

C *Economic & Market* ommentary

Collateral Damage

The major storylines in the economy and markets haven't changed much since year-end, and we continue along the same bumpy road. The economic news worsened during the first quarter, and pending confirmation of the economic data in the coming months, it seems likely that we have entered a recession. The famous "Wall Street Rollercoaster" and the internationally acclaimed "Election Year Comedy Tour" have made this trip a bit more interesting, but the chorus from the back seat remains the same... "Are we there yet?"

While the epicenter of our current economic problem is the real estate markets, the collateral damage to other parts of the economy (whether directly or indirectly related) has created a bed of quicksand. The fear that more serious collateral damage is in the making drives the concern that the liquidity crisis may quickly turn into an irreversible, gaping hole in balance sheets, and that the bed of quicksand will engulf the economy. At its core, this view concludes that a financial meltdown is on the horizon and that a depression is a possibility. I'm not willing to draw that conclusion. Reversing the tide of sentiment and substance behind the recent downturn takes time. When both the Federal Reserve Chairman and the U.S. Treasury Secretary are set on using all the available resources of the U.S. Government and the economy to convince short-sellers in the fixed income and equity markets to stop betting on a meltdown, it's a matter of when -- not if -- the tide will change.

An interesting piece I recently saw from an economic analyst at a major brokerage house contained two flowcharts, one detailing the current problems and one of a proposed solution. The former had 25 process boxes and a commensurate number of flow-of-control (arrows) relationships between the processes that completed the loop. The latter had 15 process boxes, seven of which were the responsibility of the Federal Reserve (noticeably absent from the problem flowchart), and again, a commensurate number of arrows. While I marveled at the detail that must have taken days to draft, I was taken aback that the situation and solution were so easily condensed to such a concise flowchart. Not stunned, just taken back, since it was similar simplification of very complex products helped us get here in the first place. I guess some things won't change.

The S&P 500 stock index was down about 10 percent for the quarter. The international stock index, benefiting from stronger international currencies, performed a bit better ending down about 9 percent. Of note, *The Wall Street Journal* reported that the S&P 500 stock index moved more than one percentage point on 51 percent of the trading days during the first quarter, making it the most volatile quarter since 1934, and the fifth most volatile in history. It was the worst quarter in about 5 ½ years, and over the last five months it has looked a lot like 1990. This revived a "flight to quality," which drove the Lehman Brothers Aggregate Bond index up about 2 percent during the quarter, and depressed the yield of the 10-year U.S. Treasury yield to 3.4 percent, which was less than the inflation rate in 2007.

Worsening employment data and reduced lending by liquidity-strapped financial institutions have been negatives during the quarter and will take quite a bit off domestic economic growth through mid-year. But, on the positive side, the Federal Reserve has aggressively cut the Fed Funds rate and has continued an aggressive credit extension policy targeting troubled debt instruments. The tax-rebate program checks are scheduled to be mailed to individuals in May, and with the prospect of the current lower tax rates sunsetting in 2010, economic activity should be brought forward into 2008 and 2009 to avoid higher tax rates in the future. The elephant in the room is the magnitude of both the Bear Stearns debacle and the subsequent rescue by JPMorgan Chase and the Fed. Whether it was based on fear or opportunity, after direct investors in Bear Stearns lost most of their investment, this coordinated effort controlled the spread of collateral damage, and deftly positioned U.S. taxpayers to assume part of the risk...all without political fallout during an election year. All things considered (and not discounting the current situation), one can make a decent case that conditions should improve for both the economy and the markets.

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