Lombard Street Research

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Daily Note: 17 September 2008

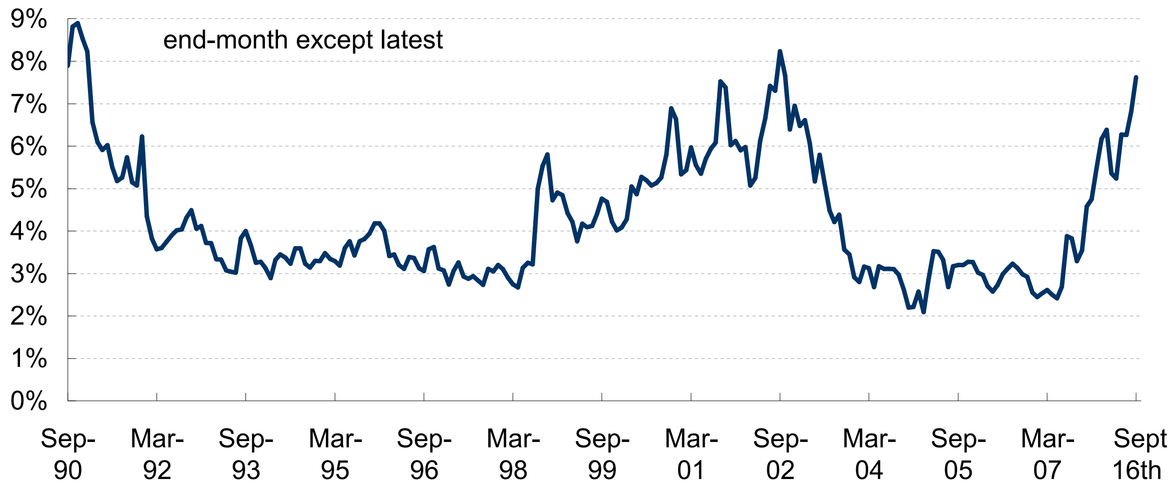
US wagons in circle to beat off Hedge Row

WE SUGGEST: Chief bear phase for S&P largely over

SUMMARY: After the Fed's panic a year ago, and the Bear Stearns shambles, its holding the funds rate at 2% was a relief, adding to firm treatment of Lehman, safe parking of Merrill, and market-orientated rescue of AIG. Housing is not as bad as the one-month starts data suggest, though the economy could recede in Q3-Q4. The market could rally and then relapse, but now looks good value, maybe close to its low.

The question on Monday-Tuesday was: do the US authorities have a follow-up strategy for AIG, after Lehman? The answer seems to be "Yes" … or at least "Probably, in principle". And for the first time US reactions to the banking crisis begin to resemble the excellent Swedish rescue plan of the early 1990s. The Bear Stearns episode six months ago was a toxic mixture of denial and surrender, and had been preceded by ill-concealed panic over the previous autumn and winter, as the Fed muddled up badly needed liquidity provision with unnecessary and damaging interest rate cuts. The latter demonstrated clearly the Fed's failure to understand that the fundamental problem was too much household debt: why would you attempt to stimulate over-borrowed Americans by making it cheaper to borrow more? What it actually stimulated was flight from the dollar and speculative purchases of oil and other futures – hammering consumers via higher inflation, and worsening the economic downswing.

