

January 2008

Chaos, liquidity, and long term growth

Sifting through the past week's global equities volatility, which seemingly began with concern over the U.S. economy... prompting overseas markets to plunge on a day that the U.S. markets were closed... leading to a plummeting of U.S. stock index futures in advance of an unsuspected and quite decisive rate cut by the Fed before market-open... which in turn stemmed the likely U.S. equity market collapse... although stock indices did fall rather precipitously nonetheless before rebounding later in the week... what a rollercoaster! And in an unprecedented sharp turn, just as we thought the ride was ending, there comes the revelation of massive fraud by an alleged rogue trader... which situation and related unwinding of positions not only resulted in more than \$7 billion in trading losses for his employer... but, even more amazingly, may have caused the global markets to plunge in the first place, leading to the Fed's substantial cut (that now together with its more recent action has shaved 1.25% off the Fed Funds rate in roughly one week)... which, incidentally, many economists had already been urging, for months in fact, in any case... A wild ride indeed! And perhaps it isn't over... But in the longer term, after the confusion is behind us, could this assortment of ups, downs, turns, and screaming choppiness, prove just a setting of the stage for a substantial and prolonged rebound?

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Chaos:

That one trader could have manipulated the systems and infrastructure of a major international financial institution to the tune of \$7 billion in losses is to say the least concerning, especially as a reflection of the broader financial sector that has recently suffered through quite a few bruises. Confusion regarding this incident still remains, as does some skepticism about what actually took place at Société Générale, and whether one individual (whose motives remain unclear) could indeed be the sole cause of such a fiasco. That this comes on the heels of countless write-off announcements, almost all of comparable multi-billion dollar magnitudes, by virtually every major bank worldwide (including Soc Gen), undoubtedly fuels the skepticism. It certainly does not add to any sense of stability that none of the said organizations are ready to pronounce their asset write-downs to be sufficient. In fact, we are now also

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reminded by the ratings agencies that the very critical bond insurers which provide many fixed income instruments with necessary strength, may be facing liquidity issues of their own, the potential ripple effects of which could lead to countless other issues and possibilities, none good.

It is no wonder then that some of the more nervous economists have called for strong and preemptive monetary policy intervention, (and lo but also fiscal activism at the Capitol is snapping to), while some even go so far as to suggest that such actions would no longer be preemptive per se, but rather to curtail a recession already underway. If these groups are correct, which is not at this time clear, then the next area of debt market concern will be consumer credit card receivables, which will further exacerbate financial and economic turmoil. With this in mind, therefore, the Fed's 0.75% easing last week, which took place between meetings as referred to above, may prove to have been proactive rather than reactive as advertised. In some respects, one cannot help but speculate whether the supposedly inadvertent global market sell-off that seems to have prompted the Fed's action, was not somehow a blessing of sorts, particularly in light of the central bank's much more timid rate reductions heretofore.

Liquidity:

All of which said, there is a significant flip-side to the economic risks and market bumpiness described. Having not long ago witnessed a major equities market correction and general economic decline that burst the bubble of what had been referred to as "irrational exuberance," it seems that the more recent bubble – that of loose credit – was not similarly due to any fleeting investor psychology, but rather a very real excess of liquidity that needed to find a place to call home. That liquidity still exists, and this is a key feature of our global economy that cannot be discounted when trying to make sense of the chaos previously described.

Hedge funds, private equity funds, even banks, to this day and despite all the issues mentioned, remain flush with cash, and this cash still needs to be put to work. Citigroup's write-offs notwithstanding, to use one example, the bank's equity market capitalization remains well in excess of \$100 billion, a very far cry from insolvency. Combined with normal bank leverage, including but certainly not limited to consumer deposits, there is a lot of money, even at the currently stumbling Citigroup, to invest. And



although global markets have fallen considerably in recent months, there is not any sense of capital broadly being pulled out of hedge funds by limited partners. As private equity funds, moreover, had taken advantage of the more heady years to complete substantial fundraising, the multi-year partnerships that such funds entail virtually insure that private equity capital will remain a source of liquidity in the marketplace for quite a while yet.

Long term growth:

When stopping to consider these global forces of liquidity, and others (e.g., sovereign funds), that can act en masse, in addition to the combined fiscal and monetary policy measures being taken to (re)vitalize the economy, it is not at all far fetched to anticipate major market and economic growth once the near term dust has settled. We already see signs of the liquidity described in action, almost chomping at the bit to get moving, in the market spikes and intraday swings that seem to be triggered by any trace of positive news, or by the perception that a bottom may have been hit. It is almost as if investors don't want to miss out and are using the smallest excuse to buy in.

And when further taking stock of the current financial sector turmoil, and seeing it as something like necessary housecleaning, as it were, enabling a fresh start with a more structurally disciplined approach going forward, one's sense of confidence may become even stronger. An environment of both strong liquidity and structural discipline, in combination, could in fact lead to formidable economic results.

The precise turning point, however, remains indeterminate, as is the case with any roller coaster worthy of its name.

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