A 2nd Half Strategy Appetizer

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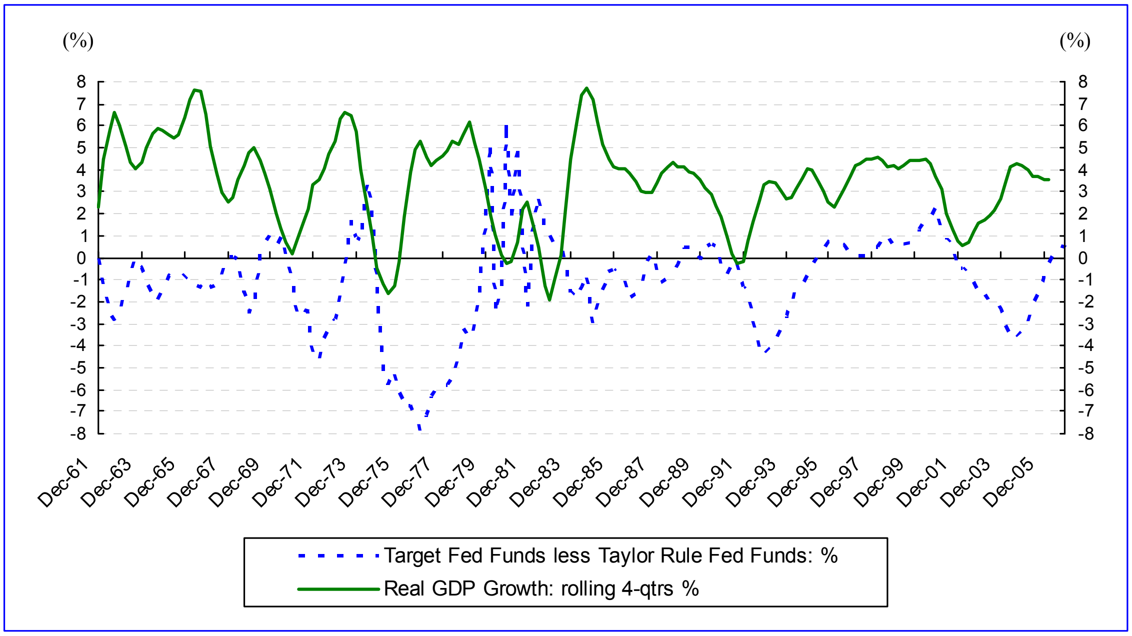
As an appetizer to my soon to be completed *2006 2nd Half U.S. Credit Markets Outlook & Strategy* publication, I want to present some thoughts and insights on the primary source of the chronic indigestion that has afflicted all financial markets – domestic and global alike – for most of this year, namely the Fed. While you might be tempted to qualify this source as the "Bernanke" Fed and, in so doing, imply a unique cause for the financial markets' intestinal grumblings of late, I would assert that the basic ingredients are the same as the "Greenspan" Fed and that only the presenter and presentation are different. This may seem a significant change for the palate, but to the stomach of financial markets where presentation only supersedes substance when it comes to bond salesmen, the mix of tighter monetary policy and the hiss of a leaking bubble has always churned the acids of investors into a fit so that even good news can not be digested well. In fact, I would argue, while continuing this absurd culinary analogy, that the first course and source of indigestion – the Fed, albeit with Bernanke spice – has largely been served. Although one or two more bites of rate hikes remain to be swallowed, the fate of investors' stomachs rest not with these last tidbits of a perennially difficult to digest monetary appetizer, but rather with the unknown main meal to be served up by consumers and corporations over the next couple of years.

The Fed By Any Other Name…

The Fed by any other name would tighten the same, or so I would argue is the true nature of the modern Federal Reserve, whether it be called the "Greenspan" or "Bernanke" Fed. Clearly, Greenspan exerted significant influence over the short-term timing of rate changes, but the process and rationale for arriving at these decisions was largely institutionalized and remains so under Bernanke's stewardship, at least for the foreseeable future. His "rookie" mistakes in trying to introduce misleading and meaningless concepts like "the pause" and "plain talk" have already given way to the more prudent protective – not to be confused with secretive – posture of the recent Greenspan tenure. Until Bernanke develops a framework that is distinctly different from the current institutionalized thinking of the Fed and sells this effectively to the body at large, the path of future rate changes should be fairly predictable for this cycle. Still, the inexperienced and slightly dovish nature of Bernanke will be cause for uncertainty and thus market volatility around the Fed for a while, which is the price of change, but the result in terms of interest rate policy will most certainly be the same as if Greenspan were running the ship.

