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Fixed Income Research
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Market Focus

Global Strategy

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Today is the Day

Today is the day which could mark the watershed between a "healthy" correction to riskier assets and something far more sinister which could lead to real economic distress. More of a system changing crash than a prudent re-pricing of risk.

Indeed, in our view, if policy makers don't act today in a strong and concerted fashion, we are at risk of seeing the biggest market driven tightening of global financial conditions in a very long time, as investor risk appetite collapses and Japanese investors stop recycling their excess savings to the rest of the world, and even potentially bring funds home.

World Wealth is now down 5.1% from its peak and about 1.4% above its last correction low from March. These numbers do not include the violent declines in Asia overnight, which will be counted in today's closing level for World Wealth.

The type of price action we are getting is quite clearly of the forced de-leveraging/risk reduction type, not of the kind which normally occurs for economic reasons. But it can nonetheless become very dangerous for the real economy.

This is no longer just a question of sub-prime related losses: when volatility rises measured Value At Risk (VAR) rises, meaning that risk management models signal the need to reduce risk.

Actual and implied volatility in asset prices has been in a long trend decline since 2002, promoting a big expansion of VAR. But once volatility rises above a certain threshold, it feeds on itself by forcing a big compression of VAR, which in turn drives volatility higher until (leveraged) positions are reduced to minimal levels, and cash investors have the means and the courage to take on the liquidated positions. That is what's happening now, and it feels more dangerous to us than anything we have seen in the current bull market for riskier assets, even though the absolute decline in World Wealth is still well short of the May 2006 correction.

Such storms of volatility normally blow themselves out very quickly, but like hurricanes, leave a trail of real destruction in their wake.

Unlike hurricanes, however, policy makers have the power to do something to prevent, or at least substantially mitigate, that destruction.

Today is the day to take that action, in our view. Especially given that it is a tax day in the US which can add to pressures in Commercial Paper, one of the key transmission points of the current contagion. It is also the deadline for many investors in hedge funds to give notice of redemptions for the end of this quarter.

But why should central banks act far more forcefully than they have to date, when the corporate sector globally is highly profitable and liquid, and the economy itself robust?

In our view, the new danger is that this process will halt or even partially reverse the huge and steady outflow of excess Japanese savings that has been supporting global economic growth, including massive capital inflows into China and other Asian countries. This is the fundamental source of savings underpinning the global circulation of capital, and the high level of global "liquidity", risk appetite and ultimately, economic growth See Exhibits 1 and 2.

If that flow reverses, or grinds to a halt for several months as Japanese investors suffer big foreign exchange losses on their (unhedged) overseas portfolios, it will come on top of a major tightening of credit standards and credit availability that is the likely longer-term consequence of banks and investment banks taking huge commitments onto their balance sheets as credit markets cease to function normally.

It may even be too late to prevent a full unwind of the carry trade more generally, or to prevent further significant credit dislocations. And of course the world's central banks don't want to underwrite a return to the excessively easy credit terms and conditions of the past year or two. But if cash investors are to step into the breach, they will require greater clarity that the securities they should be buying even now are not going to be hit by a new wave of distressed selling, or by new revelations of deteriorating asset quality.

This is where the central banks can usefully help by providing term liquidity to the banks in unlimited size in an effort to make sure that further forced selling is not caused by a complete breakdown in the willingness of banks to provide funding to each other, and to other financial market participants. This need not even be classed as an official rate cut, unless and until it becomes clearer that this is what is required by the as yet unknowable economic fall out.

The problem in all financial shocks is lack of certainty and confidence about the factors most central to valuing securities in the longer run, and pricing them in the shorter run. Liquidity injections now are a way of buying time for (cash) investors to do their due diligence, rebuild their confidence and restore more orderly pricing conditions. That's not a moral hazard, that is realistic and focused central banking, in our view.

There is one final reason for thinking that today is a critical day. It will probably not appeal in academic or policy circles, but may resonate with experienced market participants.

At the time of writing, we are on the cusp of a whole host of very important technical levels in fixed income, equity and foreign exchange markets. It is very rare indeed for markets to be testing so many key levels, which define the point at which long-established trends can be said to have broken down, at the same time.

For the S&P 500, our technical analysts see 1364-1384, the area of the March low, as critical to the longer-term trend. So long as that holds it is possible to see this as a correction in an ongoing bull market. For 2-year US treasury yields, the longer-term uptrend resides around 4.26% and 4.32% on five-year Treasuries, more or less exactly where we are today. For dollar/yen, key longer-term support is around 115-116, for euro/yen around 156-7. Failure at any of these levels would in technical terms suggest significant deeper declines in stock prices and yields, and gains for the yen, over the short-to-medium run and a change in the longer-term trend. Or at least a 1998 style shock - see Exhibit 3.

The S&P 500 is perhaps the most critical of these levels, and perhaps the most likely to hold if the central banks acknowledge the dangers which have quickly escalated far beyond what could have been easily foreseen. More detail on these markets and several others will be published by our technical analysts more or less concurrently with this piece.

This is in a sense an extremely technical market – it's not about what we usually call the economic fundamentals so much as the financial fundamentals. And that's what makes it so difficult for central banks, or investors, to know exactly what to do next.

