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MACROCOSM

Hell of a Year?

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Beyond the housing collapse and the credit implosion, things look remarkably good at year-end.

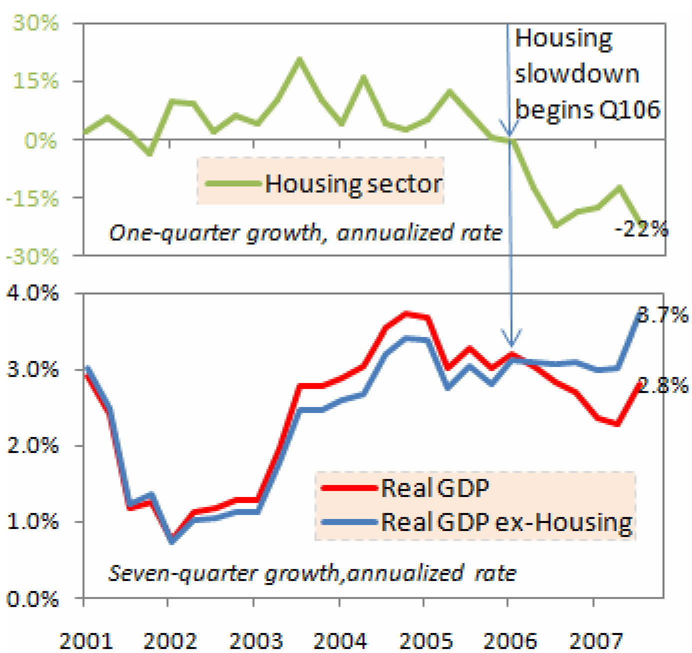
As difficult as this year has been in many ways, it's been a good one. Here at year-end, the bulk of the evidence in markets and in the macroeconomic backdrop is quite positive. Yes, the housing slump continues. And some credit markets remain in distress. Other than a brief soft-spot driven more by sentiment than reality (see "Fear Itself" November 16, 2007), we still hold our bullish outlook for the economy and the equity markets, and believe that the burden of proof remains on the pessimists.

Update to strategic view

US MACRO: In this expansion the Fed never got real rates to the restrictive levels that have preceded every recession in the last forty years. Real rates are moving lower, giving the economy and the markets the resiliency necessary to absorb an ongoing housing contraction and credit crisis, and avoid recession.

[see Investment Strategy Dashboard]

The housing sector has been in contraction for seven quarters, six of them with severe double-digit rates of negative growth. For the pessimists, this has been an open-and-shut case for recession. Yet the recession has not materialized. Quite the contrary. As the chart at left shows, *for the rest of the economy* -- that is, the 95% of the economy other than housing -- the seven quarters of housing sector decline have been *the best seven quarters* since the present expansion began in 2001.



A familiar narrative the last two years has been that housing is uniquely central to the economy, and that the housing boom earlier this decade fueled employment and consumption growth and made the overall economy look stronger than it really was. But a man from Mars looking at the chart at left, and trying to understand the last seven quarters, might conclude that housing was

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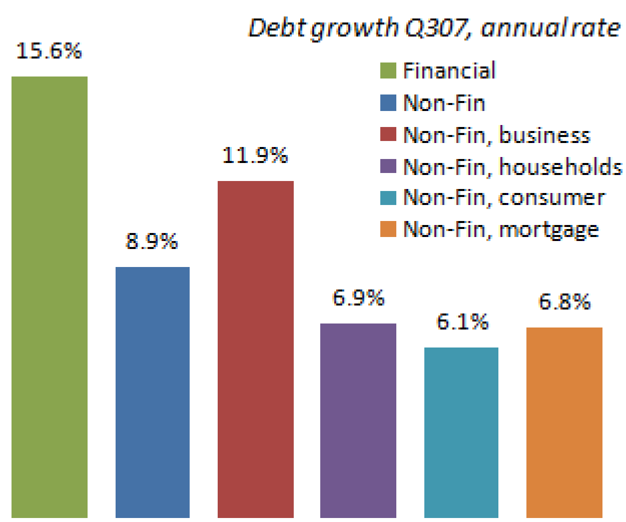
some kind of parasitic burden on the rest of the economy -- the more it contracts, the better the rest of the economy performs.

It can be argued that one cannot arbitrarily exclude a badly performing sector from the calculation of GDP growth, and thereby claim that all is well. But at the same time, one cannot reasonably claim that all is *not* well when a decline in a single sector -- in this case, housing -- has had nothing more than a computational effect on *overall* growth. That is to say, the housing contraction has only reduced the level of overall growth by virtue of its own inclusion in the calculation of growth, not because of any actual negative impacts on other sectors of the economy. *Even including the computational effect of the housing contraction*, there's been nothing especially bad about *overall* growth in the last seven quarters.