To this primary point, I offer Chart 1, which shows real GDP growth versus the difference between the actual targeted Fed Funds rate and the predicted rate based on a version of the Taylor Rule. The Taylor Rule, for those less familiar with this tool than myself, is a simple concept and mathematical formula developed by John Taylor in the early 1990s to describe the relationship between the targeted Federal Funds rate as set by the then Greenspan Fed and inflation and real GDP. The basic concept is simple yet powerful. The targeted Federal Funds rate is viewed as a function of an assumed real long-term rate, an inflation target, the difference between this inflation target and the actual inflation rate, and the difference between the economy's potential and actual real growth rates. For this chart, I use a version of the formula presented in a recent article by William Poole,* the President of the Federal Reserve Bank of St. Louis, and smooth out the data input series by using rolling four-quarter averages.

Chart 1: ***Actual Fed Funds Rate, Taylor Rule Fed Funds Rate, and Real GDP Growth***



Source: Bureau of Economic Analysis, Federal Reserve Bank of St. Louis, BACA

Although no such formal policy rule has ever existed, this chart shows just how powerful a signal the Taylor rule – or any similar guideline – can provide for assessing when monetary policy is either stimulative or restrictive. Whenever the actual target Fed Funds rate has been significantly below that suggested by the Taylor Rule, real GDP growth as been robust. Similarly, whenever the actual target Fed Funds rate has moved and stayed above that suggested by the Taylor Rule, real GDP growth has eventually slowed significantly.

With real GDP and the core PCE deflator running at 3.5% and 2.0%, respectively, on a year-over-year basis, a 5.5% Fed Funds rate would exceed the Taylor Rule target and suggest a slightly restrictive monetary stance. With employment growth slowing and the inflationary effects of higher oil prices expected to abate going forward, Bernanke's Fed probably would prefer to stop at 5.25% but will likely move to 5.5% to reinforce its credibility and, like Greenspan, position itself to manage the risk that core inflation could be building.

Of course, recent signs of slowing could reverse as the Fed is removed from the picture and economic leadership rotates from the consumer to corporate spending and keeps the economy on

* The Fed's Monetary Policy Rule; William Poole; Federal Reserve Bank of St. Louis *Review*, January/February 2006, *88*(1), pp. 1-11.

a stable 3.5% growth path. This is the optimistic scenario that most bulls effectively adhere to, but the foundation for this seems flimsy to me as I will argue in the coming pages. Still, the downside does not yet seem that negative from a growth and earnings standpoint as long as the Fed stops at no higher than a 5.5% Fed Funds target and corporations continue to spend and hire moderately. However, such a sanguine scenario does not seem consistent with what is likely to be a growing period of economic and financial market volatility, led by a vulnerable consumer.

