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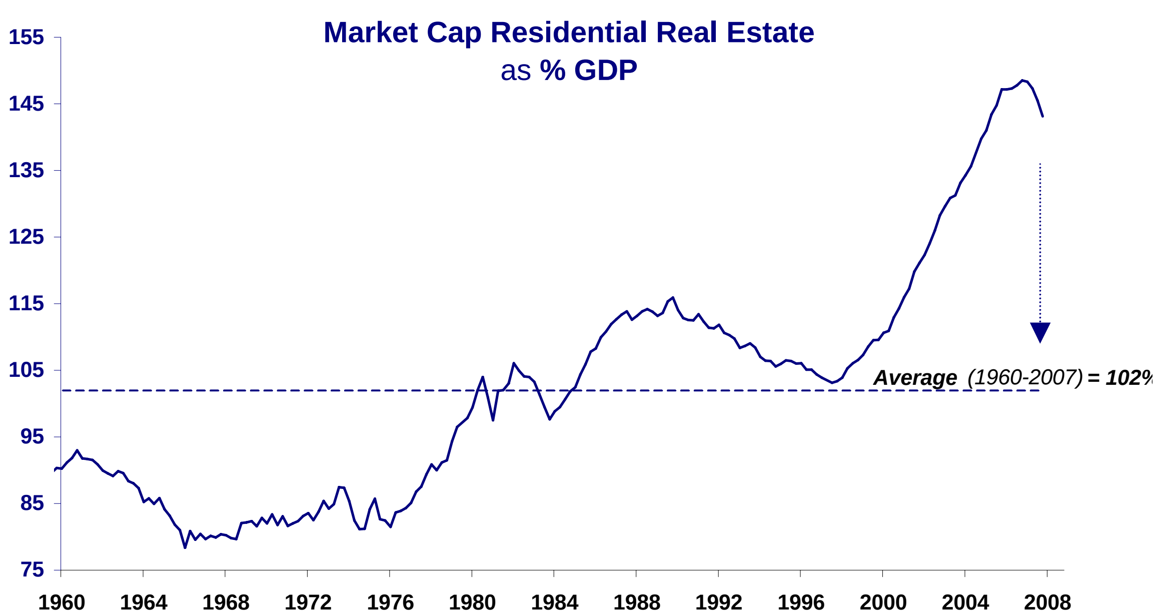
SERENITY, *NOW!!*

Times like these only bolster our conviction that *all things* eventually come back to "Seinfeld". With the credit markets in utter disarray and the economic data leaving little doubt but that we are in recession, you can virtually hear investors practicing Frank Costanza's relaxation technique. Desperately repeating: "serenity now, serenity now, serenity now" they hope that by the time they finish this mantra and open their eyes, the destruction will be over.

Joining their desperate chorus, or perhaps leading it, are our pin-striped policymakers. Last week, at exactly T minus 10 on Payrolls, the Fed broke-in with the announcement that it would further expand its TAF tool by allowing banks to borrow *more* money against more promiscuous collateral. Then, *kapow!* Payrolls hit. With the destruction in full-swing Bush called an unscheduled press conference. While the Prez was barely visible through the economic mushroom cloud, his voice carried through. "Do not be alarmed", he assured investors. The noxious fumes emanating from the economic engine room were nothing to fear. ***"Serenity, now."*** Alas, come Monday it was clear their calming efforts had failed to do the trick. So, the Fed tried again. Via its newly minted Term Security Lending Facility it would extend credit to the nonbank financial sector (which, as oft noted in these pages, dwarfs its traditional counterpart) and, again, do so against a broad array of collateral.

Watching the frenzied action pre and post payrolls, **one might suggest to policymakers that the soothing powers of their message loses a bit in the panicked presentation.** As George queried: *"Are you supposed to* shout *it??" "The man on the tape wasn't specific".* Apparently, neither was the guy on the tape Bernanke and Bush were listening to. Also absent, it seems, was any mention that **sublimating ones angst only creates *greater* problems down the road.** With each utterance of 'serenity now' (each policy initiative designed to delay the day of reckoning), the pressure builds like molten lava below the surface. Until, finally, it can be contained no longer.