All that said, we do not claim that the housing contraction has had literally no effect outside its own sector. The closely related collapse of subprime mortgage lending has triggered disruptions in credit markets around the world. No one knows what effects those disruptions will eventually have on the real economy. The pessimistic case is that the collapse of confidence in credit transactions of all kinds, and the impairment of financial institution profitability and capital due to large losses, will restrict credit availability for the entire economy. But so far, nothing like this has materialized.

Pessimistic expectations that lending will necessarily contract -- because of damaged bank capital structures -- suffer from a fallacy of static analysis: they implicitly assume that banks can't or won't obtain new capital. Yet nearly every day brings more evidence that they can and will do so, as financial institutions of all types accept capital infusions from private investors and public markets (see "Rescue Rangers" December 10, 2007).

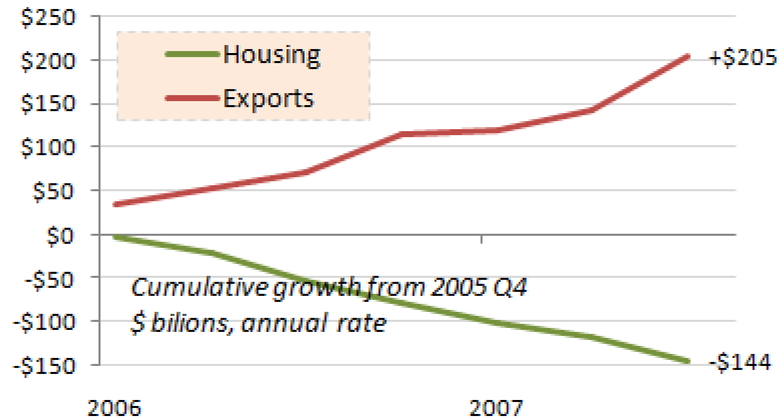
The financial sector is being forced to get back to basics now, turning away from ill-conceived schemes such as no-documentation subprime loans and SIVs. This will obviously have a negative impact on profits, as will continued write-offs of bad mortgage investments. Consensus forward earnings for the S&P 500 financial sector have already fallen about 13% from their all-time highs reached just three months ago. But instead of curtailing lending as the pessimists argue it will, we think that as the financial sector seeks profits to replace those lost from discontinued SIVs and subprime lending programs, it has every incentive to lend as actively as possible by more conventional means.

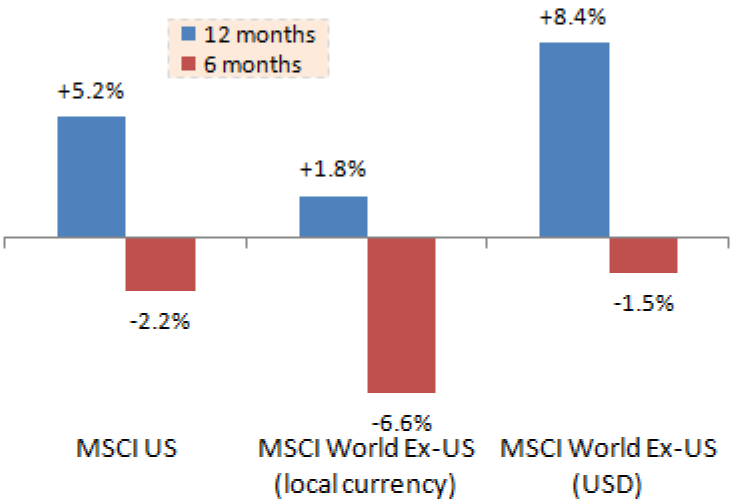


The evidence is that this is precisely what is happening. In the third quarter, when the credit crisis was well underway, credit in all sectors -- financial and non-financial, business and household -- grew at or near the fastest rates of the last several years (see the chart above). And despite the seeming shutdown of home lending markets, mortgage equity extraction was $146 billion in the third quarter -- toward the lower end, but still well within the very elevated range of the last three years.

As long as investors, businesses and consumers have good reasons to keep borrowing, we believe that the banking system will continue to be fully able to keep lending. That's one reason why, even though consensus forward earnings for the financial sector have declined 13% in just the last three months, forward earnings for *the rest of the S&P 500* are nevertheless making all-time highs. And it's why, even though the S&P 500 financial sector has returned a loss of 16.4% (including dividends) since the October highs, the rest of the S&P 500 is off by less than 1%.

