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THE GREAT AND POWERFUL FED?

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The Great and Powerful Fed?

"At one point during the last crisis, we said, 'this is the one,' meaning that we thought that the credit crunch would change the behavior of financial market participants to make them more prudent. We were wrong."—Ray Dalio, *Bridgewater Associates Daily Observations*, October 16, 2007.

"The history of the past 50 years or so has been one of a steady buildup in debt, punctuated by periodic crises that threatened to topple the whole financial edifice. Each time, the authorities have found a way to stave off disaster, and in the process, set the scene for even greater excesses down the road….We have described this process as the Debt Supercycle, and the key question seems to be: how long can this keep going on?"—Martin Barnes, *The Bank Credit Analyst*, September 2007.

Is that, as Peggy Lee crooned, all there is? Was the global credit crunch that so terrified market participants in mid-August simply…not that big a deal? Given equity market performance since August 17 (the day the Federal Reserve cut its discount rate in order to "mitigate the adverse effects on the economy arising from the disruptions in financial markets"), it certainly appears that way. Global markets have soared, even as the US$ has plummeted and commodities prices have risen sharply. In short, the reflation trade is back! However, outside ebullient equity markets, many areas are still under a good deal of stress. The beleaguered housing and mortgage-backed securities (MBS) markets, for example, show few if any signs of recovery. More broadly, the spreads between several short-term funding rates remain wider than historical averages (Table A), high-yield and emerging markets bond spreads are wider than they were prior to the crisis (Table B), and high-yield debt issuance has fallen sharply (Table C). Further, several large money center banks have already taken huge earnings write-downs, and, while many believe these will "clear the decks" going forward, the opaque nature of the structures underlying these write-downs is such that further analysis is virtually impossible.[1] Thus, while equity markets act as if Fed rate cuts have "solved" the crisis (although as of this writing volatility has begun to pick up again), this stands in stark contrast to events in the rest of the global financial system.

Our view is that the troubles that so unnerved investors in August have not been resolved; instead, they have simply been pushed into the future. Thus, our opinion on the attractiveness of various global equity markets is largely unchanged;[2] if anything, the recent rally (and concurrent rise in investor optimism) has made markets more susceptible to a sharp and sudden decline. Indeed, while little has changed fundamentally, the Fed's actions have clearly boosted the short-term willingness of traders to speculate based on the perceived likelihood of further rate cuts. It should go without saying that we do not view this to be a viable investment strategy. We would agree with GMO's Jeremy Grantham, who concluded his most recent letter to investors by quipping that this "is not how we manage money, but it sounds like a whole lot of fun!"

[1] For more details on these structures, please see our September 2007 Market Commentary *The Trouble With European Financials*.
[2] For more details, please see our September 2007 Market Commentary *Global Survey—Vive la Différence?*

How Many Legs Does a Dog Have If You Call Its Tail a Leg?

Indeed, while U.S. investors continue to play the Fed guessing game, the less discussed (but more relevant) topic is what impact should be expected from the mountain of bad debts that now permeate the global financial edifice. This is not, it should be noted, just about subprime. As David Einhorn of Greenlight Capital recently put it, "There has been a colossal undercharging for credit across the board." In short, there is an enormous volume of bad debt, both consumer and corporate, that will never be repaid, and this will have widespread consequences for a system that packaged and sold such debts in very large quantities.

Still, much of the financial world seems in denial about the true scope of the problem, not to mention what will be involved in fixing it. The latest "plan," for example, is for banks to create a $100 billion fund that will buy assets from structured investment vehicles (SIV) and conduits that would otherwise need to be liquidated in the open market. Color us skeptical. While the fund *could* provide something of a short-term balm to markets by pushing price discovery into the future (in other words, the so-called "Super-SIV" would presumably not be forced to sell assets immediately, and thus prices would remain "undiscovered" for a period of time), the exercise strikes us as little more than "moving the Jell-o around the plate." In other words, the bad debts will still exist, just in a different fund. As Einhorn sees it, "It is very important to many banks and broker-dealers that we maintain a 'Don't ask – Don't tell' policy of price discovery for troubled debt instruments."

