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INTELLECTUAL AMMUNITION

Where's the There There? Part II

Friday, October 5, 2007

Donald Luskin

With stocks back to all-time highs, was the summer crisis really about nothing at all?

Stocks have now recovered from the summer credit crisis, back to the all-time highs of July, as we have expected they would throughout (see "Burned Out" August 7, 2007). It's time to ask again the question we asked a week after the August 15 bottom in stocks -- whether, for all the atmosphere of panic in global financial markets, there was really any there there (see "Where's the There There?" August 23, 2007). With payroll jobs back into the black with this morning's report, and last month's negative reading revised away, Ben Bernanke must be wondering the same thing. While the Fed might plausibly take some credit for the economy's resilience in the face of crisis, especially thanks to its deft move with discount window policy in August (see "A Surgical Strike" August 17, 2007), it's not so clear now that there was really any need for the larger than expected 50 bp cut in the funds rate in September (see "Honey, I Shrunk The Dollar" September 28, 2007). Later today we'll publish a report on where the Fed goes from here.

Update to strategic view

US MACRO: This morning's jobs report, with its substantial upward revision to last month's alarming report, demonstrates that growth has been resilient to the continued decline in housing and the summer financial crisis. The burden of proof remains firmly on the shoulders of the economic pessimists.

[see Investment Strategy Dashboard]

What was the panic really about, anyway? In truth, it was about a single pixel on the chart on the following page, depicting the US household balance sheet. With about $72 trillion in assets and only about $13 trillion in liabilities as of the second quarter, this is a balance sheet to die for. It self-evidently puts to rest the oft-heard myth of the "over-extended" or "over-leveraged" consumer. Of the $13 trillion in liabilities, about 10%, or $1.3 trillion, is subprime mortgages -- the small pink area at the top of the smaller pyramid. The $70 billion in subprime mortgages that are in default, and the $112 billion that are in delinquency, register on the chart only as not much more than a single nearly-invisible pixel at the very tip-top of the smaller pyramid.

Let's assume that all the subprime mortgages in delinquency go into default -- and then let's triple that, just to capture the worst-case scenario. Then let's assume that all the housing stock underlying those loans turns out to be worth zero in recovery by the lender. All in all, we're talking about losses in the neighborhood of $500 billion, and the dislocation of something around half a million American families. It's a tragedy on a human and financial scale very much like Hurricane Katrina. An important event for those directly involved, but in the grand scheme of things barely a blip on the economic radar. *That* is what this whole crisis has been about.

