



Economic Quarterly – December 2007 *Ushering in a Downside Move*

The primary economic story in 2007 was undoubtedly the sub-prime housing market and its global impact. The force of that powerful economic tsunami continues to be felt and will continue well into 2008.

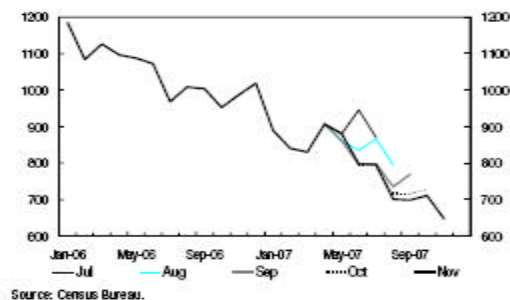
The historically low interest rates from 2001 through 2003 (at 1%) created an economic boom founded on cheap and available money. Funds were so available that financial institutions were literally giving it away free and offering credit on sub-prime property and to sub-prime borrowers at bargain basement prices. Those bargain basement prices however had many secrets, the most apparent of which was that as the economy strengthened and rates rose the rates like the borrowers were going to arise from the basement and stare at the light of day. The borrowers and lenders were soon reminded that the light of day is not always kind.

But with all those mortgages being processed, the market spread their credit risk by creating CDO (collateralized debt obligations) and SIV (special investment vehicles) which were sold across the globe by markets looking for higher yields than those available in the standard markets. The mood was so euphoric that investors and financial institutions alike forgot that with unreasonable high returns come extremely reasonable – and predictable - risks.

The cascade began in early 2007. Rising rates and slowing property markets, especially in higher speculative markets on the coasts, started to reset those bargain basement rates. Speculators who had no funds invested (no money down – no

interest until... deals) walked away from properties and real homeowners with dubious credit began to feel the squeeze. As these situations resulted in defaults the securities containing the loans also started to default and finally funds which had heavily invested in the securities also started to fall. The one dubious bright spot in the debacle was the effectiveness of spreading the risk through the CDO and SIV vehicles. Unfortunately the problem was big enough that even global markets were not immune to the lowering of credit. Funds from Australia to London fell as well as our domestic funds. Major financial institutions such as Bear Stearns, Merrill Lynch, Citibank, MBIA, and Chase all have had to write off billions of dollars. At year end, these financial institutions are laying off thousands of employees and pulling back from risk. Like the rest of the market they are moving to safe harbors for whatever resources they have left. They will stay there until the situation stabilizes somewhat.

Figure 5. New Single-Family Home Sales (Thousands) as Reported in the Last Five Months, 2007-Nov 07



The result of the *credit cascade* has been a growing weakness in the US economy, the weakening of the mighty US dollar and a deepening fear of uncertainty in the markets overall. Markets do not like uncertainty: financial or political or social. It is the role of the Federal Reserve to fight inflation, but also to support our currency and create stability in the financial markets as much as

it can. To do so, it has loosened lending to banks. It has injected funds through open market operations and it started to cut its discount and Fed Funds rates. The Fed also created TAF fund injections in November 2007 to increase liquidity and allow banks and other financial institutions access to *cheap* funds. The needed liquidity injections have raised the TAF from \$24 to \$30 billion in one month. Such injections may be needed for several more months.

One bright spot throughout the decline and disruption has been employment. Our unemployment rate has stayed around 4.7% and unemployment claims have remained low, but, the length of this cycle has also started to claim victims here. With oil hitting a record high of \$100 and the lower dollar forcing producers to pay more for raw materials and finished goods. Manufacturers and service providers are starting to cut their hiring and even lay off employees until they see some stability and reason for optimism. Although housing sales have stopped falling and affordability has risen it is questionable when the situation will stabilize.

When the producer can no longer afford to *not* pass through costs to consumers the cost to the consumer rises and the consumer – that stalwart of the US economy also starts to slow his/her ardor. The general slowing in consumer spending along with higher costs and threats of inflation from higher commodity prices is threatening to slow first and second quarter GDP to 1%-1 ½%.



Mr. Bernanke’s fixation on inflation has not made him a favorite of the markets.

Although the Fed has lowered rates slightly (from 5.25% to 4.25%) the markets have taken rates significantly lower with 3%+ on everything to the 30-year. Minutes of the December FOMC meeting are baffling in that the recession risks to the overall economy are clear but the Committee hesitates to drop rates because of inflation worries. This delay by the Fed has added but another uncertainty and worry to the markets. If the difference between bank lending rates and overnight rates is not reduced and the credit fears reduced the markets will tend to grind to a halt until a direction is set.

A recession is certainly not a positive scenario for 2008 we could simply flirt with the recessionary trends and pull out but it may take another quarter at least to do so. The consumer can continue to purchase goods at higher prices. Personal consumption has decreased slightly but continues. Retail sales at year end were marginal but not radically decreased. However, if unemployment begins to creep up past 5% the consumer will definitely curtail his/her buying. If credit concerns are not lessened by lower rates and continuing liquidity injections, the markets will continue to seek safe harbors in the US Treasuries and take rates lower themselves. This move however does not raise confidence in the Federal Reserve and has long ranging consequences of its own.

Clearly, investors in the fixed income and short money markets will see lower rates in 2008. Until the Fed acts the front end inversion in the curve (leaving overnight rates higher than short term maturities) will entice some investors to stay liquid. But, the eventual – and perhaps dramatic - rate cuts which are going to be forced on the FOMC would make this a short-sighted alternative. We are all going to have to dig in for lower rates by locking into the rates we now have in place. Then all we can do is wait for the rebuilding cycle to begin again.