This cannot go on forever, of course—at some point the underlying loans will, in fact, default—but as Martin Barnes points out, a version of this game has now been going on, in one form or another, for more than half a century. The situation reminds us of an old *New Yorker* cartoon that shows a bedraggled man holding a sign that says, "The End is Nighish." In short, while we know the endgame, we know not when it begins.

Where's the Beef?

We also think it worth mentioning that, while the Fed has clearly had a significant impact on equity markets over the past couple of months, and was also able to at least forestall the credit crisis through liquidity injections and interest rate cuts, its influence on real economic activity is enormously overstated. Indeed, despite its outsized reputation, the Fed has control over a vanishingly small segment of the U.S. financial system. The amount of bank reserves affected by Federal Open Market Committee operations is less than $45 billion, with the short-term variance (i.e., the amount that determines the Fed funds rate) generally about $2 billion. Borrowings at the discount window, which have ticked slightly higher of late, still amount to only $3 billion. As John Hussman recently quipped, "To believe that the Fed operations matter, you have to believe that a *$13 trillion* economy is controlled by a few billion dollars of reserves and discount window borrowings, *none* of which vary materially from year to year." (Emphasis in original.) "The notion of a powerful Fed," Hussman asserts, "is not knowledge born of analysis, but belief born of repetition." We would agree. Still, perception is reality in financial markets, and investors must therefore take *other* investors' faith in the Fed into account when analyzing short-term market activity.

We can get a sense of just how ingrained this belief is by looking at recent movement in Fed funds futures contracts, which estimate the probabilities for future meeting outcomes. On October 12, for example, Fed funds futures implied a roughly one-third chance that the Fed would cut rates at its October 31 meeting (in other words, the odds were two-to-one *against* a rate cut). Over the next 11 days, as equity markets began to decline, the chances of a cut rose to *more than 90%* (odds for a 50 basis point cut rose from 5% to more than 25%), with odds spiking sharply on Friday, October 19, and Wednesday, October 24—days when markets sold off sharply. Indeed, markets staged an impressive intra-day rally on the 24th, with the only discernible "news" a rumor that the Fed was *thinking* of cutting the discount rate.

In short, the Fed matters because people believe it matters. While the vast majority of market participants take it on faith that Fed rate cuts are good for equity markets, the "proof" of such theories is based almost entirely on back-tested data that show markets have generally risen after the Fed cuts rates.[3] However, such analyses ignore substantial influence from other factors. Since 1950, for example, there have been 11 cycles where the Fed cut the discount rate at least twice in a row, with average total returns for the S&P 500 over the next three, six, and 12 months of 6.2%, 12.5%, and 21.1%, respectively. However, at the time of the first cut, the average price-earnings (P/E) (based on trailing 12-month earnings)—was 14, average dividend yield (DY), 3.75%, and average price-to-revenue (P/R), 0.9. This time, the S&P trades at a trailing P/E of 18, DY of 1.84%, and a P/R multiple of 1.6. Further, using trailing 12-month P/Es understates the true difference in valuations; P/E multiples based on normalized earnings, which adjust for the cyclicality of the business cycle, are higher today than *at any point* other than the late 1990s/early 2000s tech bubble and the period surrounding the 1929 crash. Thus, it seems an extraordinary leap to not only assume that equities rallied during prior periods of Fed easing predominantly because the Fed cut rates, but also that today's richly valued market will follow the same script.

Not to put too fine a point on it, but it bears repeating that the Fed has *very little* control over the U.S. economy and, by extension, corporate profits. What it appears to have control over, at least for now, are the nebulous "animal spirits" coined by Keynes. While clearly important in the short term, the current Pavlovian response by investors to the Fed's activities will have little bearing on long-term returns.

What About Fundamentals?

