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Where's the There There?

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No recession. No deflation. Was this even a correction?

We ventured last Thursday that, based on mapping the present market turbulence to that of late 1998, "today will be an interim bottom" -- and so far that has proven to be right (see "2007 and the Ghosts of 1998" August 16, 2007). Will the bottom be just an interim one? If we continue to follow the 1998 pattern, then there will be another leg down. In 1998, after the first leg down triggered by the Russian debt default, there was another shoe to drop -- Long Term Capital Management -- and another month to wait before the Fed took action with stocks ultimately down almost 20%. But this time around a great number of shoes have already dropped, and the Fed has already acted -- and very intelligently, too (see "A Surgical Strike" August 17, 2007). While we can't rule out a bolt from the blue -- and while recovery from here surely won't be a reliable daily event when so much fear is still in the air -- we think there are sound reasons to think that a sustainable bottom for stocks is in.

Update to strategic view

US STOCKS: Opportunistic leadership in the application of liquidity to distressed markets -- by both the Fed and the private sector -- signals the end of the credit crisis. Stocks remain extremely cheap relative to rising consensus earnings and low Treasury yields, and barring a bolt from the blue, the bottom made last week is sustainable.

US RESOURCE STOCKS: The inflation trend of the last several years is intact, and may even be accelerated if the Fed errs by cutting the funds rate. Inflation-sensitive energy and materials stocks performed badly in the speculative purging of recent weeks, but will resume leadership as stocks overall recover.

[see Investment Strategy Dashboard]

Not least in our consideration is sentiment. Many of our clients are urgently concerned that Wall Street's losses have been catastrophic, and that the very mechanisms of the markets are "broken," and not likely to be repaired for a long time. An insolvency wave and a credit drought will reach from Wall Street to Main Street, and surely, after so many false alarms, recession will finally really be upon us. For us, this extreme pessimism is not aligned with the facts. Already we're seeing the beginnings of opportunistic leadership in the deployment of vast reserves of liquidity, which we said would signify the way forward out of the crisis (see "Bill Gross Shoots, But Can't Hit" July 25, 2007). Last week it was Goldman Sachs reinvesting in its flagship hedge fund, and yesterday it was Bank of America transfusing Countrywide Financial, and four other banks borrowing collectively $2 billion from the Fed's newly stigma-free discount window. As we've said since before this crisis even began, there's no shortage of money in the system (see "The Subprime and the Banal" June 25, 2007). All it takes is the will to use it -- and that will is now starting to be mobilized. Even Bill Gross, whose alarmism marked the beginning of what

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been as much as anything else a crisis of confidence, admitted yesterday it was time to "gradually assume a more risk-taking posture."

For all the fear that the financial sector is "broken," and will drag the rest of the economy down with it, the reality is that…

- …the S&P 500, as yesterday's close, is only down 5.7% from the all-time highs of last month. Even at the worst last week, the S&P never closed even 10% below its former highs, thus arguably failing to qualify the present crisis as even a true correction.
- …there has been no deterioration in consensus earnings estimates. Growing at a 20% annualized rate, forward S&P 500 earnings have moved to all-time highs, above their high a month ago before the present crisis began. That's the case in the aggregate, and for 9 out of the 10 individual S&P 500 sectors -- *including financials*.
- …since the market top in July, the financial sector -- said to be "broken" -- has *outperformed* the overall S&P 500, off only 4.5%.
- …junk bond spreads, and the absolute level of junk yields, are below their average of the last ten years, and never rose above that average at any time during the present crisis.

What these markets are telling us is that, despite all the sound and fury, there's no there there. Specifically, the net economic losses that will have to be absorbed in the present crisis are actually quite modest in the grand scheme of things. Roughly, the only actual losses will be those borne by mortgage lenders whose borrowers are in default, and who are unable to fully recoup in foreclosure. What will that amount to when it's all over -- say, $100 billion? That's serious money to be sure, but it's less than the losses suffered in Hurricanes Katrina and Rita -- and those losses hardly caused the overall economy to hiccup. Beyond those losses in the real economy, the rest of the highly publicized losses of the last several weeks have all been in zero-sum games played in securities markets. For every hedge fund that lost billions disgorging over-levered positions, another one made billions (but got no publicity for it). Providing that all the trades clear, it's all been just a transfer of wealth -- not a destruction of wealth.

We don't deny that debt securitization structures that had become very popular over the last few years have been discredited (no pun intended). And some private equity deals are not going to get done on the highly favorable terms that were initially expected, and some investment banks are going to have to earn their fees by standing up to bridge commitments they now wish they'd never made. But the securitization revolution isn't over (markets are infinitely adaptable and inventive), and the LBO business isn't dead (not when stocks are as cheap as they are now, relative to earnings and interest rates). There is no shortage of money or creativity, and good loans and good deals will get done. And the economy was never dependent on bad loans or bad deals of the type that have blown up this last month -- indeed, it will be better off without such distortions.

Some clients have expressed concern that the present crisis marks the end of the reflationary and inflationary trends of the last several years. We don't agree. We acknowledge that the recent disruptions in markets have called upon the excessive reserves of liquidity throughout the economy, built up over the last several years of the Fed and other central banks having been too accommodative. But that excess liquidity has not been permanently exhausted -- because it has not been absorbed by actual economic losses, but rather used only to ease short-term difficulties in the market's clearing of gains and losses between participants in zero-sum games. Indeed, the Fed and other central banks have recently added *more* liquidity -- at least of a temporary nature -- beyond the excess that was already there. If the Fed ends up cutting the fed

funds rate, that would have the effect of injecting far more liquidity, and of a more long-lived nature. We don't think the Fed will make that mistake, despite the market's very strong expectations to the contrary -- though those expectations are now beginning to unwind (see "The Fed Gets it Right" August 8, 2007). But if we're wrong about the Fed, then the risk is that the reflationary and inflationary trends of the last several years will end up being accelerated.

Yes, the "inflation plays" -- the resource-driven energy and materials sectors of the S&P 500 -- have fared especially poorly during the current crisis. We said early on that that they would be "the babies thrown out with the bathwater in the panic" (see "Thoughts After a Very Rough Week" July 30, 2007). But we see this not as an indicator of shifting appraisals and expectations of monetary liquidity, but rather as the purging of positions in crowded trades held by highly levered speculators -- and for other investors, as a bet on recession. If we were seeing a true reversal in liquidity trends, we would be seeing far more violent moves in the most sensitive indicators of liquidity conditions. Yet the trade-weighted forex value of the dollar has scarcely budged since the onset of the present crisis. And gold, the most liquidity-sensitive market of all, has fallen only about 2%. It's worth remembering that gold fell almost 22% over a similar period in May 2006, when it seemed that new Fed chairman Ben Bernanke was on the warpath against inflation (see "Bernanke Arrives" June 6, 2006).

BOTTOM LINE: Opportunistic leadership in the application of liquidity to distressed markets -- by both the Fed and the private sector -- signals the end of the credit crisis. Stocks remain extremely cheap relative to rising consensus earnings and low Treasury yields, and barring a bolt from the blue, the bottom made last week is sustainable. The inflation trend of the last several years is intact, and may even be accelerated if the Fed errs by cutting the funds rate. Inflation-sensitive energy and materials stocks performed badly in the speculative purging of recent weeks, but will resume leadership as stocks overall recover.