Indeed, as much as policymakers and investors alike hope these measures will eventually becalm the markets, **there is *no level of interest rate* that is sufficient incentive to lend against deflating collateral.** Unless or until, lenders sense that we are *close* to a bottom in housing, no one with a profit motive is going to take the Fed's cheap-credit bait. In this regard, the key is not to let the Fed's frantic actions distract focus from the main issue: **how close are we to a bottom in housing?** Judging by the hot-of-the-press Flow of Funds report... ***not very!*** At 143% of GDP, **residential real estate is still way above the 102% average that prevailed since 1960,** an average which includes the present bubble. (Excluding the bubble, the average in the 40years from 1960-2000 was 96%). We'll spare you the math on what a return to 96% would require. A reversion to the **102% mean is foreboding enough, requiring housing to decline another $6t (-30%) from here.**



Source=BEA, Federal Reserve (Z.1)

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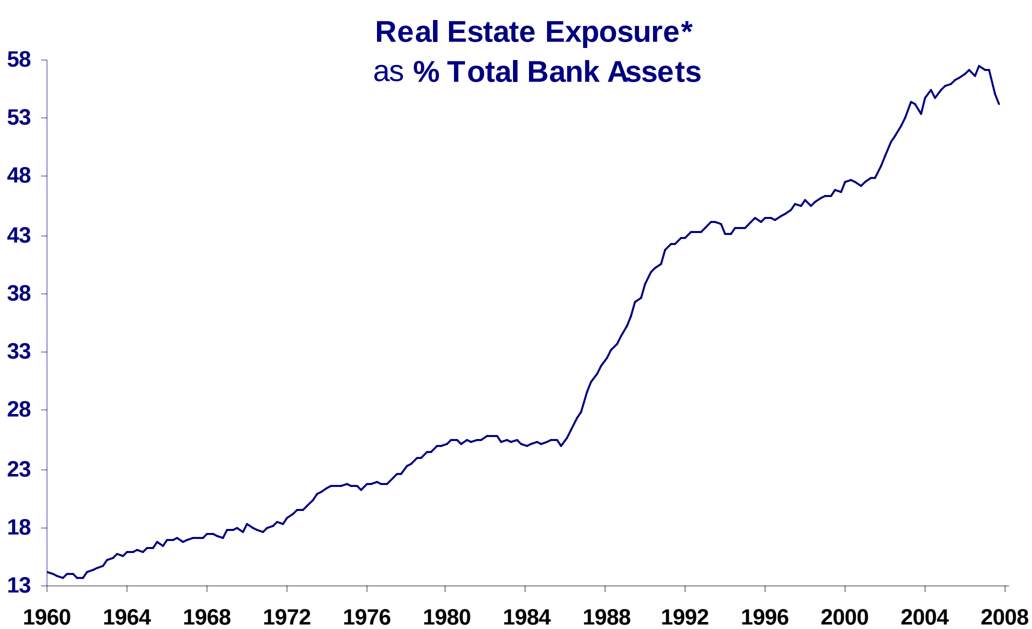
Of course, that's if we get there *tomorrow.* Not likely. But then, neither is a neat reversion to the mean! Still, if **we graciously allow that the process takes two years and nominal GDP averages 4% during that time** (the same as it averaged in 2001-2) **home prices would still have to decline $5t from here.**

Once again, our hat's off to Chairman Greenspan. It is truly amazing that Congress, in its frenzy to assign blame, has hauled in the mortgage bankers and Wall Street securitizers to explain their actions, yet Alan is allowed to chirp from the sidelines. Greedy though the Mozilo Mortgage Mafia may have been, Greenspan was their Don. They were simply implementing *his* master plan to numb the Dot-Com pain by levering-up households. That task largely accomplished, in 2004, they then did his ARM bidding, creating all kinds of new-fangled mortgage products to better enable homeowners to heed his reckless advice to borrow short. When it comes to sheer depravity the Maestro's got Spitzer beat by a mile!

