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## Enough Recovery for the Fed?

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**Credit markets have stabilized, which may be enough to give the Fed pause before cutting rates again.**

Signs of healing have become increasingly evident in the credit markets. Progress toward stabilization is an ongoing process, more apparent in some areas than others. But the debt market upheaval that at its height aroused so much angst about potentially triggering an economic bust appears to have run its course without leaving broadly damaging economic consequences in its wake. The issue now is whether the Fed sees the credit market recovery as being sufficient to compel a shift to a less pessimistic view than prevailed at its meeting last month, producing the surprisingly aggressive 50 basis point cut in its overnight rate target to 4.75% (see ["The Fed Gets the Yips"](#) September 19, 2007).

### Update to strategic view

**FED FUNDS:** Institutional momentum at the Fed for further easing is considerable, but broad recovery in credit markets and strong macro data might be enough to keep rates where they are at the October FOMC meeting.

[\[see Investment Strategy Dashboard\]](#)

The minutes of that meeting released this week were notable for the depth of their explication of policymakers' thinking about the implications of the market turbulence. They were also notable for revealing that despite its overriding preoccupation with the potential economic fallout of the crisis, the FOMC deliberately opted not to put forward a "balance of risk" assessment that would have formally signaled a higher degree of concern with growth than inflation. In the context of the uncontested focus of the panel on downside economic risks, and an accompanying downplaying in the minutes of what had been its "predominant policy concern" with inflation, that seemed a curious choice. Perhaps it represented the FOMC's effort to cling to some measure of credibility even as it was caving in to the loud voices in the market pleading for a Fed rescue.

In some ways, those pleaders appear to have gotten what they wanted. In the commercial paper arena, center of the market's reaction to the subprime mortgage meltdown, the calming influence of the Fed's action can be seen in the modest resumption of growth in levels of outstandings. The past two weeks have seen an expansion of outstanding paper by a total of \$9.4 billion, after a contraction of nearly \$315 billion in August and September. The hardest hit sector of the market --asset-backed commercial paper -- has seen the pace of contraction moderate to an average of \$6.5 billion the past two weeks, after plunging by a total of \$250 billion in July and August.

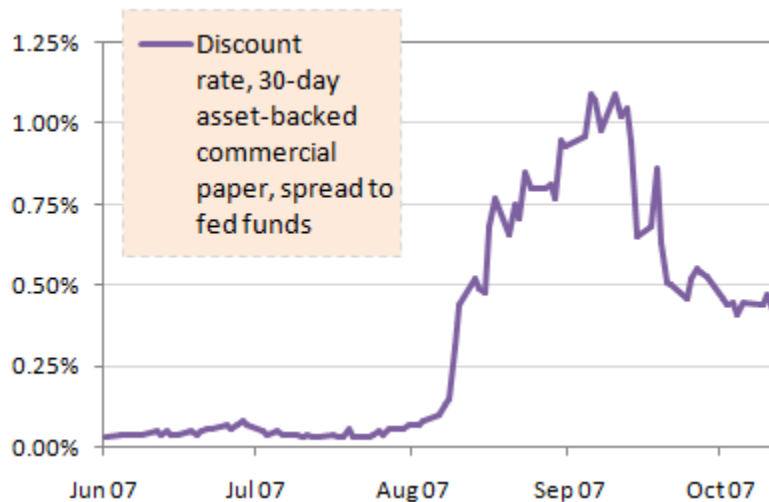
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To a considerable extent, though, those figures have failed to fully convey the functioning of what has been a highly dynamic market even in this recent period. Issuance of new paper has remained vigorous throughout, with a daily average of more than \$180 billion in the past several weeks, down only marginally from pre-crisis levels around \$186 billion in June and July. Actually, new issuance of asset-backed commercial paper is now running at about \$88 billion per day, outpacing the June and July levels around \$70 billion. Clearly, the widely propagated notion that the commercial paper market was all but shut down was a significant exaggeration. The availability of capital in this vital marketplace has continued to be robust.



A direct effect of the Fed action can be seen in the rollback of rates in the asset-backed commercial paper market. The discount rate on 30-day paper is now below 5.20%. That's down more than 100 bps from its highs early last month, and about 75 bps from its pre-Fed levels. It's also below levels around 5.3% seen in the months prior to the market blowup in August. However, those yields reflected a spread of only about 5 bp relative to

the fed funds rate. The current spread is more than 40 bp, a risk premium that could still feed into a sense at the Fed that we're not out of the woods yet.

Along the same lines, the Fed might also be viewing with considerable concern still elevated LIBOR rates and still depressed T-bill yields. At a little more than 5.2%, three month LIBOR is down some 50 bp from its highs early last month, but still showing a stiffer-than-usual premium relative to the funds rate. At a yield slightly below 4.2%, the safe haven appeal of 90-day T-bills has certainly eased considerably since the yield briefly plunged below 3% at the height of the crisis in August. But it still represents a considerable discount against the 4.75% funds rate, which can be seen as a risk premium.

Otherwise, other areas of the debt market are clearly recuperating. High-yield debt and leveraged loan deals are coming to market on somewhat less favorable terms for the issuer, but they are being absorbed by investors with ample cash on hand who are still seeking yield. Yes, there are also deals getting scrapped that would have easily gotten done in the heady days of no-holds-barred embrace of risk. But that's not necessarily a bad thing. With a more rational allocation of risk capital, and a more sensible compensation for risk, the market is adapting in a constructive way to a changed environment that should continue to provide the foundations for sustained expansion.

**BOTTOM LINE:** Easy money is almost always an effective short-term balm for the kind of turbulence that recently affected the markets, with the credit market recovery now being seen as due in part to the Fed's easing move last month. There's also almost always a longer-term price that must be paid for such monetary largesse, and there are clear market signals of the eventuality that could well be in store. That includes gold now trading around \$750 -- a level exceeded on only four single trading days in history -- up nearly \$100 since the turbulence broke out in late August and at its highest levels since the monetary tsunami of early 1980. These indicators, however, count for little among our central bankers, and for the Fed the question is whether the stabilization of the credit markets will be enough to mollify its concerns

about downside risks for the broader economy and keep it from deepening its error. The recovery seen to date might not be. Continued progress in the weeks ahead, though, might be enough to save the Fed from itself. ▶