Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Easy Does It

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David Gitlitz

For the Fed, easing the market's pain means not easing policy.

Update to strategic view

FED FUNDS: Expectations for rate cuts have receded in the last two days, but remain out of all proportion to what the Fed is likely to do, unless the current market turbulence begins to visibly impact the real economy. Betting against the market's inflated rate cut expectations is probably today's most attractive speculative opportunity.
US BONDS: We expect yields across the Treasury curve to rise as expectations for fed funds rate cuts come out of the market.

[see Investment Strategy Dashboard]

The financial media and Wall Street mouthpieces have their script and they're sticking to it: the reappearance of a measure of market calm is largely attributable to hope that the Fed will be cutting rates shortly, certainly no later than its regularly scheduled meeting next month. However, that proposition overlooks the fact that this restoration of some stability has coincided with Treasuries and interest rate futures backing away from their best levels pricing the extent of anticipated Fed action. This nascent return to financial market normality in the context of receding expectations of Fed action offers support for our view that the credit market disruption was not rooted in monetary restraint, and therefore a loosening of policy would be an inapt response. Indeed, by further deepening the inflationary impulses still visible across a range of market indicators, such a move would increase the chances that the Fed would ultimately be forced to undertake a hard-line tightening campaign that would put the economy at serious risk (see "The Fed Gets it Right" August 8, 2007).

This market event was spawned by an overdue repricing of risk which was long delayed due to the Fed's long-running accommodative monetary posture. The Fed's surplus liquidity stance encouraged a massive expansion of leverage which engendered a market environment in which compensation for risk was pulled down to levels implying that there really was no risk at all. The Merrill Lynch high yield credit spread, for example, has averaged about 500 bp over the past 10 years. By the height of the market's quest for risk in June, the spread had narrowed to less than half that, about 240 bp.

Signs of stress first showed up in the mortgage market because that's where the easy money found such a ready home, and where the rush to throw money at anyone who looked liked they had a pulse created the greatest vulnerability. The meltdown of the subprime mortgage market wasn't due to money getting tight in any real sense. It was simply due to rates rising from ridiculously low levels to somewhat less ridiculous levels, which was more than the least qualified tier of borrowers could endure.

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

Yes, in this unwinding there's real pain being suffered and losses incurred. It has precipitated a flight from risk and a rush to cash which has created an impression of somewhat tighter liquidity conditions. But we see little to suggest that this has made a material difference in the availability of dollar liquidity. Gold, the most sensitive indicator of balance in the supply and demand for liquidity, fell back from above $680 just prior to the outbreak of market turbulence last month, and traded as low as $645 in pre-market hours before announcement of the Fed discount rate cut last Friday. It's now trading around $660, just marginally below its 50-day moving average around $675, and still some 75% above its 10-year moving average. Were this a monetary event suggesting a real squeeze in the availability of liquidity, we'd expect to see gold in a steady descent, perhaps falling back below $500, accompanied by a consistent appreciation of the dollar in forex markets (see "Where's the There There?" August 23, 2007). The fact that this hasn't happened tells us that rather than signaling that monetary policy has become too tight for existing conditions, the Fed's stance remains accommodative.

Despite that, there's little doubt that the Fed will be inclined to cut rates if it sees evidence that the market upheaval has imposed a substantial hit to growth. In the Fed's highly deficient demand management model, inflation is a real growth phenomenon, so slower growth means less inflation pressure, giving them room to cut. And to be sure, a freezing up of the credit markets would have significantly deleterious consequences for growth if it continues for any significant length of time. To this point, though, we do not see signs indicating that a material slowdown is in store. While the Merrill high yield spread has spiked on net by about 200 basis points off its June lows, at current levels around 440 bp it remains consistent with a solid pace of expansion. Moreover, the spread has stabilized in the past week after jumping as high as 459 bp a week ago. In other areas, there are signs of some stress in credit creation, particularly in the hard-hit commercial paper arena. Levels of outstanding CP have declined by about $90 billion in each of the past two weeks. But at more than $2 trillion, aggregate issuance of the short-term corporate debt securities is higher than at any point prior to this past May. Commercial and industrial lending, meanwhile, continues to grow at double digit rates, with loans showing annualized growth of 18% in the most recent four-week period.

The Fed's discount rate cut last week was at first disparaged by many as too little, too late, but we see it as having effectively accomplished its primary goal: helping to restore confidence (see "A Surgical Strike" August 17, 2007). As we have previously discussed, this was an event triggered not by a shock to fundamental conditions but a shock to the market's faith in the pricing of highly speculative positions. That abrupt repricing process brought on stresses which created illiquid conditions in the most highly stretched parts of the market, spawning a crisis of confidence. By stepping forward and demonstrating it would fulfill its function as lender of last resort, the Fed appears to have gone a considerable way toward relieving that confidence crisis. Perhaps the best indicator of that can be seen at the shortest end of the Treasury curve, where the flight from risk took the yield on three-month T-bills below 3% at one point Monday. Today, the bills are yielding more than 3.60%.

BOTTOM LINE: If, as we think is likely, this crisis of confidence is *en route* to being resolved entirely through market processes without further Fed intervention, prices in a number of market segments have been pulled to levels that create highly appealing opportunities on the prospect for reversal. June '08 Eurodollar futures, for example, have dropped about 20 bp in the past week, but are still priced for nearly 100 bp in rate cuts. Similar, though somewhat less extreme, opportunities are present across the Treasury yield curve.