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The Band Plays On

By John H. Makin

In a July 9 interview in Tokyo with the *Financial Times* about the surging, liquidity-driven financial sector, Citigroup chief executive Chuck Prince characterized the situation in global financial markets more insightfully than some investors might have wished: "When the music stops, in terms of liquidity, things will get complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Prince elaborated further, saying that (as the article paraphrased it) "the way big Wall Street banks and hedge funds had picked up troubled subprime mortgage lenders was an example of how 'liquidity rushes in' to fill the gap as others spot a buying opportunity."

Exactly a week later, Basis Capital Pty. Ltd., a Sydney-based hedge fund managing about $1.7 billion U.S., suspended withdrawals from its funds, saying that "the manager is unable to calculate the value of individual client assets, many of which are rarely traded." With chilling accuracy, this statement captures the dilemma now facing the derivatives markets tied to mortgages. As Bear Stearns discovered with its two now-failed, mortgage derivatives–based hedge funds, the value of derivative securities based on mortgages, including subprime loans, is not determined in transparent markets. When investors want to sell such securities, the offers to buy are at prices far below levels that had been assumed—in some cases rendering funds insolvent. There is a built-in liquidity problem that leads, directly, to a solvency problem for investors in subprime mortgage securities. The problems have become so acute that concerns are rising about solvency issues tied to higher-grade, mortgage-based derivatives' loss of indeterminate value.

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Behind the troubling rise of uncertainty about the mortgage derivative market lies a complex, unfolding story of the relationship between the real economy and the financial sector. While the U.S. housing sector has entered another down phase (as financing costs rise, the drop in home prices accelerates, and lending standards tighten), the global economy—and with it global stock markets—has risen to new highs. The U.S. stock market has not been left out of the party: the S&P 500 Index has reached new all-time highs, having finally surpassed, after more than seven years, the high point reached just before the collapse of the tech bubble in March 2000.

The Good News in the Global Economy

Looking down at the world economy from 30,000 feet, the music is still playing, and investors—at least those outside the U.S. subprime mortgage sector and the housing industry—still feel a compelling need to get up and dance. Those who do not will underperform their competitors while the music is playing. Beyond that, at the center of the party, the U.S. stock market has, since 1982, always rewarded those who buy the dips associated with periodic crises like the 1987 stock-market crash, the 1990 Iraqi invasion of Kuwait, the 2000 bursting of the NASDAQ bubble, the 9/11 attacks on New York and Washington, D.C., and the 2005 Katrina shock.

Since 2004, the global economy has caught fire, with China leading the way. Just-released data show Chinese growth in the second quarter running at a 12.7 percent annual rate and inflation running at 7 percent during the same period. Meanwhile, growth in Europe and Latin America remains strong. Clearly, the rest of the world has learned something from the United States about the value of stable prices, market incentives, and unfettered trade in sustaining a high level of growth. The result is that investors are more eager than ever to buy the rapidly rising shares that represent claims on that new era of stronger global growth. So far in 2007, China's Shanghai Stock Market is up 87 percent, while markets in South Korea, Turkey, Poland, Brazil, Hong Kong, Indonesia, the Philippines, Thailand, Malaysia, Israel, Germany, Singapore, Taiwan, and South Africa are all up more than 20 percent.

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The music emanating from the global economy is loud and strong. China, with a GDP about one-quarter as large as that of the United States, is currently growing five or six times as fast, thereby contributing more to global growth than the United States. Even heretofore perpetually laggard Europe, about the size of the U.S. economy, is growing faster and thereby contributing more to global growth than the United States. That said, the market capitalization of the faster-growing non-U.S. economies is far smaller than that of the U.S. stock market. As investors everywhere try to add to their claims on the rapidly growing sector of the world economy outside the United States, prices of non-U.S. stocks surge.

The investors who are listening to the loud music emanating from the global economy are, in short, behaving rationally. At this point, it is difficult to worry about share prices in South Korea or Brazil just because some greedy mortgage companies in the United States over the past several years lent a trillion dollars to subprime borrowers, most of whom will not be able to meet their mortgage payments when the low "teaser rate" on the mortgage expires, which, along with higher market rates, will result in a doubling or more of monthly payments.

To date, the subprime crisis has largely been confined to buyers who cannot even pay the teaser rates or who never even made the first payment on their undocumented mortgages. This has driven default rates on subprime mortgages to 8 or 9 percent, but that figure will rise rapidly as the subprime mortgages reset from the teaser rates to far higher market levels. Even midlevel or "Alt A" mortgages are seeing higher default rates as the low adjustable interest rate loans reset to higher rates. Prime borrowers are also in for a shock. The last refinancing cycles, up to 2005, were occasions for celebration, in which prime borrowers got lower rates and, if they held their monthly payments constant, could count on a hefty cash-out payment that reduced their equity in the home. Now, as prime mortgages reset to higher rates, some prime borrowers will be surprised that, not only do monthly payments rise, but a "cash-in" (writing a check to the bank) may be required to keep the loan-to-value ratio above 80 percent on real estate whose value has fallen.