But getting back to the point… With so much more housing pain to come, it's no wonder the Fed's cheap credit bait finds no takers. Of course, the **banks *could*,** once they're done plugging holes in their balance sheets, **take this credit and lend it somewhere else.** It is this question of what "else" that has become the popular subject of discussion, with many savvy observers asking what's left for the Fed to inflate. **What area has yet to enjoy the fruits of reckless lending?**

Glancing across the economic landscape **the only asset rising in price these days seems to be commodities.** Unfortunately, this market is way too small to replace mortgage lending and thereby bailout the banking system. Besides, even if it were sufficiently large, inflating commodities only *weakens* the fundamental credit quality of the rest of the market by eroding the purchasing power of consumers and the profit margins of businesses. **Expanding credit in commodities would only intensify the credit contraction everywhere else.**

And this is the nub of the matter. **This time the Fed and its financial henchmen have simply gone too far. With roughly 60% of bank assets tied to real estate at the peak, the problem is *too big to bail*.** There is no credit-taker big enough to fill this void.



*** Source= Federal Reserve *(Real Estate Loans +Agency & MBS holdings)***

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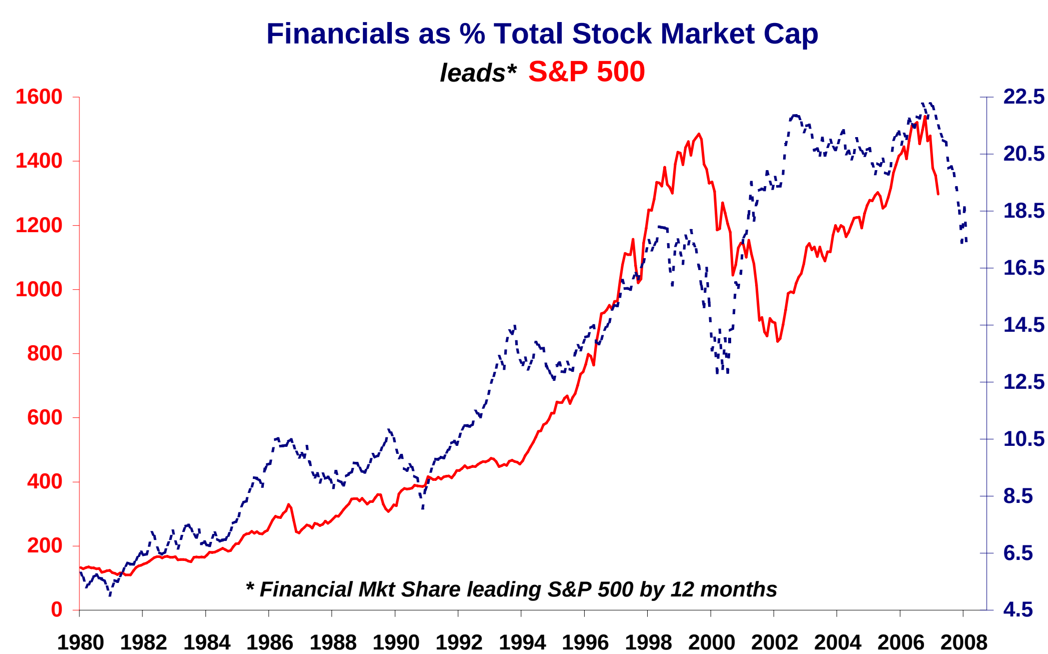
Hence the frantic efforts by policymakers to prevent the aforementioned reversion to the real estate mean. With no asset sufficient to fill the void they must, at a minimum, arrest home price *de*flation. **Realizing that NO profit-motivated banker would lend against deflating collateral, the Fed** (unconstrained by such capitalist pursuits) **is doing so itself.** We'll let others engage in the semantic debate. To us, allowing banks to pledge these dubious mortgage 'assets' at its TAF and TSLF, is essentially the Fed's way of lending against (rapidly) deflating assets.