Hissing…

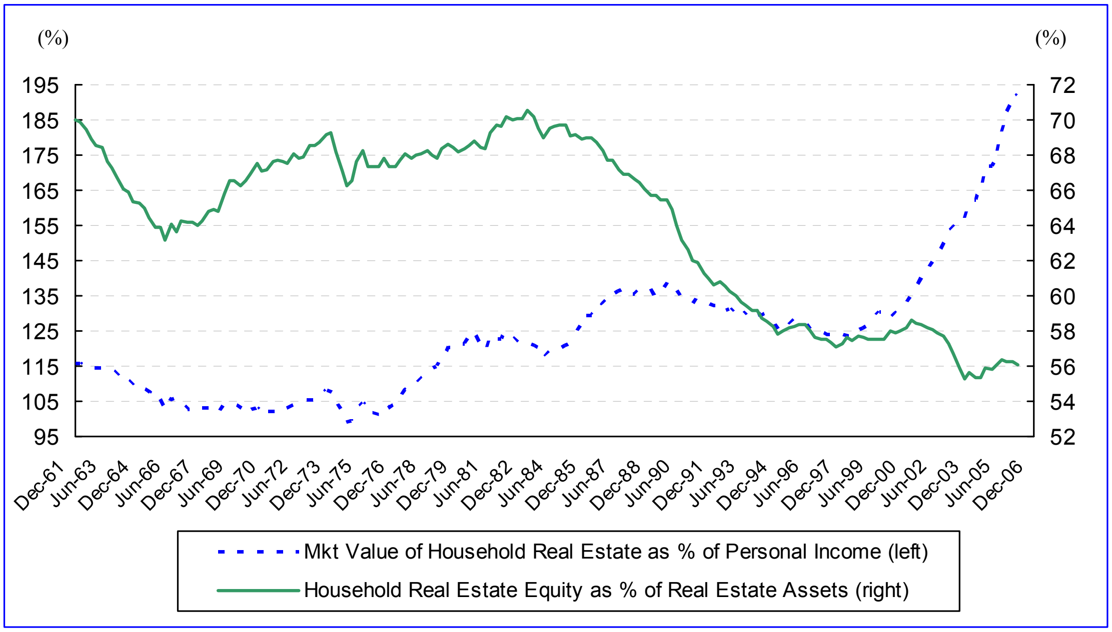
On a quiet Sunday morning in the affluent suburban enclaves of Connecticut's Fairfield County, a distinct hissing sound can be heard, like the sound of a deflating balloon or even bubble. Few of the nouveau riche remember the last time this sound was so audible, which was back in the late 1980s. The bubble that is being deflated ever so slowly but surely is, of course, real estate. The bursting of the real estate bubble in the early 1990s was the cause of tremendous financial upheaval. The steady building of another real estate bubble over the past decade has been the object of much analysis and the source of a tremendous wealth effect driven consumer spending binge. The degree of this wealth effect based spending binge can be disputed, but its existence and significance can not be denied. Now, as the hissing of pinholes in the deflating bubble can be heard throughout the country, the question of what impact it will have on consumer spending and economic growth has pushed to the forefront of factors that will determine our economic future. The fear that this bubble bursts rather than deflates in an orderly fashion is the basis for a "doomsday" economic scenario. Perhaps more important to the outlook is the fact that the real estate bubble of the late 1980s slowly deflated for almost three years before bursting dramatically in the early 1990s.

Chart 2 on the next page shows the percent of equity in total U.S. household real estate along with real estate values as a percent of personal income. Despite the nearly 12% compounded annual increase in real estate values over the past five years, the percent of equity in household real estate has actually dropped over this period. As alarming, if not more, is the multiple that real estate now represents of personal income. While lower interest rates, more creative and flexible financing options, and increased demand driven by demographic changes have all contributed to fundamental value increases, the explosive growth of this multiple over the past five years is clearly more attributable to the rate environment than anything else.

Like all valuations, real estate value increases must ultimately be supported by personal income increases. While the equilibrium level of the percent of household real estate values to personal income is likely higher today than the average historically, I am very skeptical of the current multiple and the ability of incomes to sustain current real estate values without any help from the cost of financing. Furthermore, whatever speculative element there is in current real estate values – and the nature of all such price appreciation is that there is some not insignificant amount present – will steadily, if not quickly, reverse as price momentum stalls and then reverses.

Now, add to this picture the possibility that the mini baby boom spawned by the baby boom generation and that arguably drove the housing demand increase over the past two decades is leveling off and will not quickly be supplanted by the twenty and thirty-something generations in the face of a housing market well beyond their purchasing power. The result of this harsh mix of ingredients is a bland and possibly downright ill tasting real estate market for the foreseeable future. Yet, this was one of the principal, if not the primary, engines of consumer spending growth over the past decade.