As noted above, our outlook for equity markets has changed little since August, as we were concerned about the ongoing buildup of debt *before* the credit crisis, and do not believe the underlying problems have even begun to be truly addressed. Further, we continue to believe corporate profits and profit margins, which have been running far above trend for several years, will eventually revert to the mean, with severe consequences for equity markets that look reasonably priced *only if* one assumes current earnings and earnings growth are sustainable.

[3] For more details on Fed cycles, please see our April 2006 Market Commentary *What Really Happens When the Fed Stops Tightening?*

Along those lines, it is interesting to note that while economists have been revising economic growth estimates *down*—the International Monetary Fund, for example, recently cut its 2008 forecast for U.S. GDP growth from 2.8% to 1.9%—analysts expect corporate profit growth to *accelerate*. S&P 500 earnings are expected to grow only 6.8% in 2007 (down from 15.7% in 2006), yet consensus forecasts for 2008 and 2009 are for profit growth of 12.7% and 11.5%, respectively. Further, these estimates assume huge earnings growth for consumer discretionary (expected to jump 20.8% in 2008 after rising 3.3% in 2007) and information technology (estimated 2008 growth of 20.6% after a 13.3% rise in 2007), as well as a nearly 10% rise in 2008 earnings for the beleaguered financial sector, which is (believe it or not) expected to grow profits by 5.4% for 2007 as a whole. While such growth rates are certainly *possible*, these assumptions strike us as extraordinarily optimistic, and clearly leave significant room for disappointment.

Conclusion

Our core belief, as articulated many times over the past several years, remains that high valuations across asset classes are almost certain to suppress returns over the long term, with high-risk and low-quality assets particularly expensive and vulnerable to significant declines at some point. As such, we have advised (and continue to advise) investors to lean toward quality when possible, being sure to diversify across asset classes with different *economic* bases of return. We also continue to advise against underweighting equities for two (related) reasons: first, bear market rallies can be extremely long and powerful, and second, while high valuations tend to be good predictors of low *long-term* returns, they are relatively ineffective as guides to short-term market activity.