Of course, just because the Fed is willing to undertake this unprofitable endeavor doesn't ensure its success. At $800b, the Fed's balance sheet is dwarfed by the dubious mortgage-linked paper it hopes to support. Clearly, it will need a helping hand. Enter the GSEs. As we admonished it would in "Mama Said Knock You Out" (1/23/2008), **the prospect of nationalizing the GSEs has moved from the lunatic fringe into the media mainstream.** With such feckless policy now considered appropriate dinner conversation, it is probably ill-advised to bet against these efforts.

However, **any success the Fed enjoys in arresting the mortgage meltdown** will come at a tremendous price (see the dollar). And, more importantly, it **will fail in two critical regards.** First, they will still face the challenge of spurring *new* credit creation. And, second, **by the time they stop the mortgage mayhem, the collateral damage to the economy will already be done**. Indeed, the incoming data suggest the negative feedback loop, set in motion by knocking down the 70% of the economy that is the consumer, is already in full swing. Lesson to Ben: You don't deflate the largest asset on household balance sheets without inflicting significant damage on the economy at large.

And that, my friends, brings us to the real problem. As we never tire of repeating, **with the financial sector shrinking, it is only a matter of time before the *entire economy* follows suit.** This is the infelicitous consequence of a credit-dependent economy. The longer credit is withheld (the Fed's best efforts be damned), the greater the consumer spending contraction and profit fallout. In other words, **the financial sector can only shrink *so far* before it causes the entire PIE to contract.**

It is precisely this dynamic that is depicted in the chart below. Where the financial sector goes, the economy and broader market follows. **As consumers are increasingly deprived of the credit necessary to sustain consumption*, the profiit woes of nonfinancial companies will begin stealing the headlines from their financial counterparts.*** In fact, we may now be nearing the point where the financials stop losing ground on a *relative* basis and the entire market begins to shrink.



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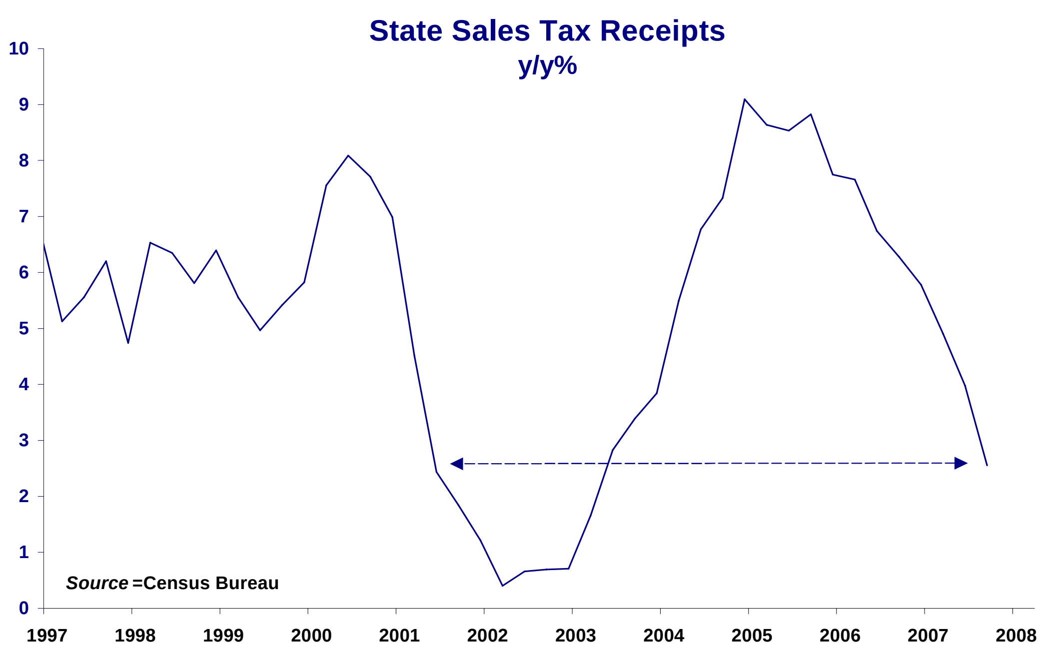
Talk about small favors! Indeed, for those seeking to generate *absolute* returns, life isn't going to get any easier. It will soon become clear that **we have only seen the *immediate* impact of the housing bubble bust.** To date, ABSOLUTELY EVERY credit market tremor can be traced back to Subprime. ABCP, SIVs, Money Markets, Monolines, Munis… all are connected by this common thread. **The *collateral damage* to the economy more broadly, is still to come.** As the economy begins to reel, consumption stalls and profits get hit, **credit quality issues will move into the non-mortgage sphere.** This is a two-part tale. In Part I we suffered the destruction of a bubble gone bust. In Part II: the collateral economic damage will be done.

