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

MACROCOSM

Waiting Game

Friday, February 15, 2008

Donald Luskin

Passive and gradualist, the Fed is prolonging the credit crisis and the soft-spot.

If this is a credit crisis, it's the strangest one we've ever seen. At the top of the last rate cycle, real rates -- the Fed funds rate minus core PCE inflation -- never got higher than a low 3.3%, and they're now at just 0.8%. And the world is awash in cash. There is no shortage of liquidity, and the world's central banks are making more and more of it (see "A Stronger Dollar? Don't Be Fooled" February 12, 2008). For all the talk about scarcity of credit in the economy, bread-and-butter borrowing and lending is surging. The dollar value of bank loans and leases is at all-time highs, overall and in every individual category -- commercial and industrial, consumer, real estate and home equity. Overall, C&I and consumer are growing at rates far in excess of historical norms; real estate and home equity are growing at below-normal rates, but they are nevertheless still growing. Last week's ISM non-manufacturing survey revealed that more than 85% of respondents reported no difficulty with credit availability.

Update to strategic view

FED FUNDS, US MACRO: Nothing in Ben Bernanke's testimony yesterday gave markets any reason not to expect, and indeed not to continue to demand, further rate cuts, with 50 basis points in March a minimum. At this point the expectation of future rate cuts, and the market's confidence that it can force the Fed to deliver them, may be acting to defer valuable economic activity that could rescue distressed assets and reinvigorate growth.

[see Investment Strategy Dashboard]

For all that, the economy is definitely in a soft-spot (though we don't think it is in recession). And it seems each week some new leak breaks out in the credit market's dam, renewing threats to systemic stability and contributing to the sense of apprehension underlying the current economic weakness. It seems that it's always something. Last week it was leveraged loans, and this week it's auction rate bonds. Some say we have a solvency crisis on our hands, not a liquidity crisis. It's true that there are very real solvency risks in some of the credit market ruptures, especially those that have at their root defaulting subprime mortgages. But the latest ructions in leveraged loans and auction-rate bonds don't have much to do with default risk. It's not that anyone really thinks First Data won't be able to service its senior medium term notes, or the New York and New Jersey Port Authority its auction rate muni's.

The issue in both cases is that markets now seem to be targeting situations in which vulnerable investors expected liquidity, and in its absence are left fearfully holding the bag. For leveraged loans, it's the underwriting banks that expected to be able to syndicate the loans and now find that they can't seem to price them low enough to attract any buyers -- and yet urgently need to

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

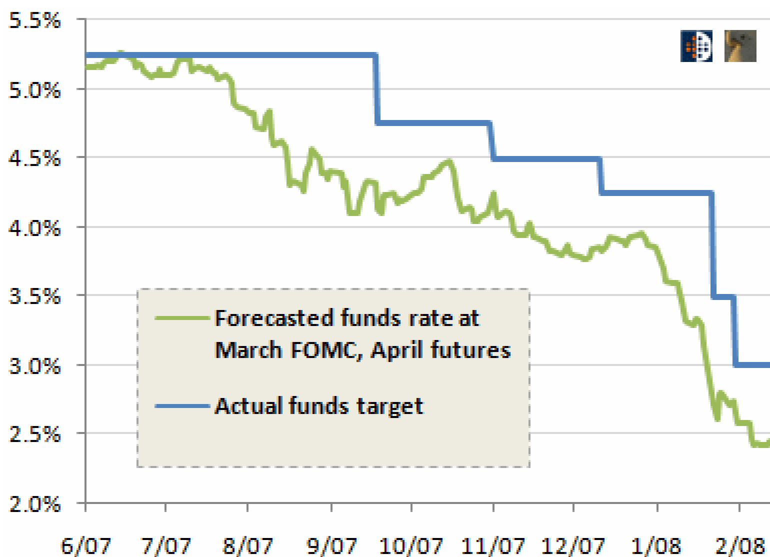
Copyright 2008 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

get them off crowded balance sheets. For auction rate bonds, it's holders who expected regular auctions to provide perdiodic liquidity opportunities who are discovering that when auctions "fail" there are no ready markets at all -- so now they want out, if for no better reason than because they think can't get out.

