spectrum of possibilities.

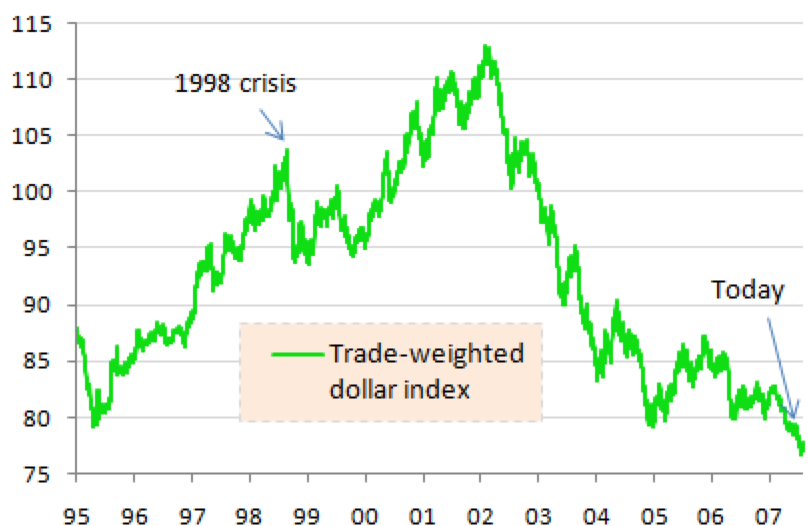
In 1998, the global economy had been weakened by the 1997 Asia crisis (Japan's GDP growth in 1998 was -2%, and Korea's -6%). This time around, we enter the crisis with a very strong global economy. In fact, in the statement following the most recent FOMC meeting at which the Fed declined to lower interest rates in light of the present crisis, strong global growth was mentioned specifically (see "The Fed Gets it Right" August 8, 2007).

In 1998, we were in the period of so-called "irrational exuberance," and stocks were very richly valued. In fact, at the July top before the onset of the crisis, the S&P 500 equity risk premium versus Treasury bonds was at its lowest level since the stock market peak that preceded the crash of October 1987, and not seen again till the top of the "bubble" market in 1999/2000. This time around, stocks are deeply undervalued, with the equity risk premium near all-time highs, competing with levels see in the panic bottoms of October 2002 and March 2003. Though stocks have come off all-time highs in July just as they did in 1998, this time around they have much less far to fall in value terms. After the crisis passed in 1998, stocks recovered sharply, making new all-time highs on November 27 despite their rich valuation. When the present crisis



resolves, we would expect stocks to recover even more sharply, as they have become almost absurdly undervalued.

The most important difference between 1998 and today is the posture of monetary policy, as we have already pointed out several times (see, for example, ["Fever of Fear"] July 26, 2007). In 1998, the crisis was triggered by the Fed having been too tight, engineering a dollar scarcity which led to the deflationary collapse of commodity prices and rise of the forex value of the dollar, causing first the 1997 Asia crisis, and then the Russian debt default. This time around, the crisis was triggered by just the opposite -- the Fed having been too easy, engineering a dollar overabundance which led to foolish credit practices, soaring commodity prices, and a falling forex value of the dollar.



In this regard, the learnings of 1998 are not serving markets well today. The present consensus is that the Fed will ride to the rescue by cutting interest rates, informed by the three rate cuts of late 1998 that put Alan Greenspan on the cover of *Time* as the chairman of the "committee to save the world." That was just the right thing to do then, as we urged at the time, to provide the monetary liquidity necessary to begin healing the damage the Fed's dollar deflation had caused. This time around, there is no shortage of monetary liquidity, and the Fed's open market operations of late demonstrate that there will be as much more as may be required to meet specific systemic needs. That's a critical function for the Fed, and it will help credit markets eventually find their footing here. But in our judgment rate cuts today would be irrelevant, and would in fact create long-term inflation problems that would be even harder to solve than today's credit crisis.

Yet, it seems, the markets demand a rate cut, if nothing else than as a talisman, based on the seemingly magical power they exerted in 1998. Looking back on the exact sequence of the timeline of events in 1998, it is clear that it was indeed the Fed's increasing commitment to rate-cutting that turned the tide, not the bail-out of LTCM (after which the stock market declined steeply, ultimately making new lows on an intra-day basis, but not on a closing basis). At the onset of the 1998 crisis, Eurodollar futures showed that the market expected the Fed to stay tight, actually hiking rates rather than cutting them. Even after the S&P 500 had fallen more than 10%, markets still expected no rate cut. Indeed, there was no rate cut

at the August 18 FOMC meeting, the first meeting during the 1998 crisis. This time around, markets have been more eager -- Eurodollar futures started anticipating a rate cut just days after the S&P 500 came off its July all-time highs. In 1998, rate-cut expectations didn't reach today's level until a couple weeks before the September 29 FOMC meeting (following by one day the LTCM bail-out), at which rates were indeed cut by 25 bps. After that, rate-cut expectations became more intense, eventually exceeding the 75 basis points in cumulative cuts that would end up being implemented in three steps concluding in mid-November. Stocks ultimately bottomed in early October, a week before the Fed's second rate cut -- a surprise intermeeting cut of 25 basis points on October 15.

We have argued the Fed need not and should not cut rates here -- and applauded the FOMC for its decision last week, seeing it at the time as a steady-hand approach that would enhance confidence (again, see "The Fed Gets it Right" August 8, 2007). We continue to believe that the panic currently gripping credit markets can and will resolve itself through private profit-driven action, aided by the Fed's provision of system liquidity as needed through open market operations. Yet we recognize that markets can be irrational things, operating normally on confidence but presently on fear. Fear is in the driver's seat now, and while it makes it hard to forecast exactly what will happen because of its fundamental irrationality, it's far preferable to a state in which actual material damage has been done. Our assessment remains that the subprime crisis is, in material economic terms, quite trivial. The issue is one of sheer sentiment now, and given that, perhaps the talismanic power of a Fed rate cut might help break the spiral of fear, and allow credit markets to find their way back to doing business on a sensible basis. St. Louis Fed president William Poole is quoted today saying "only a calamity" could justify a cut, and we agree with that. But as steadfast as we've been on this matter, at this point we can't rule out a cut.

BOTTOM LINE: Stocks entered in to the current crisis undervalued, and are now getting absurdly so. Without material damage to the economy, we must be getting close to the limits of what sheer negative sentiment can do on the downside. We look for at least an interim bottom here within days. There is no material reason for the Fed to cut rates in the current crisis, and important long term reasons why it shouldn't. We still expect no cuts. But the market's urgent expectations for rate cuts could potentially exert an irresistible demand effect on Ben Bernanke.