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WILE E. COYOTE IN MID-AIR

One of the most appropriate cartoon characters to describe those of us who manage money is Wile E. Coyote, the ever-creative hunter who tracks his quarry, the Road Runner, through a multitude of cartoons. Wile E. tries every trick in the book to catch the Road Runner, a member of the cuckoo family of birds, but it is always one step ahead of him. The coyote's continuous search for a way to catch this bird is symbolic not only of professional money managers, but also of everyone who must provide for his or her family by coping with the economy and its markets, searching for a way to send their children to university, to retire in comfort, or just to afford a good dinner, like the coyote. In all the cartoons, Wile E. gets close, but never catches the Road Runner, just like us in the real world. But sometimes the coyote gets into real trouble, and those of us who spent our youth watching these cartoons know where we are. We are exactly at that point when the coyote has run off the edge of the cliff with nothing but air beneath him, and he perceives for the first time that a great fall is ahead.

The whole world is at that Wile E. Coyote moment of recognition, with nothing to hold us up, and a tremendous recession staring us in the face. Almost no one seems to have recognized what a horrific spot we inhabitants of market economies are in. A recent survey saw a 10% uptick in US consumer attitudes since mid-October as the price of petrol had declined, Obama had won the election, and the authorities had halted the economic crisis. Those consumers – we – are in mid-air with a thousand meter drop ahead of us, and we won't recover from the fall as quickly as the coyote. The implosion of credit from Wall Street,

London, and global securitization machines will force a decline in global growth more severe than any since World War II no matter how quickly the Central Banks and treasuries allow the monetary aggregates to grow. Even if the banks were to make the loans, which is unlikely, the securitization and risk intermediation processes are no longer functioning so the loans can not be widely placed. As there is a very tight relationship between the expansion of credit and economic growth in the real world, the de-leveraging of the global financial system including banks, near banks, hedge funds, private equity, and other leveraged speculators, means that global growth will pause for several years at a minimum.

Although interbank market liquidity is improving, this does not mean that credit is becoming or will become more available to end-users. Treasury Secretary Paulsen, as well as most of the US Congress, has complained that the banks are not lending out the billions of dollars that the government has invested in them; and they will not, as bank management sees a tsunami of credit losses ahead. Risk premiums will continue to expand and money will be more difficult to obtain as the economy goes into recession, increasing the risk of default, and this fear of loss will make investors more reluctant to lend and more desirous of a strong liquidity position. Although this happens in every recession, this is the first global recession since 1982, and more important, this is the first one since 1929 where almost all of the major economies are highly leveraged. The way out of this recession will be long even if aggressive policies of very low interest rates and massive fiscal stimulus are followed. ✘

CYCLICAL PERSPECTIVE

The crisis that began in the summer of 2007 first showed itself as a financial one, with liquidity being the primary focus of the problems. The situation deteriorated dramatically when it became clear that Lehman Brothers would collapse and that the authorities would not take responsibility for its liabilities. At this point the interbank market ceased to function and funding maturities longer than a day evaporated. On the chart below that can be seen in the spread between 3-month LIBOR and the Overnight Index Swap, which climbed to the 350 basis point area from a level around 100 at the start of September. This swap rate averaged below 10 basis points in 2006 when markets were liquid. Today, this spread is at 163 basis points, and we would argue that the first part of the crisis is over. It ended on October 10 when the short-term market reached its most illiquid point very shortly after the coordinated interest rate cuts on October 8,

during the G-7 meeting, which went into that weekend.

The crisis is now an economic one and the risk has shifted from liquidity to solvency, a far more virulent problem, as pumping money into the system can't solve it. Ample and inexpensive liquidity is a necessary but not a sufficient condition. This phase is dominated by the real economy where capital and demand are being destroyed, and it takes much more time to reverse this type of decline. The business cycles will now shift into the dominant position, as they are far more important in economic recessions, than the shorter financial cycles, which have more to do with speculative emotions. The equity market will be the best financial marker of this cycle and now the dollar and equities will show a strongly negative correlation. 

