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April 2008 – March Madness Saves Bear, Fuels Inflation

There's not much wiggle room for an economy caught between the competing forces of rising prices and deleveraging.

March was a great month for those who like roller coasters. On March 5, the Institute for Supply Management said its service-sector composite index for February read 49.3, which was up from January's reading of 44.6. A reading below 50 indicates that the business activity of service companies (e.g., banks, retailers, shippers) declined. Despite the decline, markets rallied on this news, since the expectation was that the decline was going to be worse.

Bear Stearns buyout

Probably the most notable event of the month was the demise of Bear Stearns (BSC). BSC got caught in a modern-day version of a bank run. It was the second-largest underwriter of mortgage-backed bonds, but traders became increasingly worried about engaging in long-term transactions with BSC as the counterparty.

In the financial markets, expectations can become reality. The expectation that BSC could fail as counterparty to a transaction led to a scarcity of lenders. Before you could say "bailout," the Fed stepped in to orchestrate a JPMorgan Chase buyout of BSC. Let's look at this transaction. The buyout of BSC has caused a lot of noise and fury—more than is merited by the fundamental significance of the event, although the suddenness and magnitude of the failure of a Wall Street fixture was remarkable.

Many op-ed pieces asserted that this was a bailout of Bear. When a stock goes from $171 to $2, and then to $10.50, that does not seem much like a bailout, but more like an attempt to protect creditors. The Fed, in an unprecedented step, formed a limited-liability company to buy the troubled assets of BSC to sweeten the appeal to JPMorgan. The Fed will contribute $29 billion to the fund, while JPMorgan will contribute $1 billion. JPMorgan's investment will be the first tranche at risk.

Does this mean that the Fed will be left holding worthless assets? No. A reasonable estimate is that in the event of a bankruptcy, lenders recover about 40% of the value of the original mortgage. It would take more than 8.3% of the loans to slide into insolvency before the Fed would have any capital at risk. This is well above the historical average.

Inflation

A more pressing concern, however, is inflation. On March 18, the Federal Open Market Committee cut its target rate for federal funds (the overnight lending rate between commercial banks) to 2.25%. This was fully anticipated, but the surprise was that the accompanying statement intimated that the committee was now

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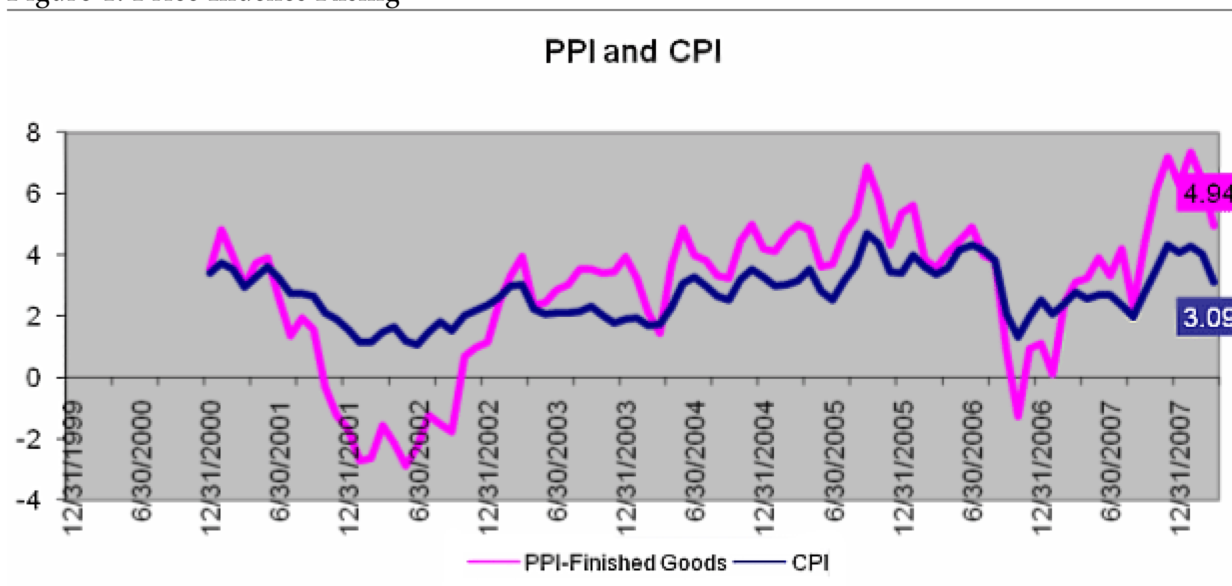
beginning to become concerned about inflation.

The Fed is in a precarious position. Its concern about risks to growth led it to lower interest rates aggressively. This has caused the dollar to depreciate against other currencies—as has the anticipated slow growth in the U.S.—which has helped drive import-price inflation. This is also a partial reason for the continued run-up in commodity prices (the full explanation involves speculative flows).

Interestingly, the inability of producers to pass on their price increases to consumers has helped keep inflation at bay, but at the risk of growth (see Figure 1, below). This will serve as a drag on reported profits for the first quarter, which could cause more volatility in the financial markets.