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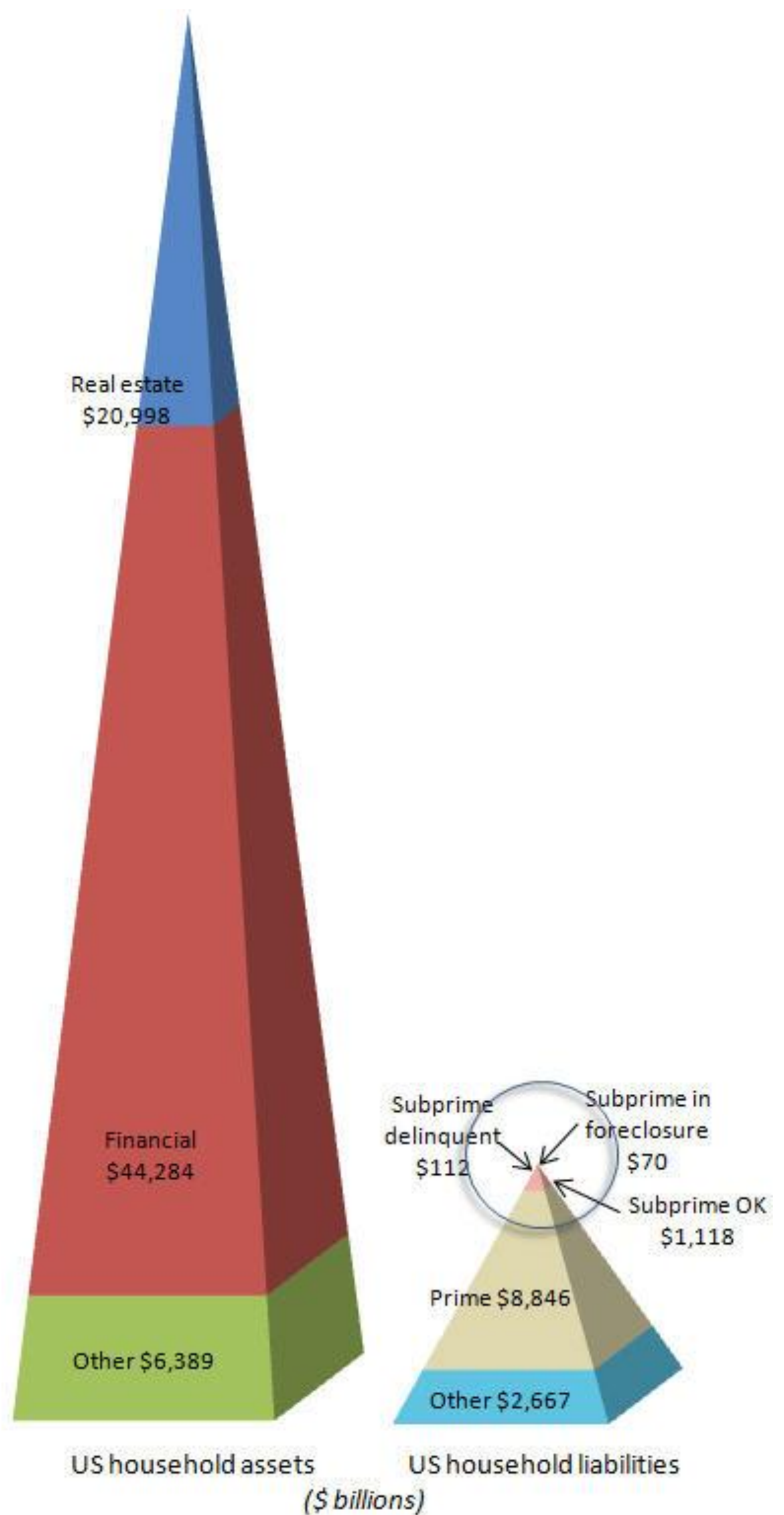
Beyond the potential loss of wealth arising from subprime mortgages defaults, all the turmoil in credit markets has hinged on zero-sum games designed to speculate upon those mortgages. In such games, for every winner there is a perfectly offsetting loser. No matter the volatility or the enormity of the transfer of wealth between the players, a transfer is all that it is. Overall wealth in the system is necessarily conserved. The only exception to that would be counterparty risk, in which an over-leveraged loser can't pay off his offsetting winner, potentially trigging a cascade of defaults in the financial system. But the Federal Reserve was born to intervene in such scenarios -- which is precisely what it did on August 17 when it liberalized the terms of discount window borrowing.



In terms of lasting economic impact in the broad economy, we turn to the issue of rate resets as variable subprime loans put in place over the last two years reset to higher market rates, with mortgagors unable to roll them into new loans with low teaser rates. Press accounts would have us believe that the magnitude of resets is such that all the cash will be sucked out of the consumer economy -- but the reality is very different. If we make the wildly pessimistic assumption that all subprime loans are variable, and that they all reset at once, and that they all reset at rates 4% higher than their original teaser rates, then the total value of resets is only $52 billion. In the context of nearly $10 trillion annual consumption, that is barely noticeable.

BOTTOM LINE: This morning's jobs report, with its substantial upward revision to last month's alarming report, demonstrates that growth has been resilient to the continued decline in housing and the summer financial crisis. The burden of proof remains firmly on the shoulders of the economic pessimists.