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

MACROCOSM

The Fear Trade

Friday, October 24, 2008

David Gitlitz

Fear got us into recession, and fear is going to keep us from getting out of it.

Today's panicked opening on Wall Street underscores that while the worst of the credit market tsunami may have passed after the extraordinary, concerted intervention of global governing authorities, the course toward restoration of the confidence required to support the resumption of growth-critical risk taking is not going to be smooth or quick. The paralysis afflicting short-term funding markets has been quelled, substantially relieving the threat of a cataclysmic systemic breakdown. But deep fissures continue to be manifest, with market participants putting the greatest premium on the least risky assets, in many cases being forced to liquidate the riskier ones at any price.

Update to strategic view

US MACRO: A market that continues to be gripped by fear is not one poised to generate supplies of fresh capital that come with the restoration of a healthy appetite for risk. Prospects for full economic recovery will not take shape until that day arrives. The decline in gasoline prices will offer some support and help keep the economy from suffering as much as it would otherwise. But it's not likely to mean the difference in pulling the economy back to expansion mode.

US BONDS: The flight to quality that has kept Treasury yields down will likely give way to the flood of new issuance required to support the federal governments many interventions in the credit crisis and the recession -- and to growing risks that the Fed will, in the end, not be able to resist the inflationary error of monetizing some of that new debt.

[see Investment Strategy Dashboard]

That has been most evident in the flight to liquidity seen in the dollar's striking rally and the concomitant sell-off in gold and other liquidity-sensitive commodities. On a trade-weighted basis, what had been a chronically weak dollar is up 13% in the past month and 5% in just the past week. The latest moves can be largely attributed to the panic spreading through the emerging markets. The emerging market crisis cannot really be separated, however, from the pressures continuing to bear down on investors more broadly. The downdraft in the developing world has been sparked by funds liquidating their portfolios of the most risky assets, importantly including emerging market debt. One favored method for financing those holdings was through the yen carry trade, borrowing cheaply in Japanese yen to buy high-return assets. Essentially, that amounted to shorting the yen. The "de-risking" of portfolios can be seen in the reversal of the yen carry, which requires buying yen to close out the position. Even against a soaring dollar, the yen today is up 3.5% and, at about ¥94.5 per dollar, has gained more than 11% in the past month.

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

With the dollar so strong and gold, at about $730, back down to levels last seen a little more than a year ago, it's tempting to think that in the midst of this chaos we can at least take some solace that inflation is unlikely to be as much of a problem as appeared likely until very recently. We'd resist that interpretation. At the moment, surging dollar demand is more than sufficient to absorb the massive torrent of liquidity being supplied by the Fed. This dollar demand, however, is not likely to be sustained for long. With its lengthening list of special facilities putting it in the position of a major purchaser of a wide range of assets, the Fed's exceptionally generous liquidity stance figures to be maintained for the foreseeable future, and may be difficult to reverse quickly when the demand for it inevitably ebbs. In just the past six weeks, the size of the central bank's balance sheet -- which now stands at $1.8 trillion -- has more than doubled. In the face of this pace of expansion, the dollar rally and slide in gold is likely to prove transitory.

We also see growing vulnerabilities in the Treasury market. At present, the absence of default risk and the guarantee of at least some nominal payout -- small though it might be -- is reason enough to park capital in the safe haven of federal debt. In this crisis atmosphere, with an economic downturn at hand and commodity prices reversing their run-up of the past year or so, inflation risk is a non-issue for the market. The five-year TIPS spread is now negative. But while reported statistical inflation is being subdued temporarily by the decline in crude oil prices, underlying price pressures remain evident. The Cleveland Fed's measure of median CPI is running at a 12-month rate of 3.3%, a level which has been maintained for the past three months even as headline CPI has fallen off due to the drop in oil prices. Also, given the federal government's huge new financing needs -- call it a trillion and half dollars, including the stimulus bill, the GSE rescue, the housing bail-out, and now TARP -- plus additional demands for spending likely to come with the recession, there could well come a point where the risk of the Fed being forced to monetize the debt is recognized. At this point, with the 10-year Treasury yielding about 3.6%, such concerns may seem far fetched. At the least, though, the asymmetry of the current situation should be recognized. With a return to more normal market conditions at some point, the market will be compelled to again face the reality of inflation risk. Even a doubling of yields from today's levels would not be out of the question. We say that's an asymmetry because a reasonable supposition cannot be made that yields are just as likely to go to zero.

In the midst of the ongoing epidemic of fear, we are encouraged by some early signs of healing in the market's capacity to absorb risk, as seen for example in the narrowing of swap spreads. Two-year spreads blew out to more than 160 basis points at their peak early this month but have come back to around 110 bp. That's still higher than normal, but the 10-year spread has reversed all of the spike seen since the outbreak of market turmoil and at about 40 bp is back to levels last seen in 2005. The narrowing of spreads suggests a degree of easing in risk aversion because it indicates less of a push to swap floating rate exposure for fixed rates. Movements in swap spreads have traditionally been a good forward-looking indicator of the market's risk preference. Early this decade, the narrowing of swap spreads anticipated by nearly a year the rally in junk bonds that took off in late 2002.

In the meantime, though, the market continues to exhibit a very limited appetite for risk. In commercial paper, announcement of the Fed's new facilities has led to some decline in rates and increase in issuance, but concentrated in the shortest maturities. Outstanding paper maturing in 81 days or more stood at $6.9 billion last week, compared with $157 billion for paper maturing in one to four days. Still, that represents some progress. Late last month, the totals were $1.7 billion for paper maturing in 81 days or more and $161 billion for one to four days.

In the world of corporate bonds, even investment-grade issuers are paying steep premiums, with spreads at levels in not seen in decades. This week, Pepsi Bottling Group brought a 10-year issuance to market with a 400 bp premium to Treasuries, versus about 100 bp normally, with its syndicate manager explaining "it's obvious you've got to bring them cheap in order to get them done." Even at that, investment grade issuance is down 27% year-on-year for October.

BOTTOM LINE: A market that continues to be gripped by fear is not one poised to generate supplies of fresh capital that come with the restoration of a healthy appetite for risk. Prospects for full economic recovery will not take shape until that day arrives. The decline in gasoline prices will offer some support and help keep the economy from suffering as much as it would otherwise. But it's not likely to mean the difference in pulling the economy back to expansion mode. The flight to quality that has kept Treasury yields down will likely give way to the flood of new issuance required to support the federal governments many interventions in the credit crisis and the recession -- and to growing risks that the Fed will, in the end, not be able to resist the inflationary error of monetizing some of that new debt.