Take Munis, for example. Last September, with the subprime meltdown in full swing and the ABCP market coming apart at the seams, we fingered Munis as "The Next Disaster". Confessing that few would find this sleepy corner of the credit market cause for concern, we cited the inevitable deterioration in State and Local finances that the housing bust attend. Home price deflation would hit State & Local budgets directly (as real estate transaction taxes suffered from reduced volume and price and property tax assessments began to be challenged) and indirectly (as reduced employment and economic weakness crimped sales tax receipts). **On top of which we noted that Municipalities face massive rate resets of their own,** having converted long-term, fixed-rate obligations into short-term, floating rate notes via the Swaps market. The fact that levered specs had designed a vehicle to position a carry trade in municipals—the Tender Option Bond—only compounded our concerns.

As it turned out, munis were in fact "The Next Disaster". But for none of the reasons we described! **To date, the problems plaguing the muni market have had exactly NOTHING to do with credit quality.** Well, at least not the credit quality of the municipal borrowers. The problems in this market—like all the other segments of the credit market--can be traced back to subprime. In the case of munis, it was their reliance on insurance provided by monolines who, in turn, were being roiled by losses on subprime.

In other words, **for munis the FUNDAMENTAL credit destruction is still to come.** And, if the plunge in sales tax receipts through the 3rd quarter is any indication…this could get really nasty. *We await with bated-breath the 4th quarter stats to be reported at the end of the month.*



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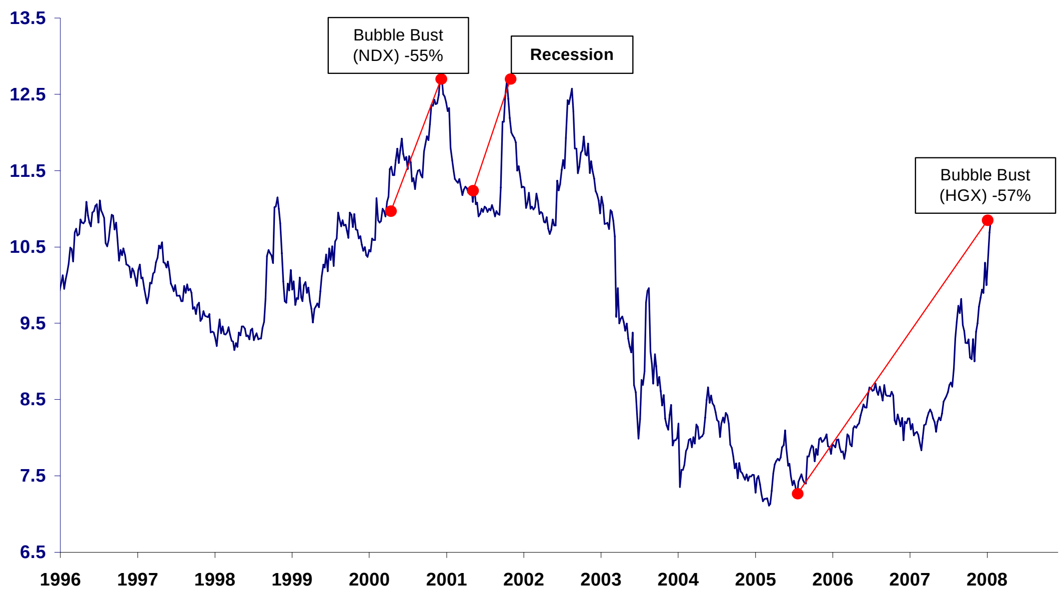
So while opportunists like Wilbur Ross and Bill Gross have begun to pounce, to this Pollyanna their interest seems premature. Sure, **the liquidity crisis in Muniland may soon pass. But the credit quality storm will follow hard upon,** as the collateral damage from the bubble bust begins to be felt.