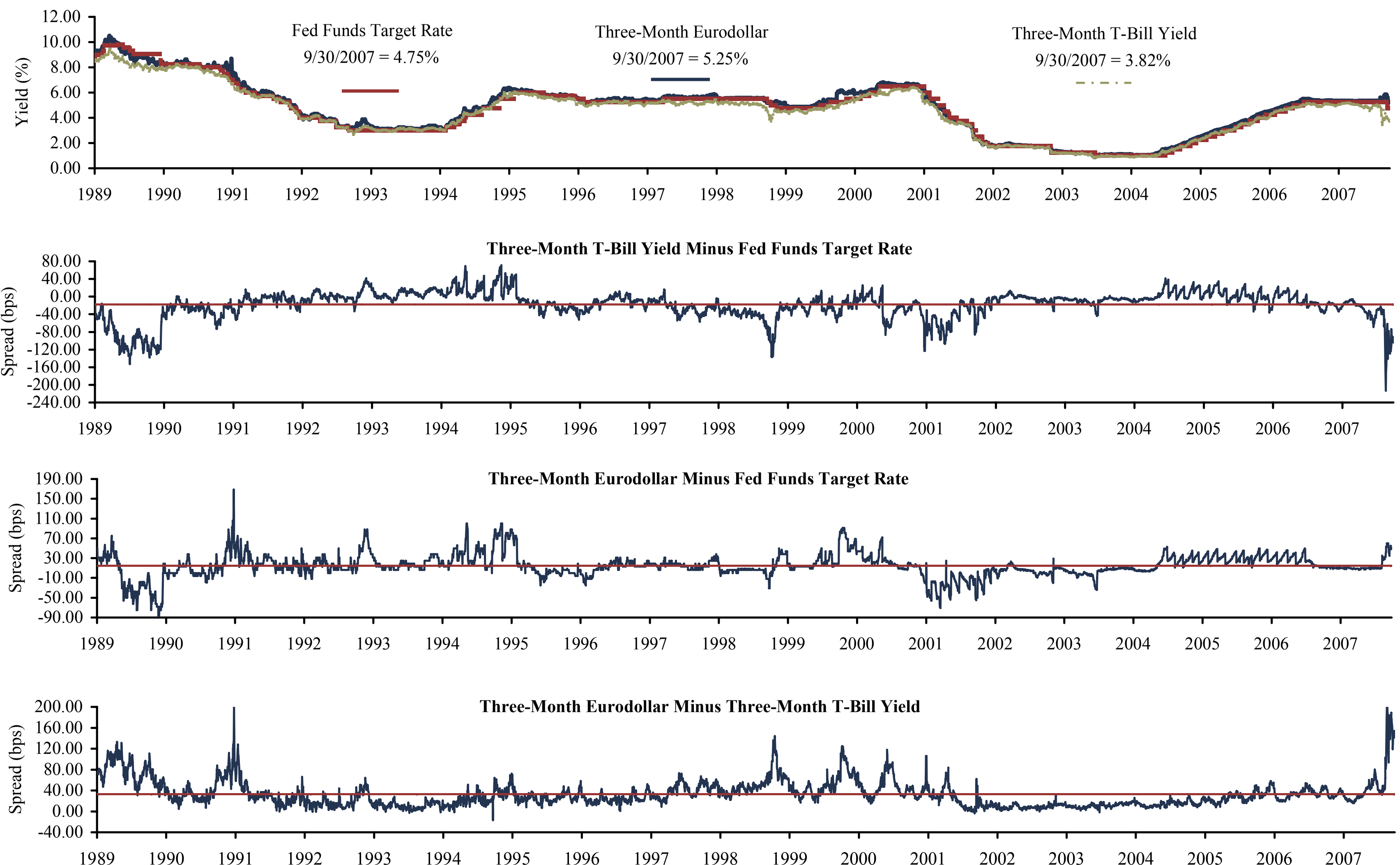
Further, the extremely aggressive actions by central banks over the past few months (including the Fed's unprecedented step of accepting MBS as collateral for short-term loans through its open-market operations) have convinced many market participants that the "Greenspan put" is not only alive and well (with a slight name change, of course), but that its strike price may be, depending on circumstances, only a few percent below all-time market highs. Importantly, the *belief* that the Fed will bail out the market is more critical than whether it is, in fact, targeting asset prices. There are many who believe the Fed and other central banks acted appropriately by pumping money into the system and lowering rates (on the part of the Fed) by more than was expected. Nevertheless, traders clearly believe the Fed acted to support equity prices and will do so again if necessary, and have positioned themselves accordingly.

In sum, it is critical now more than ever that investors distinguish between *short-term* market influences, which are currently heavily weighted toward Fed-watching, and *long-term* factors such as whether earnings can continue to grow at above-trend rates. We cannot predict the former, but recent events have done little to change our stance on the latter. Stay defensive.