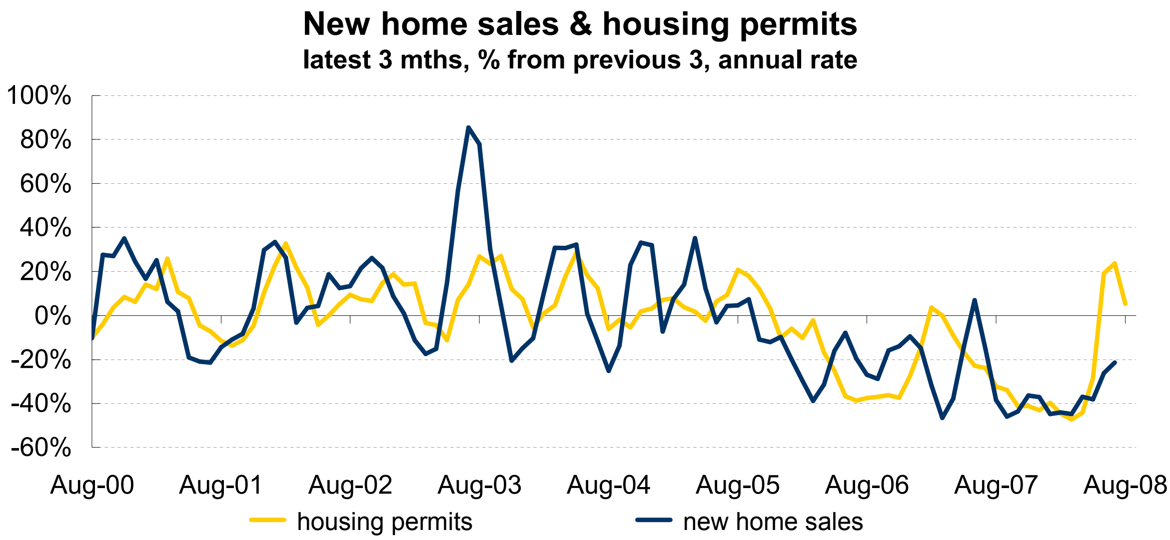
Junk spreads rising: KDP index yield - 10-year Treasuries



This time round, the government got a decent bargain, with upside as well as downside, unlike the Bear rescue. Clearly Lehman was not too big to fail – any more than the Bear.

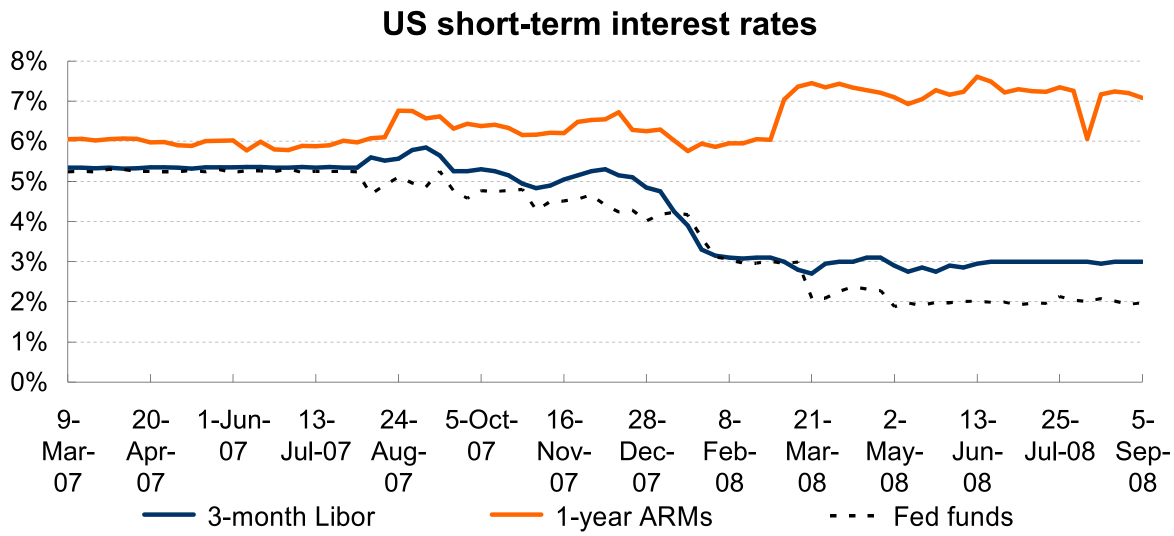
The official story in March was that the complications of the Bear's myriad swaps and other derivatives with the global markets were such as to make its bankruptcy intolerable. Now apparently, it can be tolerated. And rightly so. What this really tells us is that the Fed was as much in denial as Wall Street last winter about the true depth of the crisis – otherwise, why no contingency preparations for the Bear's demise, including, if necessary, changes in the bankruptcy laws and codes? Now that Lehman is in the can, its assets can be taken out without the due-diligence and other legal complications of a full takeover, as the Barclays deal for investment banking assets shows.