We'd expect that, given the enormous amount of liquidity available, that at some point these distressed assets -- or, more correctly, good assets in distressed hands -- would become so attractive that arbitrageurs would snap them up. We've heard anecdotally that, in the case of leveraged loans, their present very low floating rates are making it impossible to finance arbitrage positions with a positive "carry." But since such positions are themselves financed at low floating rates, and since the loans can be bought at discounts to par that would have seemed outrageous not so long ago, that explanation does not make sense to us; and we don't see why a positive "carry" has to be a binding criterion in the first place.

An entirely different explanation is that arbitrageurs are not jumping in because they believe that credit markets will never function normally again. That is, when First Data's notes mature in two years no markets will exist in which the company will be able to refinance; and that auctions for auction rate bonds will now *always* "fail". But again, we'd think that fire-sale prices would be able to equilibrate for such risks.

Another explanation is that the arbitrageurs are waiting, confident that as outrageous as today's fire-sale prices are, they are likely to get more outrageous in the future. This could simply be a bet that each passing day puts additional pressure on distressed bag-holders, ultimately provoking them not just to liquidate at fire-sale prices, but to actually pay the arbitrageurs for taking unwanted assets off their hands. Warren Buffett's proposition to the bond insurance industry this week had this flavor. His proposition was not a "good bank/bad bank" split, some version of which could potentially work. Instead, by demanding 50% of the premiums received by the bond insurers in exchange for reinsuring their least risky obligations -- with Buffett's reinsurance only kicking in after the insurers' own considerable claims-paying assets had been exhausted -- Buffett was inviting Ambac and MBIA to commit corporate suicide, and pay him for the privilege. Wisely, the companies seem to have rejected his proposition. But as time goes by, increasingly pressed holders of leveraged loans and auction rate bonds may not be able to remain so rational.



A variation on that theme is the notion that arbitrageurs are waiting for the Fed to inevitably lower interest rates further. Why take on risky assets when the fed funds rate is at 3%, when you can be nearly certain it will be 2% in just a couple months? For that matter, why should any participant in the economy not wait -- to make a consumer purchase, to expand his plant, to make a capital investment, to hire a new employee? If that psychology is operative, then the recovery from the present economic soft-spot is likely being unnecessarily held back by the Fed's gradualist approach to rate-cutting when the market's expectations for rate cuts are so extreme and so relentless. As the chart at left

illustrates, displaying the actual funds target versus expectations in futures markets for the funds target at the March 2008 FOMC meeting, the Fed has been consistently far behind expectations and remains so today. Even its surprise 75 bp intermeeting cut in January was generally anticipated by the futures markets (and we specifically predicted it the very day before it happened: see "Another Leg Lower" January 21, 2008).

There is a theory that holds, approximately, that any fully anticipated Fed policy move will be ineffective in virtue of having been anticipated. If that's true, then the Fed is destined to be especially ineffective here in the face of a continuing credit crisis and an economic soft-spot. That's because today the Fed is not only fully anticipated by markets, it is indeed the slave of markets, having demonstrated repeatedly that it will deliver whatever rate cuts seem to be reflected in futures markets or demanded by the momentary exigencies of credit market turbulence (see "Jump! How High? Cut! How Low?" January 31, 2008). If this is true, then the best thing the Fed can do is the thing it is least likely to do, and the thing the markets most fear. Specifically, to dare to defy the markets, and declare that some funds rate -- say, 2.5% -- is as far as it intends to go, judging it by historical standards to be more than sufficient to deal with anything but outright depression or a wholesale market collapse. By the Fed declaring that it is done acting and that it intends instead to start waiting, a signal would be sent to arbitrageurs, and economic participants of all types, to be done waiting and start acting.

BOTTOM LINE: Nothing in Ben Bernanke's testimony yesterday gave markets any reason not to expect, and indeed not to continue to demand, further rate cuts, with 50 basis points in March a minimum. At this point the expectation of future rate cuts, and the market's confidence that it can force the Fed to deliver them, may be acting to defer valuable economic activity that could rescue distressed assets and reinvigorate growth.