Table A

T-BILLS, FED FUNDS AND EURODOLLAR SPREADS

January 3, 1989 – September 30, 2007

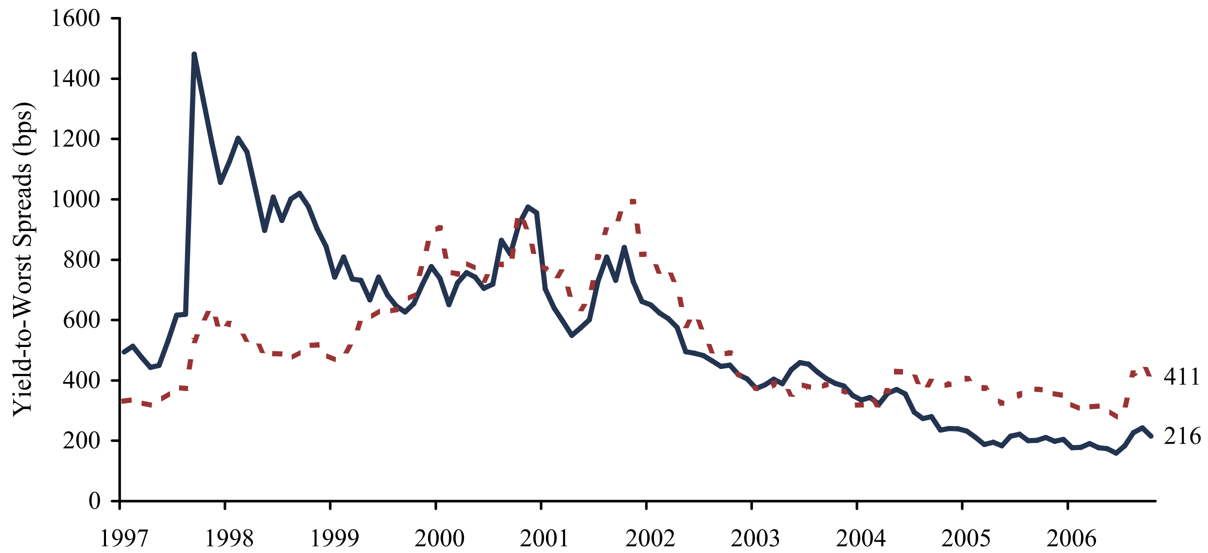


Source: Thomson Datastream.