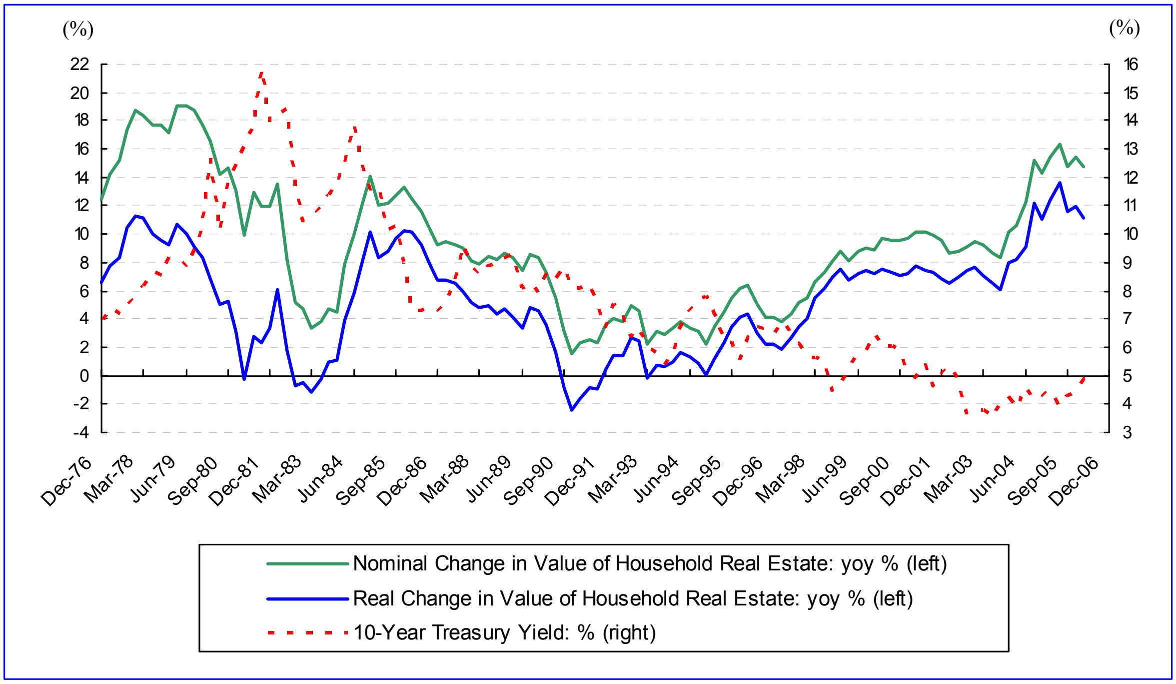
Chart 2: *Household Real Estate Values and Personal Income*



Source: Federal Reserve, Bureau of Economic Analysis, BACA

If all this sounds like someone who never got into the vacation home market and is mourning all the never-to-be-realized gains, well it is, but also look at Chart 3, which shows nominal and real changes in the value of U.S. household real estate versus the 10-year Treasury yield. This real estate boom has been the second best on record from a 5-year nominal appreciation measure and the best on record from a real appreciation standpoint. The history of real estate market performance following such peaks is low single digit nominal appreciation overall for up to five years. Nominal real estate has never gone down in value overall in any one year. Real appreciation is usually flat following a peak, with a couple of years of outright declines in value. In case you might think there is hope that the Fed will plug the pinholes creating the hissing noise in this real estate bubble, a look at the 10-year Treasury yield on this chart should convince anyone that there is no momentum likely coming from the cost of financing anytime soon. In fact, that hissing is the sound of momentum leaving.

Chart 3: ***Household Real Estate Appreciation vs. 10-year Treasury Yield***



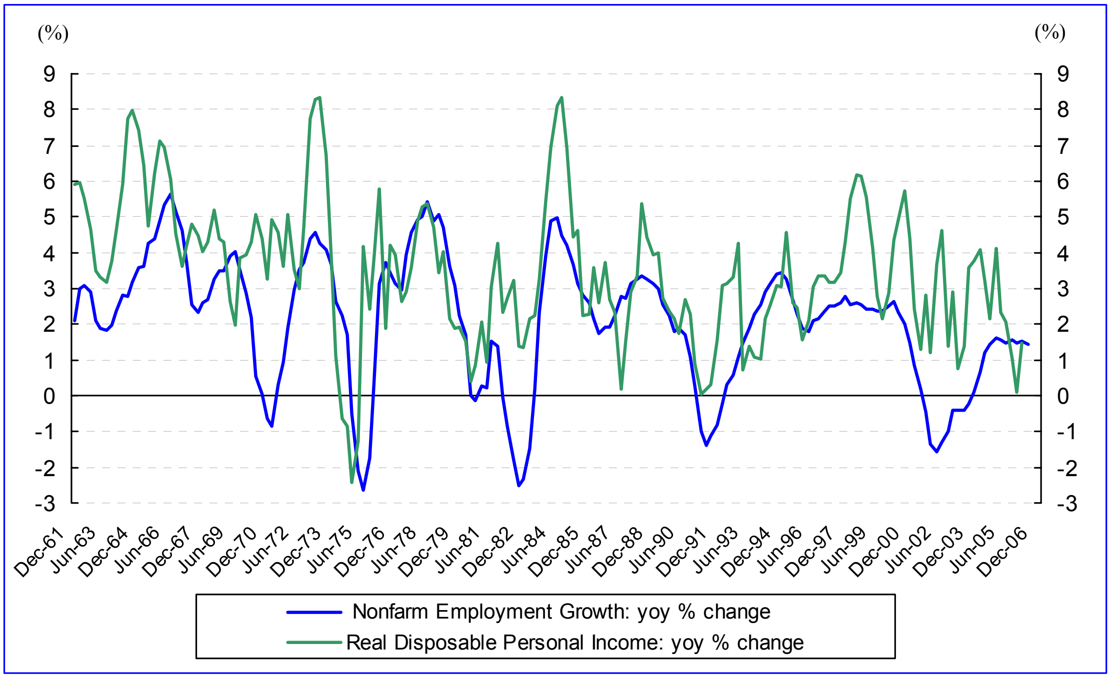
Source: Federal Reserve, Bureau of Economic Analysis, BACA

