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MACROCOSM

Peeking Out of the Bunker

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Lagging macro news is horrible, and may be for a while -- but risk-tolerance is coming back.

Update to strategic view
US BONDS: Credit spreads have narrowed, as the Fed has stepped on rates and confidence has begun to be restored. A bad macro news background provides buying opportunities as the market's risk appetite continues to gradually improve.
[see Investment Strategy Dashboard]

In the wake of Friday's employment report showing the loss of another half million jobs in December, we don't underestimate the current dismal state of the US economy. There's no getting around it: we're probably in the midst of the worst recession since the dreadful 1981-82 downturn.

But listening to the great bulk of economic opinion, one can only be drawn to the conclusion that there's no way out, and we're all but doomed to remain in a state of never-ending economic decline. Even the *New York Times*, no slouch in casting the worst possible slant on all things economic, was moved to note that "economists fell over themselves in describing the dire nature of the jobs report." With the herd instinct in full flower, it seems there's no career downside in maintaining a posture of maximum bearishness.

Markets have soured a bit over the last week, but the contrarian in us can't resist at least looking at the other side of this bet. Employment is a lagging indicator, so it's by no means far-fetched to posit that the labor market could remain weak even with the economy showing signs of revival otherwise. At the same time, though, it should be noted that the survey period for the December jobs report came in early-to-mid December, which corresponded with some of the worst conditions of this downturn to date, prior to any sign of recovery in indicators of credit risk, relief from the safe-haven quest for liquidity, or an apparent bottoming in commodity prices. Also, initial jobless claims have dropped by more than 100,000 in the past two weekly reporting periods -- *after* the monthly employment survey had already been taken. While it's too early to say whether this represents a trend -- and to be sure, nearly 470,000 weekly claims are still a level indicative of a poor job market -- it's at least possible that the worst of the jobs losses may have been absorbed.

We are probably most encouraged, however, by continuing signs of a restoration of capital market stability. We're not entirely out of the woods yet, and the past week has seen something of a setback to the emerging re-establishment of confidence. Stocks last week were down more

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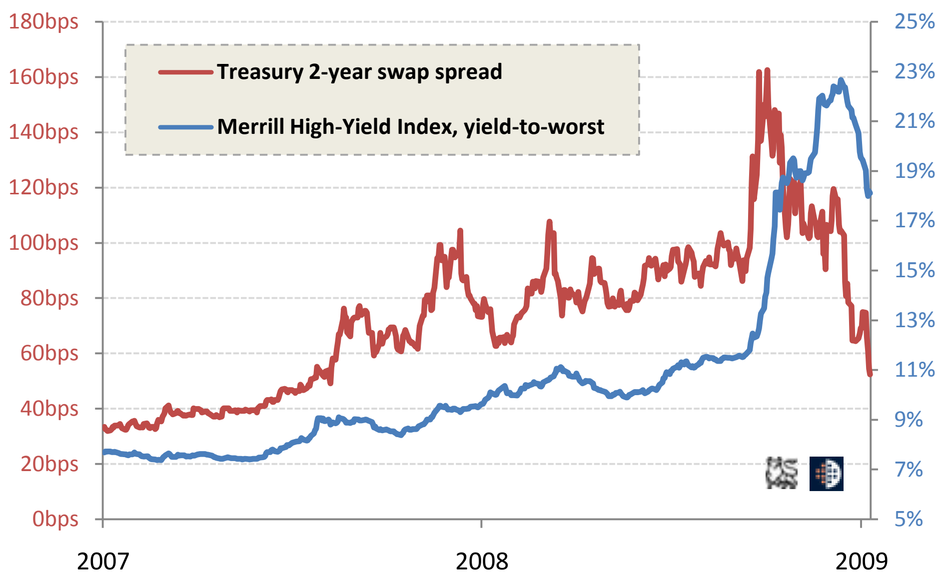
than 4%, and the VIX implied volatility index bounced higher by about 10% after falling sharply over the previous month. Waves of safe-haven demand for cash could be seen in the dollar's forex trading and volatile gold price movements, including today's $30 drop in gold below $820. For the most part, though, the signals remain clear that a healing process is underway. High yield credit spreads, having topped out at eye-popping levels near 2,200 bp in mid-December, have contracted by more than 500 bp (see "Signs of Life" December 30, 2008). That still leaves spreads at levels projecting an unprecedented default rate, so further gains in this asset class are likely as confidence is gradually restored -- especially as markets gain confidence that the Big Three automakers continue be deemed by government to be "too systemic to fail," as their debt makes up about 10% of the high yield market by par outstanding. Also, we noted previously that swap spreads have been a good leading indicator of movements in the corporate bond market (see "Vicious Cycle Visions" November 10, 2008). Swap spreads have largely been restored to their pre-crisis levels, and the nearby chart, plotting the 2-year swap spread against the yield-to-worst of the Merrill Lynch High Yield Master Index, suggests considerable upside remains in speculative grade debt.



From our perspective, restoration of the market's capacity to absorb risk is indispensable to the process by which recovery is engendered. To help understand why that's the case, consider the circumstances which brought about the current downturn. The extraordinary market turmoil last fall, precipitated by the federal government's bungled bailout efforts, resulted in a total rupture of economic confidence, for all intents and purposes shutting down any activity that involved bearing risk (see "Death by Rescue" November 17, 2008). Thus was the sharp and sudden slide into recession precipitated. With the government acting now to nurture capital rather than destroy it, and the Fed taking exceptional measures to ensure that the system is amply liquefied to meet the demand for cash, what had been factors lining up on the side of risk abhorrence are now promoting a return of risk tolerance, catalyzing a renewal of capital formation without which growth is impossible (see "New Year, Same Old Recession" January 9, 2009).

Other indications that the functionality of the credit markets is returning include a sharp jump last week in investment grade bond issuance. A total of $40 billion in new issues came to market last week, the most since last May. At the same time, investment grade spreads to Treasuries contracted by about 40 bp, and are down by nearly 100 bp from their peak last month. At more than 500 bp, however, investment grade spreads remain extremely wide relative to historic experience (pre-crisis norms were less than 100 bp). The juicy yield gap, however, is acting as a lure to investors, which no doubt is part of the Fed's thinking in bringing the funds rate down to essentially zero, anchoring the yield curve so as to have the Treasury long bond posting a yield of just 3% (see "'Some Time' A Great Notion" December 17, 2008).

Another positive element in the environment has been the bounce higher in commodity prices. The CRB spot index is up 10% off its lows last month -- after falling by nearly 40% from its peak last summer. What began as a correction from clearly overbought levels morphed into an all-out rout under a combination of crisis-driven liquidations, deflation fears and the rapid darkening of the economic outlook. If commodities have indeed bottomed, it would suggest that prices have turned from manifesting an economic freefall, deflationary spiral and a general atmosphere of fear and panic to circumstances suggesting at least the beginnings of economic recovery and a nascent return of confidence.

BOTTOM LINE: As far as the pillars of conventional economic wisdom are concerned, there is nothing to look forward to in the economic outlook except continued and unceasing gloom. But we think this perspective is overlooking some important indicators suggesting nascent restoration of market confidence is bringing back a degree of risk tolerance, the absence of which was the primary catalyst for the economy's sharp braking last fall. This emergence from the bunker of risk abhorrence continues to present appealing investment opportunities, with yields relative to Treasuries remaining at extraordinarily attractive levels.