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MACROCOSM

Signs of Life

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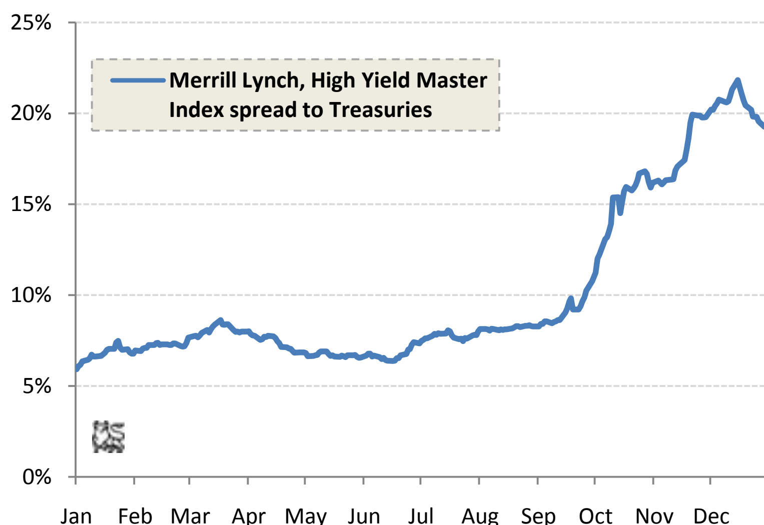
With the Fed maximally easy now, risk tolerance gradually returns to credit markets.

Update to strategic view
US BONDS: At last, corporate spreads have backed off record levels that reflected near-total risk abhorrence. With historic risk premia having drawn in the first wave of the boldest investors, there's the opportunity for at least slowly starting a virtuous cycle of risk-taking, return, and recovery.
[see Investment Strategy Dashboard]

As the deluge of extremely weak economic data continues to pour forth on a daily basis, it might be difficult to conceive that this recession is not a permanent state of affairs and that at some point the dynamics of recovery will take root to propel economic revival (see "Is This a "New Era" Recession?" December 29, 2008). In fact, we see early indications that the groundwork for recovery is now being laid. The intense fear and panic that was raising the market's risk abhorrence to astronomical levels has begun to recede, allowing investors to begin capturing the outsized premia in risky assets. As we suggested last month, conditions for recovery would be in place when risk premia were sufficiently attractive to bring back the market's willingness to bear risk (see "Vicious Cycle Visions" November 10, 2008), and that is now happening.



Perhaps the most encouraging sign of an easing in the market's risk abhorrence has been the emerging rally in high yield debt. Since blowing out to record levels approaching 2,200 bp late last month when we highlighted the extraordinary undervaluation in this asset class, high yield spreads have contracted by more than 200 bp (see "It's a Recession -- Not the End of the World" November 21, 2008). With spreads still at levels projecting an unprecedented default rate approaching 20%, this is a rally that could have considerable room to run as worst-case fears are allayed and confidence is

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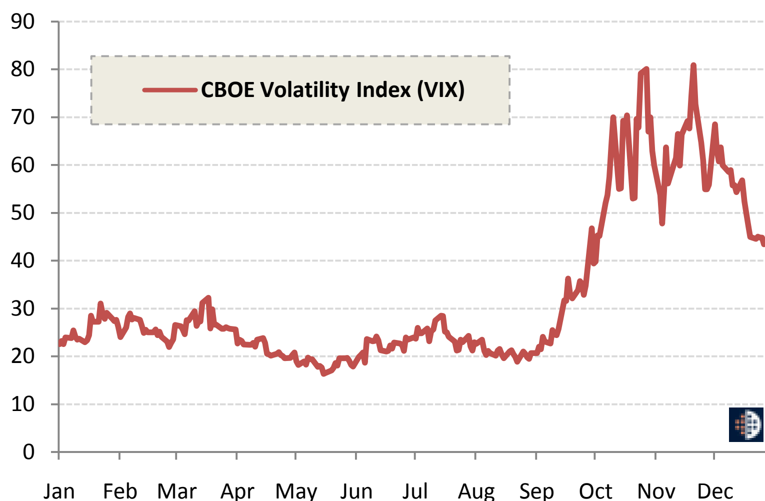
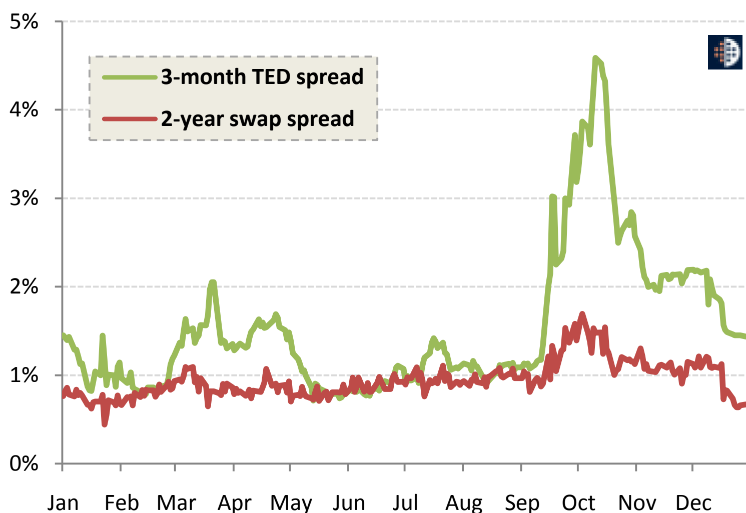
gradually restored.