Where Do We Go from Here?

Chuck Prince also presciently said in his Tokyo interview, "At some point, the disruptive event will be so significant that instead of liquidity filling in, the liquidity will go the other way." He added that he did not think events had reached that stage, but rising market volatility from day to day suggests that financial markets are nervous. Everyone has to dance, but the corollary is that, when the music stops, everyone will want to stop dancing at the same time. It will not be a pretty sight.

The key to the future direction of the world economy remains the U.S. economy and stock market. Most analysts are sanguine at present. Growth of demand for world goods is still driven largely by the U.S. consumer who, in turn, is driven by the path of wealth and income of U.S. households. The market capitalization of the U.S. stock market, at nearly $14 trillion, dwarfs that of China, which, even including Hong Kong, is about $2 trillion. European market capitalization is $2.7 trillion, while that of the UK is $3.3 trillion and Japan's is $4.7 trillion. In short, U.S. stock market capitalization is larger than that of most other global stock markets combined. Wealth drives the U.S. economy, and that wealth is concentrated in stocks (rising) and real estate (falling). Output growth drives emerging economies, and it remains strong.

Continued strong global equity markets are further supported by moderate U.S. growth and contained inflation. There is little likelihood that the Fed will need to tighten further, because the U.S. economy is already moderating to a slightly below-trend 2 percent growth path that still qualifies for the "Goldilocks" moniker (not too hot, not too cold—just right).

There is another benign feature of the current global financial picture: a reduction of imbalances that have heretofore raised tension about the sustainability of global growth. As U.S. consumption growth has slowed, probably to about a 1.5 percent annual rate in the second quarter, down from 4 percent in the previous three quarters, the dollar has weakened. Consequently, more global demand has shifted to U.S. production just as a slowdown in U.S. consumption has freed more resources for production of U.S. goods for sale to the rest of the world. During the three months ending in May, U.S. exports rose at a 21 percent annual rate, almost double the rate of the previous three years.

The strength of U.S. exports, coupled with a weaker dollar, improves the earnings prospects for U.S. companies oriented toward the global economy and thereby supports their stock prices. In this sense, the hesitation in consumption, perhaps in part tied to difficulties in the housing sector, has been helpful in rebalancing the distribution of demand and output growth around the world economy. This has boosted output and reduced demand in the United States, so that buyers of U.S. exports in Europe and Asia switch more of their expenditures toward American output. The U.S. trade balance has yet to improve because U.S. imports have surged along with exports in recent months. However, a 6 percent drop in the trade-weighted dollar since March suggests some reduction in imports relative to exports in coming months as the well-known "J-curve" pattern of trade-balance response to a weaker currency plays out.

The strength of global financial markets is tied to steady and strong growth of the U.S. economy, albeit with slower consumption growth. That scenario requires that inflation remain well-behaved, thereby avoiding any need for Fed tightening, which, were it to occur, would constitute a major threat to rising global financial markets. In that sense, the weakness of the U.S. housing sector, which Fed chairman Ben Bernanke has acknowledged has been more pronounced than the Fed had expected, is serendipitous for global financial markets. The serendipity depends, of course, on the absence of a collapse in U.S. real estate or a widespread financial crisis tied to difficulties in U.S. mortgage markets.

U.S. Consumption

Continued support for U.S. consumption growth, the key to avoiding a U.S. recession in view of the persistent drag from housing, is questionable. Sixty percent of the first-quarter consumption growth above 4 percent was supported by the sale of stocks and bonds and by borrowing. However, since May, benchmark interest rates have risen by about one half of 1 percent, with the rise largely in real rates attributable to a combination of continued strong global growth, the rising attraction of stronger global equity markets, and a firm anti-inflation stance by the Fed. This has dashed market hopes for a Fed easing during 2007. Even more telling is the sharper rise in mortgage interest rates measured by broadening spreads between Treasury securities and mortgage-backed securities, which will further increase the burden of mortgage servicing for U.S. households at a time when higher energy prices have already drained about $100 billion from household budgets in 2007.