A Good Job Pays For Everything…

While the Fed is feeding us stomach turning fare and the real estate well is running dry, the steady, if unspectacular, pace of new job growth has made up for everything…until now. Historically, once job growth resumes following an economic downturn, it tends to have momentum and remain positive for a while. After a protracted delay in resuming, total nonfarm job growth has been positive and fairly steady at 1.5% year-over-year for the past couple of years, with private nonfarm payrolls increasing slightly more than this. Yet, this is the most anemic recovery on record. While the strength of job growth in the late 1990s and other structural and policy related reasons can account for this slow pace of job growth without negative implications, momentum in job growth is showing signs of stalling, if not reversing.

The late stages of a Fed tightening cycle are not usually great periods for job growth momentum. Neither is the deflating and possibly bursting of a real estate bubble, which is partly related to the Fed. In fact, a look at construction, real estate and related industries suggests that about 40k new jobs on average were generated each month over the past several years around real estate, with year-over-year job growth rates of 4% to 5%. Reducing this pace of growth to 2% will take off as much as 25k jobs each month for a period of time and reduce the average monthly job gains going forward to under 130k from the current 150k. Were job growth in real estate related industries to flat line, the 1.5% job growth would drop to 1% or less and average monthly job creation would likely drop below 100k. There are already signs in the jobs data that some of these trends are emerging.

Chart 4: ***Employment and Real Disposable Income Growth***



Source: Federal Reserve, BLS, BACA

It's a dynamic and resilient economy you might say and that other industries will and are picking up the slack. I am a preacher of the former, but, unfortunately, the latter has yet to be seen as weakness in the service sector – specifically retail trade – has uncharacteristically detracted from job growth this year. Consumer related industries do not seem to be generating the job growth of the past several years, which seems suspiciously consistent with a fading consumer spending binge that oddly coincides with that hissing sound from the real estate market.

Hopefully, the stagnating momentum in job growth will reverse as the Fed completes its tightening cycle this Summer and positive seasonals kick in. Yet, any reversal will not be tremendous as the real estate hiring slowdown is real and permanent. Even more concerning to me is that this economy is 80% service driven from a job creation standpoint and most such services are by nature discretionary from a spending priority. Consumers need money to spend on services and that money has in large part come from the real estate wealth effect and slow but steady job creation over the past few years. In other words, there is an inextricable tie between service job creation and the consumer spending that has been fed by real estate and other cyclical forces that are now waning, if not evaporating.

Businesses also consume services, and they have plenty of money to spend on such services. I could argue that any such spending would likely generate job growth to offset slowing in consumer dependent industries. This is true and a positive without a doubt. The jobs data have shown a strong recovery in professional and business services hiring, as well as in information related industries. Still, there is no acceleration in these industries of late, while there are some signs of slowing in these areas. It makes sense. Businesses have been cautious for years now, and growth in overseas markets has been their primary focus. Despite the hoards of cash that have been building on balance sheets, they have yet to spend aggressively on new investments in the U.S. With investors, traders, private equity shops, and hedge funds watching like the lion on the edge of the zebra heard for a company to stray from this discipline so they can attack it, it seems unlikely that now - late in a Fed tightening cycle with a real estate and consumer bubble deflating and at risk of bursting – is the time to start hiring aggressively. Yet, competition and the need to grow compel companies to spend, especially when they have the money sitting around. So, business spending will buoy the job picture and the economy, but by how much?