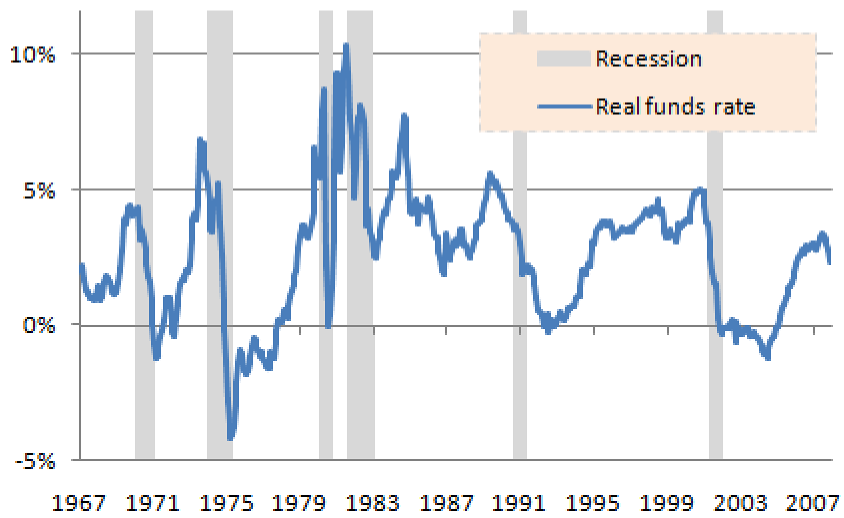
What explains the resiliency of the US economy and US stocks in the face of a housing contraction and a credit crisis? One explanation given by the pessimists is that the rest of the global economy, outside the US, is so strong that it is bailing the US out. We agree that the whole global economy is strong, and that this is a good thing for the US. In fact, over the seven quarters in which the housing sector has contracted, the US economy has added $205 billion in new *annual* exports -- more than offsetting the contraction of $144 billion in housing. But just because the US is doing more global business doesn't mean that the US economy is being bailed out by the rest of the world.





Nevertheless, some pessimists argue for the fundamental weakness of US economy by pointing out US equity performance has been poor relative to that of the rest of the world. True, one can select countries or regions in which stocks have outperformed the US. But that's always true. And the fact is that, over both the last twelve months -- *and* over the last six months, during which the credit crisis has unfolded -- US stocks have performed better than those in the rest of the world, on average (see the chart at left). It is only from the unique perspective of a US dollar-based investor that the rest of the world's stocks appear to have outperformed US stocks -- but even then, not by much, and that due entirely to the decline in the forex value of the dollar.

What explains *all* these phenomena -- the resilience of the US economy and US stocks, the continued growth of credit, and the ability of the financial sector to recapitalize itself -- is the easy policy posture of the Fed. At 2.3%, the real funds rate -- that is, the nominal fed funds rate minus core PCE inflation -- is very low. And monetary liquidity is being injected into the banking system at record levels. We are not suggesting that the easy Fed is capable of restoring the housing sector or the credit markets to the extraordinary levels of speculation and risk-tolerance that prevailed a year ago. But evidently a highly liquid monetary environment and low real rates *are* capable of facilitating the absorption of stresses coming from the housing contraction and the credit crisis.



Even at its tightest, when the nominal funds rate was 5.25%, the Fed was never truly restrictive. The highest the real interest rate has gotten in this expansion was 3.3%, while throughout modern history, every single recession was preceded by real rates above 4%. If we are headed for recession now, it will be the first one in more than forty years *not* preceded by a restrictive Fed.

If anything, it is an overly easy Fed that got us into our present difficulties in the first place. It made money so cheap that banks found ways to lend it to people who had no hope of ever repaying it, using financial structures that had no hope of surviving the least increase in volatility. Now the Fed and the rest of the world's central banks are making policy easier, in response to the global credit crisis that they themselves enabled. We're experiencing the benefits of that, in the form of resiliency in the economy and the markets. But we continue to worry that over time, once the housing contraction and the credit crisis have passed, the Fed will have to tighten significantly to curb the inflation risks set in motion by its ongoing easy posture.

BOTTOM LINE: In this expansion the Fed never got real rates to the restrictive levels that have preceded every recession in the last forty years. Real rates are moving lower, giving the economy and the markets the resiliency necessary to absorb an ongoing housing contraction and credit crisis, and avoid recession.