This is, after all, ***exactly* what happened in 2000** when the credit markets were roiled by the Nasdaq bubble bust. Once the financial damage was done, with the Nasdaq having shed –54% by Dec of 2000, things quieted back down. *Ah... serenity now.* **No sooner did their blood pressure recede and the sweat disappear from their brows, however, than investors were slammed by the collateral damage.** As the economy slumped into recession in March of 2001 the credit markets were roiled anew. By the time the bloodletting stopped, in Jan 2002, the delinquency rate on speculative grade corporates had spiked from 1% to 11% (see addenda). It is still 0.88% today. Clearly, there's much more pain to come.

Junk Bond Yield



Indeed, **the recession leg of the credit storm 'this time' should be even more destructive than it was back then, thanks to the fact that the present downturn is tied to the consumer** (70% of the economy) rather than business. But no need to take my word for it. This week, **the quarterly CFO survey "plummeted" (their word, not mine) to its lowest level since in the survey's seven year history.** The number of CFOs describing themselves as pessimistic about the economy now outnumbers the optimists by a measure of 9-to-1. That's much worse than 2001. Back then, the overall diffusion index on the survey stood at +6.9%. It is –63% today. *Yikes!* When this storm makes landfall it will be ugly indeed.

Which begs the question: with so much pain yet to come, *what rabbit will policymakers pull out of their hat next?* Are there even any rabbits left?? So far we've had the Super SIV (M-Lec), the Term Auction Facility (TAF), the Term Securities Lending Facility (TSLF), $150b in fiscal stimulus, Hope Now and Project Lifeline. To say nothing of whatever Paulson's PWG is doing behind the scenes! With policymakers already pleading "serenity now, serenity now!!!!", the outlook is anything but confidence-inspiring.

Which is why, as described in recent missives, we suspect **the next shift in market psychology will be to panic about debt-deflation.** With the Fed having fired so many of its bullets (both conventional and non) to no avail, the next recession leg of the credit storm may find investors beginning to doubt the Fed's ability to fix the situation. With the largest asset on household balance sheets rapidly deflating and no other asset left to fill the void, the deleveraging process will gain momentum. And, as anyone in Japan can attest, no force is more strongly deflationary than deleveraging.