The $85 billion advance to AIG is at a healthy 850 basis points over Libor. Our chart of junk yield spreads above shows yesterday's spread at 8.62%. But that is over 10-year T-Notes. Allowing for the "Ted Spread" – the gap between Libor and T-bills – of 2.83%, the spread over equivalent Treasuries is 11.33%. This loan carries with it 80% of AIG's equity – a key feature in this sort of rescue that enabled 1990's Sweden to make a profit on the "bad banks" it saved. At 11.33% over bills and with the equity feature, the US government might even be able to lay off some of its loan with Lombard Street Research.



While today's housing starts and permits were not nearly so bad as they seemed, the housing market is almost bound to continue to depress the US economy. Changes in regulations produced a June surge in permits and starts that is now being "paid back". Our chart shows that permits are in fact still well above where they should be, relative to the change in new home sales. But the rate of decline of the latter is easing, and after a couple of disappointing months this autumn, the housing permits and starts may fall less fast in the winter. The danger is that recent financial dramas will hasten the fall of house prices, and this will knock on to higher savings and less consumer spending. On this basis, real GDP is likely to fall or be static between Q2 and Q4 of this year, even with good exports, some government and business spending growth, and inventories under reasonably tight control.

So where does that leave stocks? As I said in Monday's note, probably near their lows for this cycle. Our "target low" all year has been down 25% (a proper bear market, but not a particularly severe one) and that would mean a low of 1,170 for the S&P. It was 1,210 when I wrote on Monday, and is at 1,185 now. From over here, the sight of US authorities finally biting the bullet is reassuring. The Eurasian savings glut has removed the normal overseas constraint on grossly self-indulgent financial behaviour and policies. That was why the debt-driven boom lasted two years too long. The fear was that the "masters of the universe" mood that has built up since the 1989-91 end of the Cold War would only be deflated by total financial collapse. Especially with China continuing to build up reserves at a $500 billion annual rate, effectively underpinning cheap US borrowing: China is making 1-2% on its (largely) dollar reserves, with a dollar/yuan loss of up to 10%, and a Chinese inflation rate of 6%, for a total real return in yuan of about minus 15%! On $1.8 trillion of reserves ($1,300 for each its 1.3 billion inhabitants) that is a loss of $270 billion a year, or 7-8% of GDP! With money like that left on the table, no wonder Wall Street and the US Main Street spiralled out of control.



The Fed's decision to hold its funds rate at 2% was another relief, on top of firm treatment of Lehman, safe parking of Merrill, and market-orientated rescue of AIG. As our chart shows, the market has seen through any idea of reflating the economy through lower rates. Fed funds may be down from 5¼% to 2% since before the crisis, but 1-year adjustable rate mortgages (ARMs) are up from 6% to 7%. More than the entire benefit of lower rates at the margin is being kept by finance houses, though existing ARMs are no doubt coming down in rate, as Libor is down to 3%. As with the junk yields shown previously, rates have cut loose from Treasuries and any idea of predictable spreads. It looks as if debt is finally being priced according to judgement of risk, rather than at Treasuries plus credit rating to give a small spread. Maybe banks are employing chief credit officers again.

The market could well enjoy a relief rally and then relapse. Meanwhile, triple-A mortgage securities priced at 50 cents in the dollar must contain a few nuggets of value somewhere. But for long-term investors the US market is good value for the first time since early 1995, excluding a few months at the low point in the winter of 2002-03.

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