

Spring is in the air

The month of April brings the end of winter in some parts of the world and starts autumn in others. It seems like a change of season is in the air for the financial markets, as the dire state of affairs have abated and confidence is returning to the markets. The 17th of March 2008 will go down in history as a significant day when the Fed bailed out Bear Stearns and averted a major collapse of the financial system. How quickly we forget the avoidance of moral hazard (remember June 07 when these problems started?).

Since March 17th and throughout the month of April the markets have started to ignore economic data and have focused on buying risk assets. Stocks rallied, with the Dow up 11.5% and the ASX up 14.2% from their lows. Despite this impressive rally, the Dow and the ASX are still down 7.5% and 11% respectively for 1Q08.

Risk aversion trades were unwound and bonds got killed. US two year yields sold off 75bps to 2.25% while the US 10 year yields sold off 45 bps to close the month at 3.73%. Credit spreads came roaring in. US financials recovered from their lows. The debt of the major US investment banks rallied some 200bps from their wides to levels seen back in September 06. Ah! Spring is the season of rebirth!

On April 30th, the Fed delivered a widely-anticipated quarter-point rate cut bringing the target Fed Funds rate to 2.00% (after a whopping 325bp of easing so far in this cycle). The market considers the Fed to be 'on hold' and is even pricing in rate hikes as early as September 2008. There are eight long weeks between the April and June meetings, with a lot of economic data due – some of it potentially pivotal for monetary policy. If history is a guide, on average, the Fed remains on hold for approximately 12 months (see chart of the month) before the rate hikes commence. Even then, it tightens in baby steps.

Does this suggest that the problems and predictions made by market experts just a month ago are over? Did the oft-stated assertion that this crisis is akin to the Great Depression end with the stroke of a pen when the Fed awarded Bear Stearns to JP Morgan? Has the Fed accomplished what market participants thought was unattainable and brought us back from the financial abyss?

Kapstream is not ready to accept it quite yet. Here is why:

1. In the 1st quarter alone, 20 of the largest US cities saw housing markets drop by over 20% in value. This will impact spending and consumption, especially in the US.
2. Higher fuel prices (oil at nearly \$120 a barrel) and tighter lending conditions will lead to a further tightening of the belt by consumers.
3. US employment has fallen for four months losing 80,000 jobs in 1Q08.
4. Inflation is starting to creep up via higher food, energy and commodity prices. Bailing out the financial system by providing liquidity is inflationary for the future as well – the Fed is robbing Peter to pay Paul.
5. The fiscal deficit is widening – which implies higher government bond issuance.
6. Real GDP growth in the U.S. in the 1st quarter annualised is a mere 0.6%.

We believe that economic data over the next 6 to 12 months will be anaemic. It will take time for the economy and markets to return to normal. Though having cut over 3.25%, the Fed still has work to do. They must ensure that the functioning of financial markets, through which money flows into the economy, continues at a smooth pace, all while combating rising inflation and commodity prices.

Recently, Dallas Fed governor Richard Fisher admitted in a statement that 'downside risks to growth remain' and 'the substantial easing of monetary policy to date, combined with ongoing measures to foster market liquidity, should help promote growth over time'.

Things that worry us:

1. Investors are getting too 'bulled up' on very little economic news and chasing after riskier/illiquid assets in a hurry. Too much money, chasing too few good investments, too soon – will lead to disappointment.
2. 80% of the S&P companies reporting earnings in the Q108 have reported year-on-year EPS of minus 13.4% – Yes, folks – MINUS 13.4%.
3. For Q3 and Q408 the markets are looking for EPS growth of 10% and 20% respectively. Astounding!
4. The borrow-spend, borrow-spend mentality is back.
5. Banks need to raise equity/capital to offset losses, and in addition generate new capital for lending purposes.
6. When and how is the Fed going to unwind all the mortgages and other collateral that it has taken on its own balance sheet in lieu of treasuries. Who is going to buy them?

We are not eternal alarmists. However we have not found convincing evidence to convert us into BULLS!