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The collapse of the two Bear Stearns subprime-mortgage hedge funds has contributed to the rising spread between mortgage securities and less risky Treasury securities. Heightened market and economic uncertainty is attached to two critical financial-market issues. First, how will hedge funds and other investors value non-traded credit instruments, such as collateralized debt and loan obligations (CDOs and CLOs), and how much will such revaluation impair liquidity growth? Second, given the laxity of rating agencies in classifying as "investment-grade securities" instruments that have turned out to be risky and illiquid, will a tightening of credit standards further impede the elasticity of the U.S. credit system that has been a critical part of support for consumption growth? The answers to these questions, as yet unknown, will play a large role in determining U.S. and ultimately global economic momentum over the next year.

The consensus outlook for U.S. growth, including our own, had shifted up in May. However, with the third quarter underway, the combination of higher and more volatile interest rates and market prices coupled with a reduction in risk appetite has pushed growth estimates back down. If the 1.9 percent year-over-year growth rate that prevailed through the end of the first quarter is shown to have persisted through the end of the second quarter (a plausible scenario), the result will be a still slower 1.6 percent annualized growth rate for the U.S. economy during the first half of 2007, mostly attributable to weaker first-quarter growth of just 0.7 percent. It is difficult to imagine how U.S. consumption growth will reaccelerate during the second half of 2007, as the consensus forecast assumes, given the higher interest rates, higher energy costs, and increased uncertainty faced by U.S. households.

U.S. consumption growth has slowed during the second quarter to about a 1.5 percent annual rate. At that rate, it will contribute only 1 percentage point to overall growth. More cautious lending standards tied to the subprime mortgage problem, as well as decreased availability of home equity resulting from continued falling home prices, has raised the possibility that consumption growth could remain weak, or weaken further, in coming quarters even as equity market gains have helped to maintain household balance sheets. While an inventory rebound will probably contribute about a percentage point to growth in the second quarter, that contribution will probably fade to the usual zero during the second half of 2007.

Global growth may continue to boost U.S. net exports, and that constitutes a bright spot going forward, although the average contribution from the relatively small U.S. external sector to overall growth is usually less than half of 1 percentage point even under good conditions, such as now prevail in the global economy.

As home prices continue to fall, the ongoing weakness of the U.S. housing sector has precipitated the acute problem in the subprime mortgage sector. The impact on other mortgage credit instruments is still unfolding, but it seems clear that a trend toward risk reduction by purchasers of mortgage securities will mean that, while credit is still available to prime household borrowers, the amounts available and the terms of availability will be less attractive than in the past. As noted earlier, even prime borrowers may have to come up with some cash at refinancing time. It remains to be seen how far the broad reduction in risk appetite proceeds in global markets, but central banks have made it clear that they welcome the less aggressive trend.

The role of central banks still appears to be largely restrictive. During his Humphrey-Hawkins testimony to Congress on July 18 and 19, Bernanke continued to emphasize inflation risks as the major driver of the Federal Reserve's determination to avoid easing. Beyond that, the persistent divergence of headline inflation from core inflation tied in turn to the rapid rise in food and fuel prices created by a surging world economy keeps the Fed on hold and raises the probability that the next Fed move will be another rate increase. Beyond U.S. shores, the Bank of Japan, the European Central Bank, the Bank of England, and the Chinese Central Bank are all signaling and pursuing still more restrictive policies for the second half of 2007. The combination of continued upward pressure on commodity prices, growth rates seen as being above sustainable trend, and—at least until late June—a robust appetite for risky assets has put central banks in a tightening mood.

Listen to the Music

One thing is clear following the rapid flow of events over the past month tied to stresses in the U.S. housing and mortgage sector: the range of possible outcomes, both for the U.S. and global economies and for global financial markets, is wider than it has been for some time. Investors are content with higher returns, provided that the risks attached to earning those higher returns do not get too high. Over the past several years, the strong upward trend in financial markets and real estate has encouraged investors to seek the highest returns available irrespective of prospective risks. The subprime turmoil, a result of underpricing the risks of making mortgage loans to borrowers unable to repay them, has boosted risk premia as the value of securities tied to subprime mortgages has been cut in half in less than six weeks. There is no liquidity in the opaque derivatives market, and so solvency problems emerge quickly, as losing investors in the Bear Stearns mortgage hedge funds have already discovered.

If market repricing of risk becomes too severe, the terms available to American borrowers, both in the household and the corporate sector, will deteriorate enough to simulate a Fed tightening. Then U.S. consumption will slow further, risk premia will rise still further, and the United States will have a recession. That outcome may take some time to materialize, and, if history is any guide as markets are currently betting, it may not materialize in the foreseeable future provided that the Fed does not have to tighten.

Meanwhile, the band plays on and the dance continues. Yet a few of the instruments are beginning to sound as if they are a little out of tune.

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