Also, don't overlook the fact that a huge percentage of the record corporate cash and profits generated over the past couple of years has come from the energy industry, which does not need to hire and spend a tremendous amount in the U.S. It's also a cyclical industry and unlikely to continue at the pace it has been performing for the past few years.

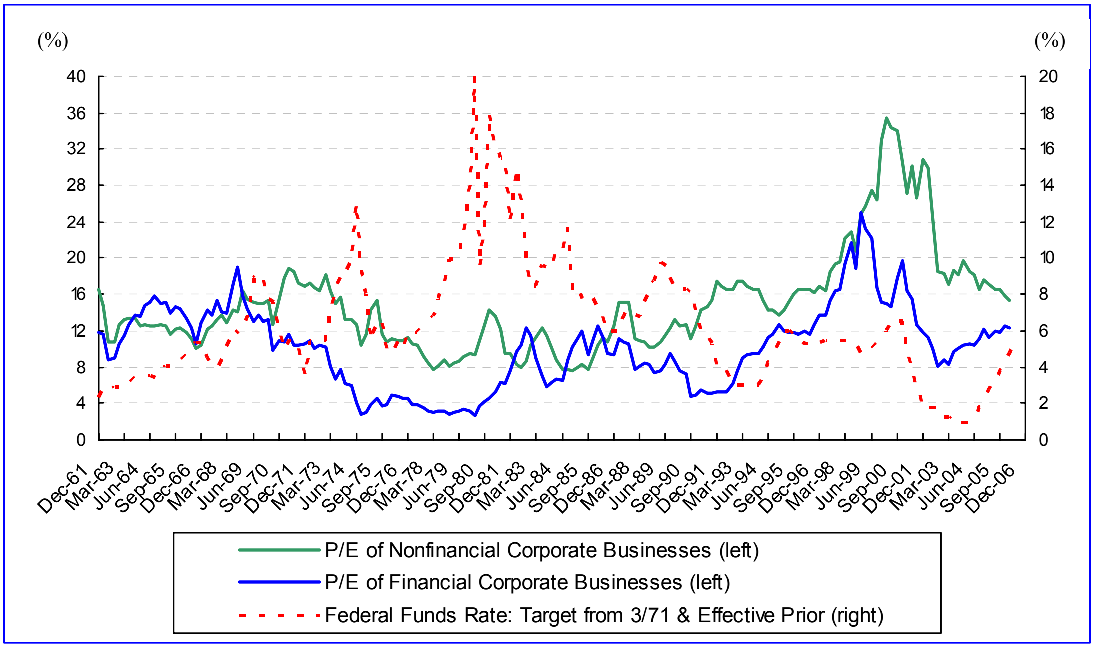
The Main Course…

Is that pungent smell the smell of a burning consumer bubble and, if so, is there a course from the corporate side of the menu to fill in so that this recovery does not leave the financial markets empty? Am I perpetuating a ridiculous analogy? The answer to the latter question is, "Yes," while the answer to the former is not intended to be provided in this piece. I will attack that issue in my complete 2nd Half Outlook & Strategy publication.

The danger in the consumer sector is real and potentially significant, while the strength and resiliency of the corporate sector is undeniable but not necessarily the savior for this economy. I have long been of the belief that Greenspan, regardless of how great he was at his job, made a mistake in trying to dampen economic and financial market volatility well beyond its natural tendency and, in so doing, created artificially low risk premiums in nearly all asset classes. The consumer hardly showed any retreat during the last recession. Look at vehicle sales during the period as an indication of the lack of any consumer retrenchment. Now, the Bernanke Fed will attempt to continue this legacy of dulling the pain of necessary economic adjustments. Unfortunately, the Fed must respond to the recent spurt of higher inflation and inflation expectations and will not be able to smooth out the pain to the extent that Greenspan was able to.

Corporations did not fare as well as consumers during the last years of Greenspan's tenure because the global economy brought brutal competition to the table and forced painful and necessary adjustments to be made immediately. The good news is that they were made, and now businesses are in great shape to weather the consumer slow down. In fact, valuations of corporate equities as shown in Chart 5 are fair to slightly cheap for the earnings and balance sheet fundamentals likely to exist over the rest of the year.