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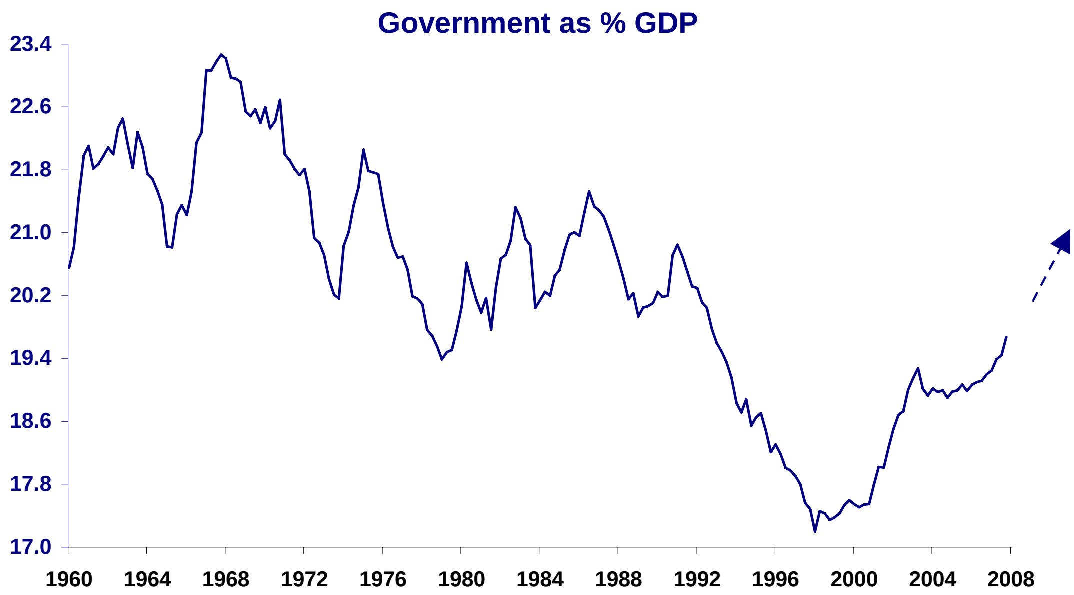
'Tis a conundrum if ever there were one! **How do you reflate an economy whose largest asset is rapidly deflating???** While Ben puzzles over that one, his fiscal counterparts will swing into gear. As the second front in the credit market storm makes landfall, **Congress will seize the reflation reins.** This, arguably, is a far more effective tool to address what ails us anyway. For, as should now be clear, borrowing more is *not* the solution to excess leverage. And never less so than when the underlying assets are deflating! **What consumers need…and urgently…is income. The income with which to service their ponderous debt burdens and in so doing avert delinquency and/or foreclosure.**

With the private sector unlikely to provide such support (just ask those CFOs) that task will fall to the federal government. Through a variety of programs… from extending unemployment benefits to specific homeowner programs like the one now proffered by Barney Frank… they will push money out to low-end consumers to help them repair their balance sheets.

Lest the prospect of the federal sector acting as the engine of economic growth wasn't off-putting enough, it will do so at a time when **the government share of GDP is *already* at its highest level in 15 years** (and **higher than the start of any of the last 5 recessions).** Wait til they roll up their sleeves and really get to work!



On the bright side, the surge in government borrowing we are about to witness will take place at a time when **'crowding out' isn't much of an issue.** Quite the contrary, bond issuers are now balking at higher rates. Meanwhile, bond investors are desperately searching for places to hide. In this regard, expanded Treasury issuance couldn't come at a better time! Think of it, the total bond market cap here in the US is $28t. Of that, Treasuries are a paltry $4t (and long-dated Treasuries less than $2t!!). When the flight from risk gets underway in Credit Market Meltdown, Round II, investors will rush again to squeeze into the clown-car that is 'safe' Treasuries (see addenda).

It's the perfect plan! **With the federal government assuming the role of consumer of last resort and the Fed acting as lender of last resort, the problem of what to inflate will be solved.** At last, our transformation to Banana Republic will be complete.

