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MACROCOSM

What Would Say Say?

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We're certain the 19th century economic prophet would be unperturbed by the current panic in subprime lending.

Update to strategic view

US BONDS: Driven by recession fears and Fed easing expectations aggravated by the panic in subprime lending, Treasuries and interest rate futures are once again discounting a worst-case scenario that we believe won't occur. As the difficulties in subprime remain encapsulated within their own small domain, fears will abate and expectations will move from rate cuts to rate hikes. Treasuries and rate futures will fall sharply from their present unsustainable highs.

[see Investment Strategy Dashboard]

The economic pessimists, it seems, never lack for a ready supply of rationales to posit that this expansion is heading for the rocks. The latest in the long line of their so-far unrealized gloomy prophecies is that the unraveling of the subprime mortgage market will significantly deepen the woes of the housing sector and put less affluent homeowners behind the eight ball (see "Subprime Time" February 26, 2007). As the pessimistic narrative goes, even if a relatively small percentage of these mortgages end up in default, avoiding foreclosure will mean appreciably higher monthly payments for these householders as their adjustable rates reset in a much less forgiving credit environment. With more of their income going to keep a roof over their heads, less will be available to sustain consumer "demand," and the economy inevitably will feel the pinch. As this subprime panic has raced through the markets over the past several weeks, interest rate futures have sharply upped the odds that the Fed will be compelled to enter easing mode to prop up a faltering economy. In late January, the Eurodollar futures market was priced for a 50% chance of one 25 basis point rate cut by year end. Today, the December Eurodollar futures contract is fully discounting more than two rate cuts, with bonds moving in concert. With a 4.54% yield, the 10-year Treasury is some 35 bps below its recent peak in late January.

JEAN-BAPTISTE SAY
1767-1832
"AS GOODS INCREASE,
SO DO THOSE WHO
CONSUME THEM."
-- ECCLESIASTES 5:10

But from our perspective, this latest iteration of the bearish case is no more persuasive than the earlier versions. From early in the housing downturn, we have maintained that worries over the macroeconomic risks were significantly overdone. The supposed restraint on spending arising from a negative wealth effect due to flat or falling real estate

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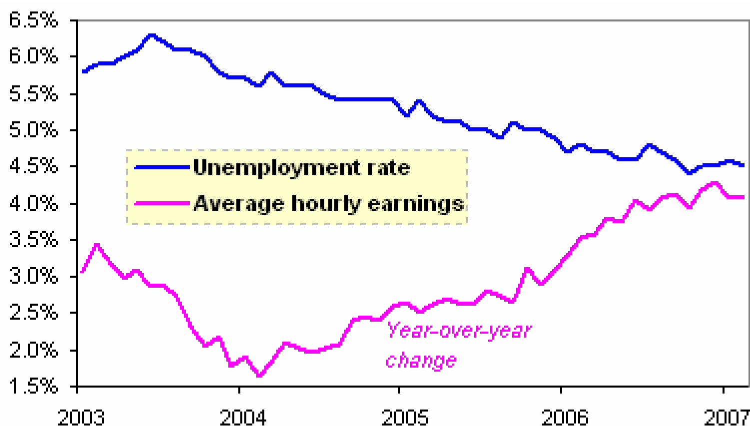
values was unlikely to pan out, we said, because very little consumption growth the past several years was dependent on wealth effects (see "Immaculate Consumption" September 20, 2006). The vitality seen in consumption has been almost entirely attributable to the pace of income growth. We see little reason to think at this point that the subprime "credit crunch" represents a potential exogenous shock to that relationship.

Our conviction in this regard has been based in our grounding in classical economic principles which recognize that the driving force of economic expansion is production (supply) not consumption (demand). Consumption is the reward for production, and as long as increases in production yield increases in income, consumption will rise in turn. As Thomas Sowell put it in his book *Say's Law*, "An increased supply of output means an increase in the income necessary to create a demand for that output. Supply creates its own demand."



CONSUMPTION IS THE REWARD FOR PRODUCTION -- A LOT OF PRODUCERS ARE GETTING A LOT OF REWARDS

Jean-Baptiste Say, we feel fairly certain, would view current conditions as consistent with his thesis, and would likely have little concern that the economy's health was imperiled by the housing slump in general or subprime mortgage problems in particular. To meet the needs of continued expansion in output, employers are absorbing the available pool of workers, pulling the unemployment rate down to 4.5%, a level which in the past 37 years was only bettered at the height of the late 1990s expansion. With labor growing increasingly scarce in a tight jobs market, wages and income continue to be driven up, supporting further growth in consumption. Average hourly earnings of production workers are up about 4% in the past year, not far below their best levels of the late 90s, and in the past three months personal consumption expenditures have grown at a 6.9% annual rate.

As for the subprime market itself, it's difficult to see how the worst-case scenarios could add up to much even on their own terms. For one thing, subprime ARMs represent only seven to eight percent of outstanding mortgage debt. Estimates suggest that resets this year and next will total about $10 billion, which comes to only about 0.1% of personal consumption expenditures. Moreover, subprime households are generally in the bottom 20% of income distribution, accounting for only about 8% of overall consumption spending.

BOTTOM LINE: The latest economic scare infecting the markets, the "credit crunch" in subprime mortgages, is no more likely to be borne out than have any of the other previous scares. As with the others, however, this alarm has been seized on by the credit markets as an excuse to push prices up and yields down on the hope that it will lead to Fed rate cuts. At this point, though, such a bet appears highly implausible, and we'd be taking the opportunity to short Treasuries and interest rate futures that are now pricing such an eventuality.