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Commentary

Market Opinions and Topics of Interest

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Hurricane Perspective

The United States prior to World War I was the greatest emerging market of all time. Still, the country's capital markets could take investors on a wild and woolly ride every now and then, with that time period defined as 20 years or so. The United States had panics in 1819, 1837, 1857, 1873, 1893 and 1907.

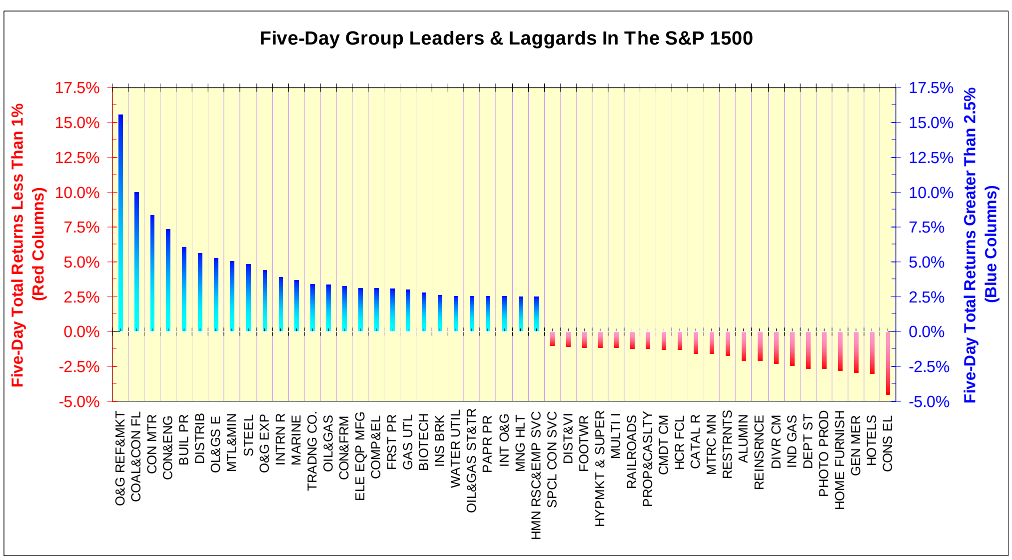
It is two of these panics, those of 1873 and 1907, to which we draw our attention. Both came in the aftermath of the only two times in American history we had to rebuild major cities in their entirety; the former was the residuum of the Chicago fire of 1871 and the latter was the residuum of the San Francisco earthquake and fire of 1906.

As we are now faced with the task, magnitude still uncertain, of rebuilding New Orleans and other Gulf Coast cities, we must be mindful of these historic precedents. Over the first three post-Katrina days, bonds exhibited a flight-to-quality response, stocks have rallied in anticipation of stronger economic activity, energy prices have surged from already-record levels, and markets have begun to speculate openly whether the Federal Reserve will hew to its sacrosanct "measured pace."

Two very recent Commentaries, one crediting the Federal Reserve with saving financial markets by not repeating its 1970s-era mistake of offsetting higher energy prices with easier credit, and the other noting how the flattening yield curve posed a greater danger to stocks than did higher crude oil prices remain apropos today.

Neither envisioned, of course, the destructive event of Katrina, but given the constancy of the observed data patterns, we can state it will be the response to the disaster, not higher energy prices themselves, that will determine the future course of events.

Let's first review the pattern of S&P 1500 market leaders and laggards over the past five days. This index was chosen to reflect the large number of small companies involved in reconstruction-related industries. As we might expect, Refiners, Coal producers, Construction Materials, Construction Engineering and Building Products lead the winners (blue columns). Consumer Electronics, Hotels, General Merchandising and Home Furnishings (red columns) performed the worst.



The Monetary Response

Now let's cycle back as to why the panics of 1873 and 1907 were linked to the financial stresses of rebuilding cities. "Linked" is the operative word; the proximate causes of the panics were the failures of Jay Cooke's investment bank and the Knickerbocker Trust, respectively. But in both cases, the economy had been distorted by the frictional costs of diverting great quantities of materials, labor and capital to the rebuilding efforts of Chicago and San Francisco. Cities need to be rebuilt with borrowed money, and these loans essentially are unsecured and therefore highly speculative.

The Federal Reserve did not exist as a lender of last resort during either period; indeed, J.P Morgan's rescue of the banking system in 1907 defined the need for (another) national bank. The demand for credit and its tenuous nature exceeded the supply of available funds, creating a liquidity crisis.

We noted in a January 2005 Commentary how the Federal Reserve created a set of asymmetric risks. The Greenspan Federal Reserve engaged in inter-meeting rate cuts after the 1987 stock market crash, after the LTCM debacle in 1998, during the stock bubble deflation in both January and April 2001 and again after September 11, 2001. Never did they execute a surprise rate increase.

We now have a situation wherein credit demands will be large not for the construction of new plant and equipment, but rather for the restoration of existing plant and equipment. Tax revenues will be lost, the dislocations of higher energy prices will be felt and vast numbers of unsecured loans for residential purposes will be extended.

Does this situation demand the Federal Reserve cease and desist in the swift completion of its appointed rounds? The market believes the Federal Reserve will err on the side of ease in the belief it can retract excess liquidity if rising inflation proves to be a problem. The Greenspan Federal Reserve – and let's put those Jackson Hole valedictories on ice, it is still the Greenspan Federal Reserve – has never risked recession in the past. Why would it start now?

Moreover, the economists who insist on linking crude oil, a commodity already at its all-time highs, and natural gas, a commodity whose price increase had outstripped that of crude oil prior to Katrina, to monetary events and who say silly things like "the oil/gold ratio," cannot attribute any subsequent increase in the energy prices to monetary largesse. Let's spell it out for them: **An existing shortage of commodities and of processing capacity therefor cannot be created by a subsequent easing of credit.** This would be unintelligent design, if we do say so ourselves.

Our most recent Market Facts, which addressed the real-time reaction in the federal funds futures market to Katrina and to the dreadful Chicago Institute of Supply Management report, noted how this market was having second thoughts about the December FOMC meeting. These second thoughts helped trigger a rally within the stock market, a selloff in the dollar and a continuation of a drive lower in bonds. Most important, though, was an abrupt steepening of the yield curve, albeit from new narrowing lows in this long trend.

Conclusion

The Federal Reserve may see itself accomplishing two goals simultaneously, saving us from a 1907-style panic with the same intrepid gallantry with which they slew the dragon of deflation in 2003, and preserving economic growth in the face of untethered energy prices. Inflation can be addressed later.

If the combination of reconstruction-related credit demands and looser credit leads to lower long-term rates, we should all be surprised. The short-term reaction seen over the post-Katrina days may well reverse once the bond market assesses this shift in policy.

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