Yes, there is much more fun to come! Make no mistake. While we may enjoy a temporary respite from the *financial* maelstrom, the economic storm will shortly begin. And those who are becalmed by recent policy actions will learn, as Frank Costanza did, that **actions promising *serenity now* all but guarantee *insanity later.***

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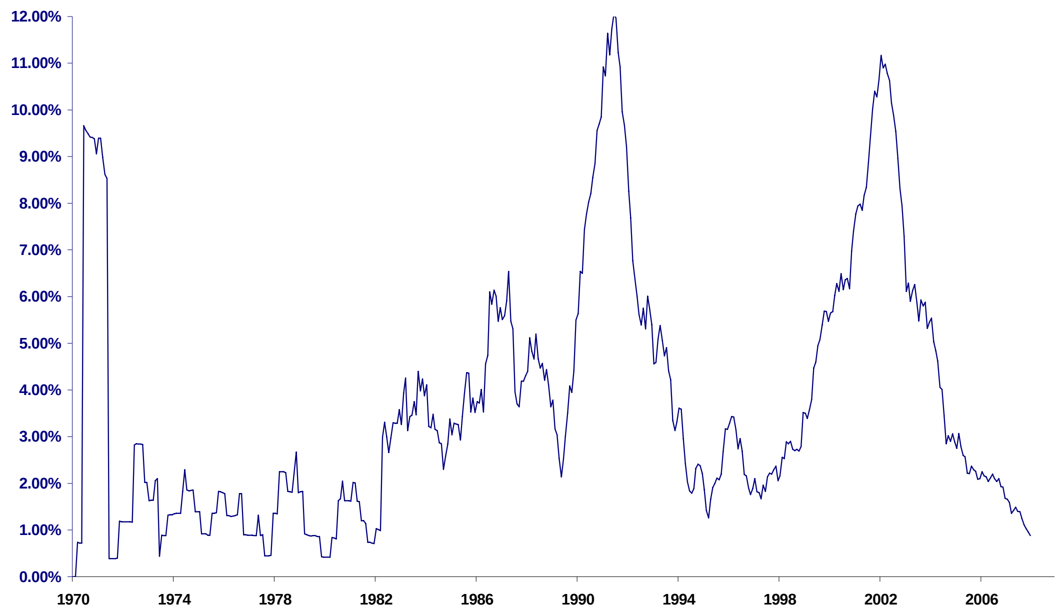
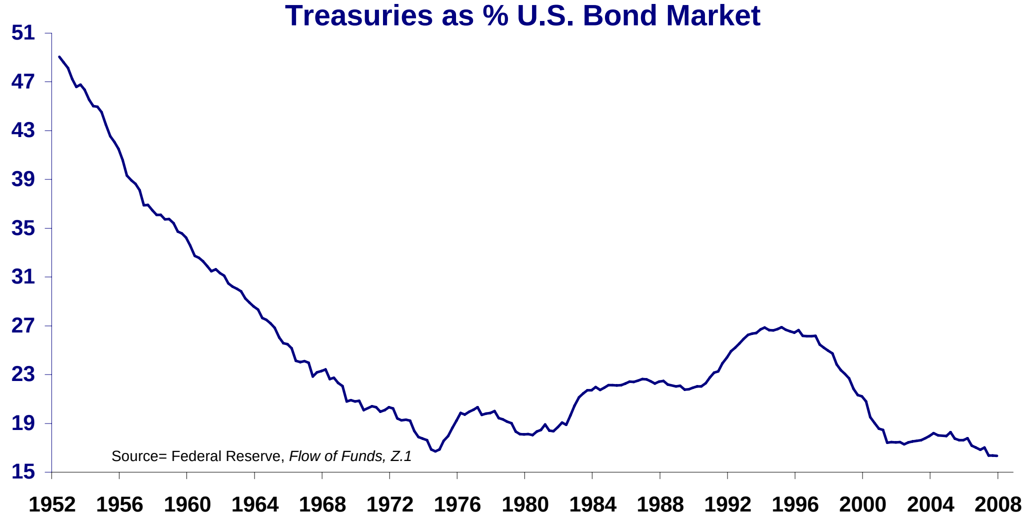
US Speculative Grade Default Rate



Source= Moody's

Treasuries as % U.S. Bond Market



Source= Federal Reserve, *Flow of Funds, Z.1*