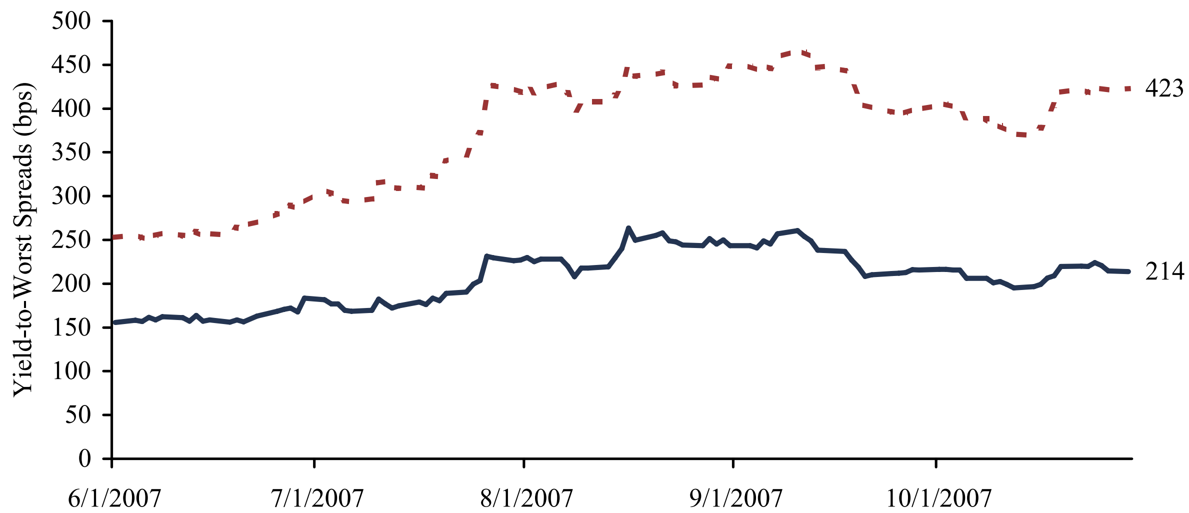
Table B

YIELD SPREADS FOR HIGH-YIELD AND EMERGING MARKETS BOND INDICES RELATIVE TO TEN-YEAR TREASURIES

December 31, 1997 – September 30, 2007



June 1, 2007 – October 29, 2007



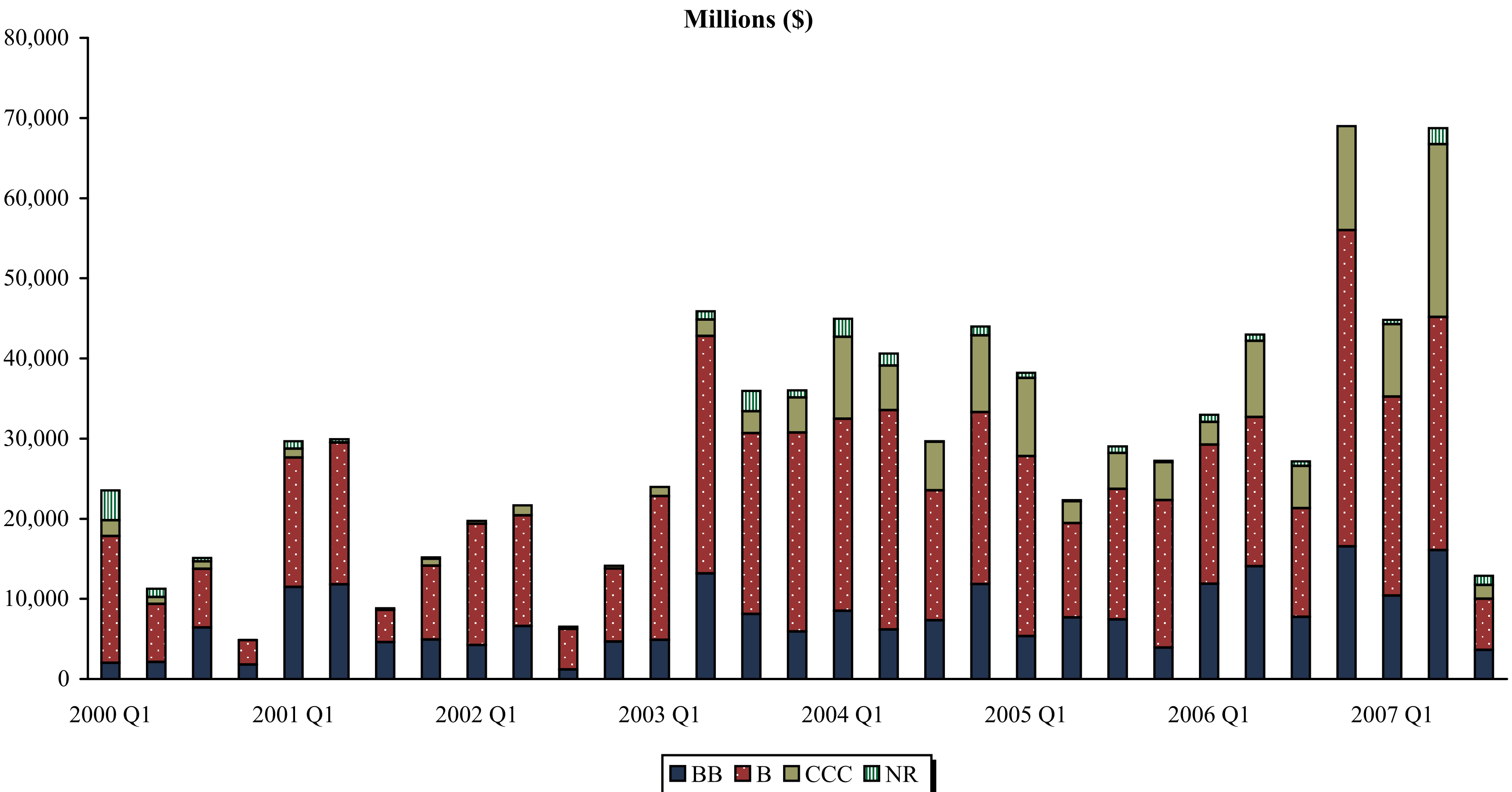
Sources: J.P. Morgan Securities, Inc., Merrill Lynch & Co., and Thomson Datastream.

Note: Top graph represents monthly data and bottom graph represents daily data.

Table C

VOLUME OF NEW HIGH-YIELD ISSUANCE BY RATING

Millions ($)



Source: Merrill Lynch & Co.

Notes: Graph represents quarterly data through September 30, 2007. Includes nonconvertible, corporate debt rated below investment grade. BB rating includes issues that are rated BBB or BB by Standard & Poor's, or Ba1 or lower by Moody's.