Chart 5: ***U.S. Equity Market P/Es vs. Federal Funds Rate***



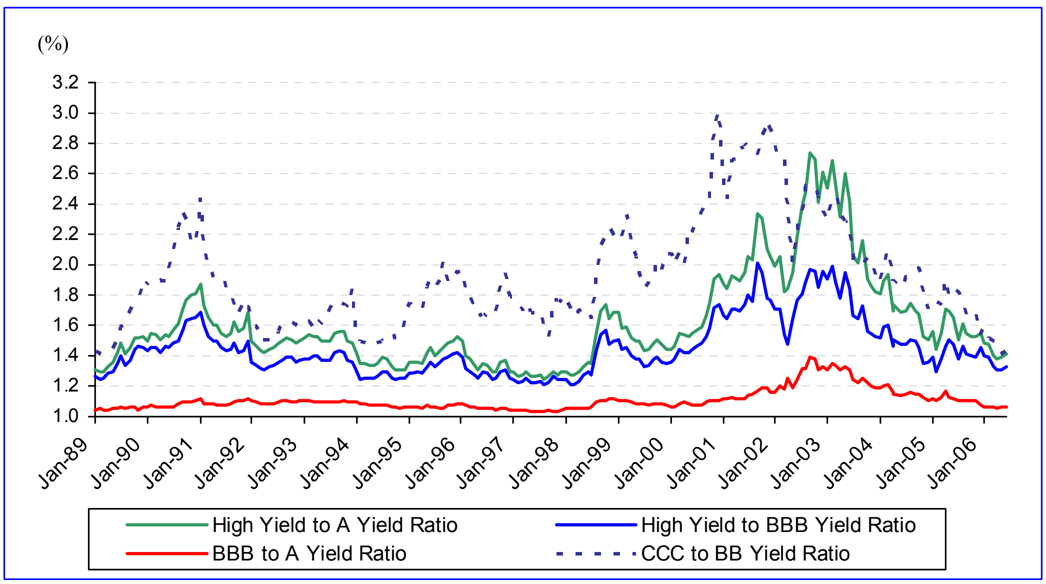
Source: Federal Reserve, Bureau of Economic Analysis, BACA

The health of corporate balance sheets and valuations are the two primary reasons why I do not expect a further significant near-term correction in equity or credit markets, and certainly not a recession for the rest of the year. In fact, financial markets performance over the next month or more could be quite positive as the end of Fed rate hikes over the Summer, combined with likely low double digit second quarter earnings growth and slightly cheap equity valuations, spark both an equity and credit spread rally. I would view this as a set-up for another significant move down going into the Fall, led by consumer cyclicals. A likely rebound in job growth for June to 160k will help this short-term outlook but also obscure some underlying negatives.

Despite the expected positive second quarter earnings performance and strong balance sheets, corporations are at a crossroad. Profit growth will likely slow to about 6% year-over-year by the fourth quarter and much more sharply for some sectors. Although corporate debt growth is still at the low end of any historical norm for this point in the economic cycle, it has picked up noticeably recently. Pressure to deliver on earnings growth and equity performance will only build over the next 12 to 18 months. Management will have to decide how to navigate in what will likely be rough seas for the next couple of years as the consumer spending and real estate market bubbles either deflate slowly or burst. Substituting debt capital for waning profit growth has been the chosen financial path of most managers late in economic cycles such as we are going into, but there are good reasons to believe this cycle will be different – or at least muted – on the corporate side compared to the last one. The table would seem to be turned as far as consumers and corporations are concerned, which may insulate the economy more than when corporations imploded under the weight of massive debt and governance scandals five years ago.

None of this argues for an aggressive posture towards financial markets over the next year. This is particularly true for credit product, especially in light of corporate bond valuations highlighted in Chart 6. Even with strong balance sheets and continued double digit profit growth, credit market valuations would normally have yielded more to the Fed and emerging risks from the consumer sector by now. However, continued near record low net issuance of corporate bonds from nonfinancial sectors and slowing issuance out of financial sectors continue to backstop high grade spreads and especially high yield valuations. The strong structured bid for credit product coming from Europe is a manifestation of these positive technical and fundamental forces. In light of the emerging risks I have discussed, this bid can also be viewed as the contrarian sign of trouble to come for credit markets. Either way, volatility is back for the foreseeable future.

Chart 6: *Credit Market Yield Ratios*



Source: Merrill Lynch Index System, Bloomberg, BACA

I will provide detailed investment recommendations in my complete 2nd Half U.S. Credit Markets Outlook & Strategy publication. This was just an appetizer and hopefully a treat as well after a long absence from the strategy table.