

## **MPS Smart Ramps Commentary - April 1, 2009**

### **What is the “New” Normal?**

My last commentary emphasized that financial markets appeared to be heading towards a return to normalcy. That trend has continued, and there has been much less volatility in the past three months than in the prior six months. That relative stability does not suggest that we are coming to the end of the recession - or depression - but it does suggest that we are coming to where we can see the beginning of the end. My last commentary also focused on the message in interest rate spreads. Let me briefly update how that message has evolved over the past three months.

#### **The Message in the Spreads?**

Three spreads were noted in the last commentary, the LIBOR-Treasury bill spread, a measure of liquidity, the BBB-AAA bonds spread, a measure of risk aversion, and the 10 year-1 year Treasury rate spread, a measure of the term structure. None of these spreads has changed dramatically over the past three months. But all have moved gradually in the “preferred” direction. The LIBOR-Treasury spread reached a high of 313 BP in September 2008, dropping to 132 BP at the end of December 2008 and falling to under 100 BP since. That is still above its historical value of roughly 50 BP, but it continues to move in a direction suggesting that liquidity is becoming less of a concern. The spread between BAA and AAA corporate bond rates averaged over 150 BP since August 2007 and was 333 BP at the end of December 2008. It has since fallen to 306 BP. That still is far above its historical average of roughly 90 BP but the recent drop suggests that risk concerns may be beginning to fall somewhat. The term structure spread mentioned (the differential between 10 year and 1 year Treasury rates) averaged about 130 BP since August 2007 and its December 2008 value was 188 BP and it has since risen to about 210 BP. I am inclined to interpret even this change as cautiously good news. This spread tends to widen in recessions and in the subsequent recoveries and is following that pattern here. If prior recoveries are a guide, this spread will continue at a relatively high level.

Let me mention one additional spread of relevance, that between real and nominal Treasury rates. Consider specifically the spread between a “normal” Treasury bond and an inflation protected Treasury bond (TIPS). At the end of December, the spread for 5 year bonds was 51 BP and the spread for 10 year bonds was 100 BP. At the end of March those spreads had risen to 76 BP and 128 BP respectively. Those spreads at least in theory reflect the view by market participants of expected rates of inflation. That is, the rate of inflation over the next 5 years is currently expected to be less about 0.76 percent. Looking at the magnitudes of those numbers, one would be inclined to say that markets do not expect inflation to be a matter of appreciable concern. That may well be the case, and certainly the current concern is to avoid deflation rather than worry about inflation. However, that both of these spreads have increased over the past three months suggests that there is a growing concern that Fed actions over the past year may be creating the stage for a resurgence of inflation in the future.

The overall message in the spreads appears to be that financial markets are returning to a state of normalcy, and that state is looking increasing like the pre-August 2007 state.

### **So what is the new “normal?”**

First, the most important thing to note is that the Fed and the Treasury now appear to have as their highest priority avoiding any additional surprises. While monetary policy, financial regulations, and bailout or bank closure options are likely to continue to evolve, it appears highly unlikely that either the Fed or the Treasury will take any actions that they believe will have a destabilizing impact on financial markets or on financial institutions. In part, the continued statements issued by the Treasury on buying toxic assets, for example, appear to be the Treasury’s method of communicating their current thinking even in a less than fully specified form and even when they believe the reception will be less than enthusiastic. Simply stated, absent any additional bad news - or, perhaps more accurately, news that would be appreciably worse than we’ve already come to expect - interest rates likely will change only marginally and will likely continue their slow march to more typical values or spreads because the Fed and the Treasury are striving to avoid further market-wrenching events.

Second, there is considerable disagreement on whether the current bailout proposal is appropriate and whether it will likely be successful. I will address only the second point. The key measure of success, given the rhetoric of the Treasury, would be whether lending picks up and whether small businesses in particular have access to adequate funding. To this end the Treasury has proposed a partnership with private investors to buy toxic assets from banks. (The Treasury prefers the term “limited liquidity” to “toxic assets.” The difference reflects a priori judgments about the likely price of assets that would be put on the auction block.) In theory, when financial institutions sell those assets they would obtain additional cash with which to lend and the increase in lending would spur investment and the economy in general. It is far from clear to me that the plan to purchase the assets will work as planned but that is not the Achilles’ heel of the plan. The plan’s fundamental weakness is the assumption that any additional funds made available to financial institutions will result in additional loans.

Historically, the average amount of excess reserves in the banking system as a whole has been under \$2 billion and in August 2008 it was \$1.4 billion. By January 2009 the amount of excess reserves had increased to over \$800 billion declining slightly in the most recent settlement period to \$700 billion. Part of that increase was due to additional deposits in the banking system, but even subtracting the maximum possible amount for those deposits (10 times the increase in required reserves) the amount of excess reserves had increased to approximately \$500 billion in the most recent settlement period. If the Treasury plan is to work by making additional funds available for loans, it needs to first explain why banks are holding so much in excess reserves rather than making loans currently. While risk premiums appear to have decreased slightly over the past few months, the amount of excess reserves in the banking system suggests that banks are still extraordinarily reluctant to lend. Overcoming that fear of lending may be the most important step on the road to economic recovery.

The last two commentaries have concluded on notes of cautious optimism. This one will make it three in a row. There are still major problems and difficulties. The U.S. unemployment rate is likely going to continue to rise, possibly exceeding 10 percent by year end. Retail sales and industrial production will continue to be sluggish at best for the rest of the year. I am skeptical that the bailout plan will work as intended to stimulate lending, and I suspect that the stimulus package was not nearly large enough to prompt a strong recovery by the end of the 2009. In addition, the U.S. faces major long term issues, primarily the certainty of a rising federal debt load and the possibility of renewed concerns about inflation.

So what is there to be optimistic about? Three things. First, at least thus far we have avoided utter disaster and a full-scale depression. Even as auto-related firms and newspapers and financial institutions struggle and some fail, even as the number of unemployed increase by about 600,000 per month, and even as small businesses face the worst economic climate ever in the U.S., the economy has avoided a free-fall, and the stimulus package makes such a fall highly unlikely. To the unemployed that may be small comfort; to those who fear for their jobs, it should be highly comforting. Second, we appear to have taken the first steps to address long term issues that have the potential to damage our economy at least as much as the financial crisis. Our escalating trade deficit ultimately would have catastrophic implications. While we are not yet in good shape in terms of trade, the movement is solidly in the right direction with the deficit dropping from \$210 billion in 2006:2 to \$132 billion in 2008:3, the most recent data available. Relatedly, our addiction to foreign oil was ultimately going to pose a problem only hinted at by \$4.00/gallon gas. 50 or 100 years from now the world will likely not be driving gasoline powered vehicles if only because the supply of petroleum will be shrinking dramatically even as the world's stock of vehicles increases. Current events make it easier to address that issue now, and addressing it now makes more options available than addressing it in 50 years. And third, while I think that both the fiscal stimulus package and the bailout package are substantially flawed, the individuals at the forefront of making policy, e.g. Bernanke, Geithner, Summers, et al., are both intelligent and pragmatic. They will make - and have made - mistakes. But they will also learn from them. They understand much better than most analysts exactly the mistakes that generated the Great Depression, and, while our current fiscal and monetary policies may not be ideal, they are far better than those in prior periods of economic distress.

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