Other signs that the market has seen the worst of the fear trade include the nearly 20% decline of the VIX implied equity volatility index in recent weeks -- and the continued contraction of swap spreads, with the two-year spread now back to levels last seen at the beginning of this year. While both these indicators remain above levels that could be considered "normal" -- that is, above their levels before the summer of 2007 when credit market turbulence began in earnest -- their steady improvement is a refreshing sign that the crisis atmosphere that has so pervaded the markets is finally fading. Likewise, the TED spread has continued to contract, and at about 145 bp is at its lowest level since the near-death episode of credit market turmoil erupted in mid-September.



The Fed's announcement that it would maintain a zero to 1/4% funds rate for "some time," while sustaining the bounteous liquidity posture of its balance sheet, has been key to a nascent restoration of risk preference (see "'Some Time' A Great Notion" December 17, 2008). For one, the Fed's commitment to indefinitely pursue an aggressively easy policy stance sharply reduces the risk of deflation, which also reduces default risk. With risky bonds priced for an end of the world default scenario, a less dire outlook can now be discounted by the market.

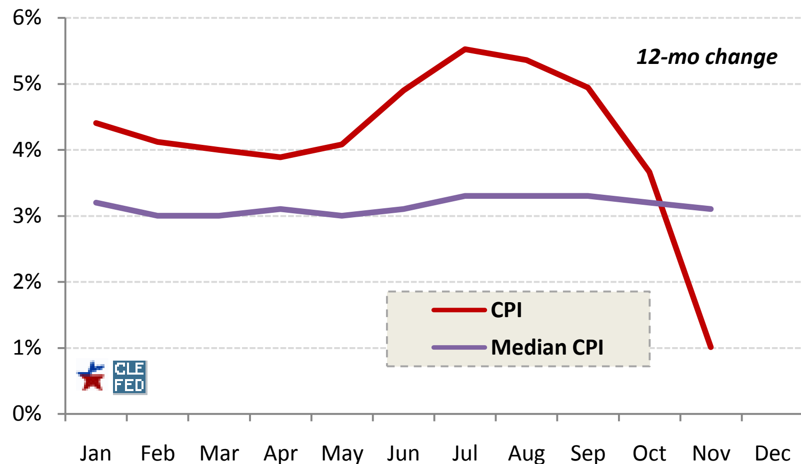


Also, with cash or cash equivalents now yielding close to zero, alternative investments begin to look like a good bet as long as downside expectations in riskier assets are not sustained at such high levels. As riskier debt has already absorbed such a huge downside hit, the safe haven of cash is presenting high opportunity costs relative to the upside potential of competing investments. This has to be considered a factor drawing investment, at least at the margin, toward risk-based vehicles.

At the same time, we are seeing growing indications that the easing of risk aversion panic, combined with the Fed's ultra-easy posture, is steadily relieving the dollar scarcity that had been driven by the crisis-driven surge in dollar demand. At about $872 today, having traded as high as $890 yesterday, gold is up some $50 from its levels prior to the FOMC meeting on December 16, with the dollar at 1.41 against the euro, versus 1.37 pre-FOMC. But even prior to the FOMC announcement which formalized the Fed's adoption of a quantitative easing regime, the dollar's purchasing power had retreated markedly from its crisis-driven highs last month, when gold fell

to as low as $700, with dollar/euro at 1.25. This suggests that the Fed, quite apart from its latest assurances that it will remain hyper-accommodative for the foreseeable future, was staying apace of -- if not getting ahead of -- the curve in meeting the exogenous spike in dollar demand.

At present, that's all well and good, as it obviates one of the greatest fears plaguing the market -- a Depression-like outbreak of monetary deflation. But the somewhat longer-term implications should not be overlooked. The Fed is engineering another reflationary cycle in the economy, not at all unlike the one sparked by its extended period of extreme monetary ease from 2003 to mid-2004. When the Fed was slow to normalize policy even after shifting toward somewhat less accommodation, the underpinnings of the housing and credit bubbles were put in place, and with the dollar put on a path of extended depreciation, the explosive commodity rally of the past few years was fueled. The reversal in commodity prices, particularly oil, has led to a sharp deceleration in the official price indexes the past several months. But through last July, CPI was running at 5.5% year on year, a 17-year high. And despite the fall off in the statistical inflation indicators, underlying inflation pressures have not evaporated. The Cleveland Fed's median CPI is running at 3.1%, down only slightly from its recent 3.3% high. In all likelihood, the Fed will again be hesitant to aggressively restore monetary neutrality following this period of exceptional accommodation, setting the stage for additional bubbles of one sort or another, while further deepening the inflationary impulses that are already subtly apparent.



BOTTOM LINE: The first stirrings of the kind of activity that will be required to put the economy on a course for recovery are now being seen as the fear and panic that has prevailed over the past several months is giving way to a modicum of risk taking. The Fed's adoption of a strongly anti-deflationary stance has been integral to this shift. But the Fed is now engineering another reflationary cycle that could well have some of the same consequences as the last one earlier this decade.