Figure 1: Price Indexes Rising



Source: CMC EResearch

The problem with the Fed's aggressive rate cutting to spur growth is that monetary policy operates with a substantial lag. It began cutting back in October, and the only impact on the economy so far is in inflationary pressures and a declining dollar.

The Fed can make more money available to banks to lend, but it cannot force banks to make loans. With fears of default, banks have been hesitant to lend. So the pass-through from monetary policy to the real economy is likely going to appear in the inflation statistics but not the growth numbers. A real risk is that with all the lending capacity available to banks, a quick change in sentiment could cause a very rapid expansion in the money supply—and inflation.

The growth of credit has outstripped the growth of income since the turn of the millennium. This has meant spending could expand more rapidly than income, which of course is not sustainable. There is the possibility

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that the necessary deleveraging will have an additional effect of slowing economic growth. The current disparity between credit growth and income is not as bad as it was prior to the March-November 2001 recession, so the deleveraging may not be recession-inducing, but it will likely serve as an additional drag on growth.

The ironic thing is that the slowdown in growth could save the Fed from itself. Low interest rates have created inflationary pressures, but deleveraging could offset the pernicious inflationary effects of previously loose monetary policy. If commodity prices drop, which they should in the face of slower growth, inflation could stay contained and there would be a weird change to something called normalcy.

The Treasury yield curve is now clearly inverted, and the jury is still out on whether the next Fed move will be to raise or lower interest rates. Core inflation remains "uncomfortably high," according to Fed chairman Ben Bernanke, at 2.2%. Therefore, monetary policy will be gauged to keep this in check and within reach of the Fed's 1%–2% target range. Unemployment is low, capacity utilization is rising, and oil prices are escalating again, so there are fresh data being reported, which are often associated with inflationary pressure.

However, the economy is clearly advancing at a desirable but modest clip: GDP growth is beginning to come in below the long-term trend line (2.5% for the fourth quarter of 2006 vs. the long-term trend of 3%). First-quarter growth appears to be even slower (e.g., the Conference Board's leading indicators declined in February and March, and according to the Institute for Supply Management, the manufacturing sector is barely growing). The impact of rising rates and commodity prices appears to be registering in economic activity.

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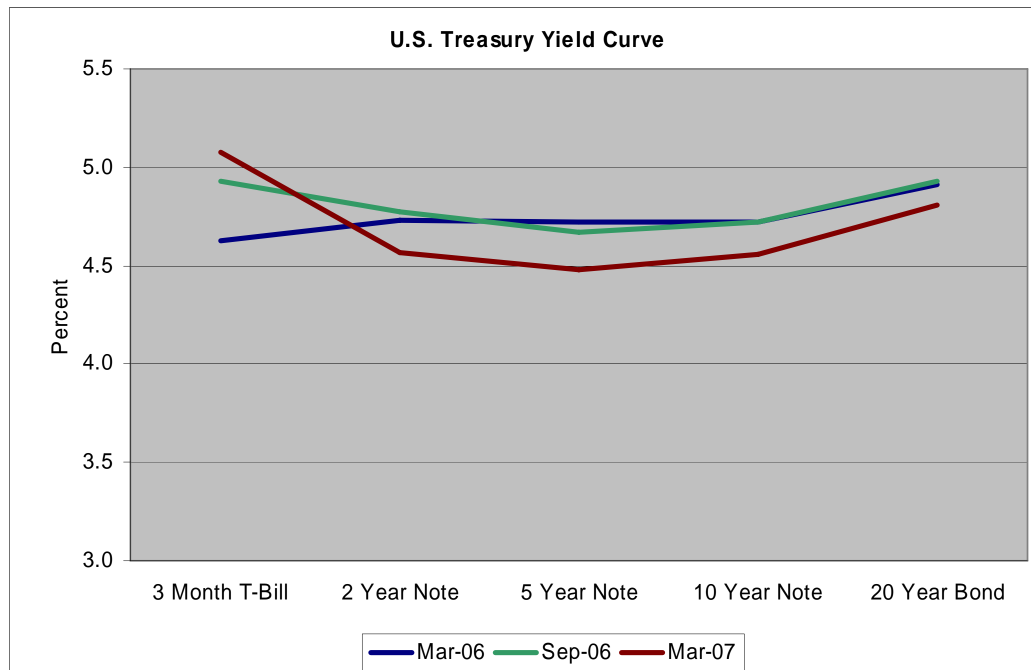

However, as always, the data are mixed, and the Fed appears prepared to wait on the sidelines until clearer signals emerge. According to Bernanke, "the current stance of policy is likely to foster sustainable economic growth and a gradual ebbing in core inflation."

What does this mean for advisors? Based on futures prices, the market appears to be betting on a cut in interest rates in the third quarter from a slowing economy. We have believed for some time that a cut this year is likely. This should be good for the performance of the stock market as a whole (and the bond market), and perhaps, with the prospects of slowing growth, high-quality large-cap stocks will finally take over performance leadership. There is still a risk that the economic slowdown will be too much and too fast.

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