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MACROCOSM

We Can Build on This -- But How High?

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They won't let the world end. But today's anti-growth politics limit the upside.

Equity markets, especially bank stocks, continue to be roiled by intense uncertainty owing to the confused state of the economic policy environment. In the latest twist, the financial authorities have announced that they will be conducting "stress tests" to gauge the capacity of the nation's 20 largest banks to withstand a worse-than-expected economic decline. Those whose capital adequacy is judged as vulnerable to such a downturn, and who are unable to raise capital in private markets, will be subjected to additional federal capital infusions through the Treasury's purchase of mandatory convertible preferred shares. It remains highly unclear at this point the extent to which public shareholders would stand to be diluted by such injections. Indeed, the government might end up with controlling stakes in institutions judged "too big to fail" and too weak to stand on their own.

Update to strategic view

US MACRO: Markets have absorbed the fact that governments will not let a worst-case systemic collapse occur, fostering a basic level of risk-preference that should stabilize the economy and asset prices. Bank policy remains an important risk to the near-term upside, and its resolution would be good for risky assets in the short-term. But a strong drift toward anti-growth policy overall will limit the long-term upside.

[see Investment Strategy Dashboard]

We got a glimpse at the potential fallout today with the announcement of Treasury's offer to convert its preferred holdings in Citigroup into 36% of the firm's common equity. In early afternoon trade Citi stock had fallen more than 30% to below $1.60. But this is only a glimpse through a distorted lens, leaving considerable uncertainty for the future. Citi's putatively voluntary "exchange offer" is nothing more than that -- an exchange of one form of equity for another, and a corresponding exchange of one form of existing dilution to a new form. While this bows to the faddish fetishism for common equity, it does not in fact contribute a single dollar of new capital to Citigroup.

Key documents

Treasury CAP white paper
Citi exchange offer term sheet

[Client Resources home]

Until the issues involved with restoring stability to the banking system -- and the government's ever-changing role in it -- are resolved, and resolved correctly, the economic outlook will remain uninviting (see "Stocks Test the Lows, Gold Tests the Highs" February 23, 2009). But while the range of uncertain outcomes certainly contains some seriously negative scenarios, markets appear to be assured at least that the very worst-case scenario

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won't play out. Specifically, while the governments of the world may still inflict more harm in unpredictable ways through counterproductive interventions just as they did last fall (see "Death by Rescue" November 17, 2008), at least the government safety net will be there. In a nutshell, the markets are becoming confident that while there may be more AIG's, there will not be any more Lehmans. *Government won't do nothing.*

So amid all the turbulence, it's encouraging to observe that various indicators of baseline systemic confidence have shown considerable resilience, or at least returned to levels assigning a very low probability to a worst-case outcome. For example, the TED spread, the gap between three-month LIBOR and the 3-month T-bill yield, which soared to nearly 460 bp during the banking panic last October, has settled into a range around 90 bps. While that's still high relative to historic norms -- it was about 40 bp pre-crisis in summer 2007 -- it is back to levels seen prior to the outbreak of intense market turmoil late last summer.

Similarly, during the peak of counterparty risk last fall, 2-year swap spreads blew out from less than 90 bp to more than 160 bps. They are now trading in a range from 50 to 60 bp, which is only slightly above the levels seen pre-summer '07. Swap spreads have been a good leading indicator of the market's risk preference, although the lags can be long. The extended narrowing of high-yield credit spreads that began in late 2002 followed by more than a year the decline in swap spreads. As for high-yield, the rally from extremely depressed levels that began in late December has stalled since earlier this month, with the Merrill High Yield Index spread, at around 1700 bp, up about 100 bp from its January low. However, there has been no sign of the outright panic that drove spreads up by nearly 1300 bp, topping out at about 2200 bp, last fall.

These signs suggest to us that against the backdrop of an unrelieved string of extremely poor economic data and continuing market volatility, a basic level of confidence is being restored. That confidence could bode well for a continuing gradual return of the market's risk appetite, especially if the financial policy measures now being considered to relieve the banks of their biggest risks actually succeed in stabilizing the system. While that's no sure bet, the opportunities that would be made available under such a scenario should not be overlooked. In high yield, for example, even with its narrowing by some 500 bp on net, spreads remain at extraordinarily high levels considering that they averaged less than 600 bps over the past 10 years. Further gains are likely to be available here when and if it becomes apparent that the frailties of the financial system are being addressed in some stable and predictable way. And that renewed tolerance for risk across a range of asset classes will also be critical to revitalizing capital formation, key to putting the economy back on a growth track.

No question, these indications of improved conditions are attributable in no small measure to the Fed's highly aggressive response to the crisis beginning last September. Its massive liquidity injections backing a variety of lending programs have considerably relieved the risks that were paralyzing the markets and threatening outright systemic collapse. We have considerable concern about the longer-term inflationary consequences of the Fed's actions, due primarily to the risk that it will be tardy in unwinding its programs once the climate of crisis fades (see "Deflation and Inflation: A Delicate Balance" December 19, 2008). But the Fed's response has been entirely appropriate to its central banking function, meeting the demands for liquidity that were spiking higher in the spasm of risk abhorrence. Absent the Fed's efforts, the system could well have been sent into a deflationary death spiral.

Today's report of a surprisingly steep downward revision in fourth quarter GDP to an estimated 6.2% contraction paints a grim portrait of this economy, and the current quarter is unlikely to be much better. But we have been somewhat heartened by the market's response. The lows in trading today actually came in pre-open activity, on a sharp drop 10 minutes prior to release of the GDP data, in what appeared to be a manipulation in response to the data's having been leaked. Since then, the shorts have been covering and the market has traded well above those early lows. This suggests that as bad as the economy currently looks, the market is fully priced for it, that it is no longer surprised by evidence of the obvious, which is that we are presently in a sharp recession. Having absorbed the obvious, and with at least the basic confidence that the governments of the world won't let the lights go entirely out in the global credit grid, we a situation in which capital can at least consider coming back into the markets for risky assets.

That said, given the political realities, this is an environment shaping up as one that will be less inviting to risk-taking and entrepreneurship than any we've experience in the last quarter decade (see "Obama: '…today does mark the beginning of the end.'" February 20, 2009). It's already painfully apparent that President Obama's extremely ambitious domestic agenda, backed by large Democratic congressional majorities, will involve imposing higher taxes on investment, entrepreneurship and the labor of the most productive participants in the work force. The revenues collected from these higher levies is likely to fall well short of the $1 trillion projected by the Obama budget, as the restraint on the economy's growth potential results in disappointment in the level of labor income and capital gains realizations.

BOTTOM LINE: Markets have absorbed the fact that governments will not let a worst-case systemic collapse occur, fostering a basic level of risk-preference that should stabilize the economy and asset prices. Bank policy remains an important risk to the near-term upside, and its resolution would be good for risky assets in the short-term. But a strong drift toward anti-growth policy overall will limit the long-term upside.