But experience tells us that it is one of those very rare and critical moments that make history. And that it has global significance, but not merely for investors and bankers.

Make no mistake about it, the real economy is at risk too, in our view, no matter how strong it may feel today.

Exhibit 1: Three Month Japanese Private Capital Flow: FX Reserves – Current Account (updated until June 2007)

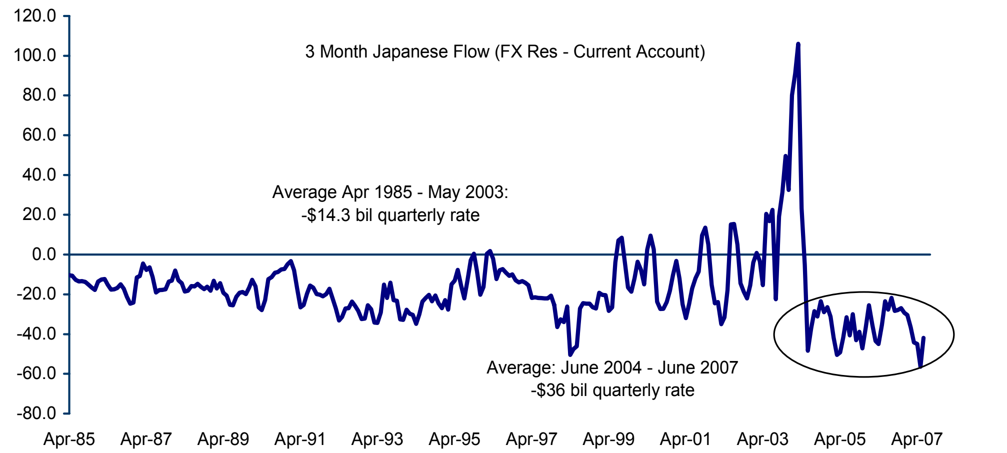


Exhibit 2: Three Month Asia x-Japan Private Capital Flow: FX Reserves – Trade Balance (updated until June 2007)

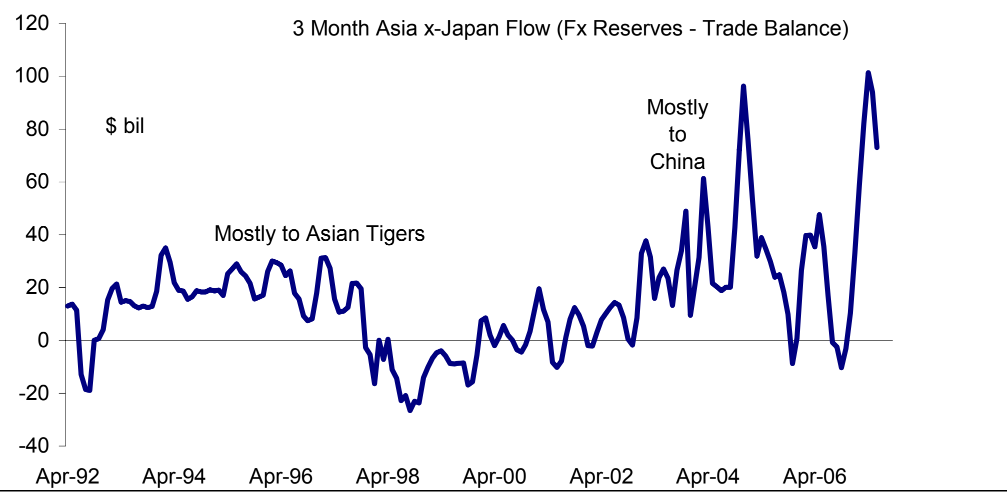
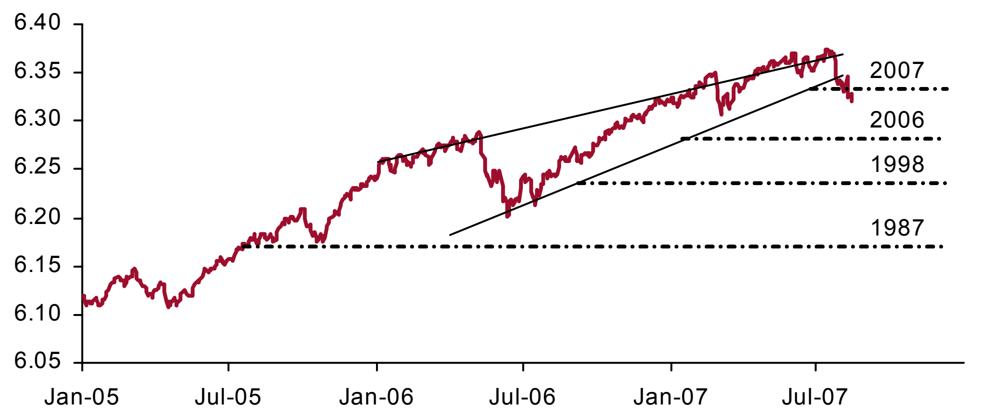


Exhibit 3: World Wealth with Past Declines



Source Credit Suisse, Bloomberg

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Disclosure Appendix

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Sell: Indicates a recommended sell on our expectation that the issue will deliver a return lower than the risk-free rate.

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