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MACROCOSM

Rescue Rangers

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Daily rescue investments in the financial sector signal that the crisis is near an end, and that the Fed has done enough.

Shortly after the onset of the present credit crisis we wrote that the crisis would end when we saw "evidence of strong hands willing to come forward and grab some risk" (see "Burned Out" August 7, 2007). Ever since stocks successfully re-tested the August lows on November 26, almost every day a new pair of strong hands has arrived. It started with the Abu Dhabi Investment Authority's investment in Citigroup on November 27, and there have been many since -- the most recent examples are this morning's announcements of investments in UBS and MBIA.

These rescue investments signify that valuations of risky credit assets finally got low enough to overcome the uncertainties about them, uncertainties exacerbated by the complicated and opaque structures of many of the securities involved. And they signify that the Fed's rate cuts have succeeded in providing sufficient liquidity, and with sufficiently low cost of capital, for risky investments to be feasible and attractive.

That this was so was symbolized beautifully by the equity risk premium reaching all-time highs in late November, indicating that the prospective returns from risky equity cash-flows were greater than ever before in relation to riskless Treasury bond cash-flows (see "Time to Earn the Panic Premium" November 13, 2007). Having reached an extreme, a less risk-averse value equilibrium is in the process of being established. Since the peak of the equity risk premium on November 26, stocks have returned a gain of 7.0%, while bonds have returned a loss of 2.1% (as of Friday's close). The S&P 500 stands just 3.5% below all-time highs -- only 1.2% below, if the financial sector is excluded.

Perhaps the world was a happier place a year ago when each morning brought news of a new private equity deal, rather than news of a capital infusion allowing some troubled financial

Update to strategic view

FED FUNDS: We expect the FOMC to cut rates by 25 bp tomorrow, and issue a stern statement to indicate the end of the easing cycle begun in August/September.

US STOCKS, US BONDS: Daily rescue investments in the financial sector indicate that the fever of fear in risky securities has broken, and that the bottom has been reached for stocks, and the top for Treasuries. Markets may react negatively to a hawkish Fed tomorrow, but after that passes we expect a new equilibrium to settle out with the S&P 500 at new highs, and long-term Treasuries at yields at least matching the funds rate.

[see Investment Strategy Dashboard]

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company to survive. One might worry that economic growth now can't be sustained by credit markets more concerned with survival than entrepreneurship. But in some sense that private equity activity was indicative of the credit excesses that led to the present crisis, and such excesses don't support economic growth any more than excesses in the housing sector did (as the housing component of GDP has substantially weakened over the last seven quarters, GDP ex-housing has had its best seven quarters in the present expansion).

The rescue investments we're now seeing are, in their own way, an important kind of entrepreneurship -- money put at risk to acquire stakes in durable franchises, and return the credit markets to a more realistic footing. So as we look ahead on growth prospects, we do not see the banking system as *im*paired, but rather as *re*paired. We have seen no evidence that the system cannot or will not extend credit to worthy borrowers for legitimate economic activity. Even mortgage and HELOC lending, in the prime sector at least, has been expanding at a healthy pace. For example, in the third quarter, in the very center of the credit tempest, we estimate that there was about $146 billion in mortgage equity extraction. We believe that once the smoke clears, growth prospects will actually be stronger for the horrific experience the credit sector has had to suffer. We do expect some slowdown in the current quarter, simply because sentiment has been so negative (see "Fear Itself" November 16, 2007). But we are ruling out recession.

Based on our conversations with Fed officials, we believe the FOMC feels approximately the same way coming into tomorrow's meeting. Obviously, a 25 bp rate cut is a sure thing, but we expect the meeting's statement to be rather stern, indicating the Fed's strong preference to be done with rate-cutting. We can't rule out a 50 bp cut, but with markets visibly on the mend over the last two weeks, such a cut would surely be accompanied by the strongest possible message that "we're done." Either way, in the aftermath of a hawkish statement from the Fed, we could well see at least a short-lived elevation of the equity risk premium, with stocks falling and bond prices rising. But we're probably at the point where the good news that the credit markets and the economy are successfully coming through the crisis will outweigh the disappointment that the Fed's printing presses won't be running quite as fast as they otherwise might.

BOTTOM LINE: Daily rescue investments in the financial sector indicate that the fever of fear in risky securities has broken, and that the bottom has been reached for stocks, and the top for Treasuries. Markets may react negatively to a hawkish Fed tomorrow, but after that passes we expect a new equilibrium to settle out with the S&P 500 at new highs, and long-term Treasuries at yields at least matching the funds rate. We expect the FOMC to cut rates by 25 bp tomorrow, and issue a stern statement to indicate the end of the easing cycle begun in August/September.