CHART 1

NO ONE HOME

United States (000s of units : s.a.a.r.)

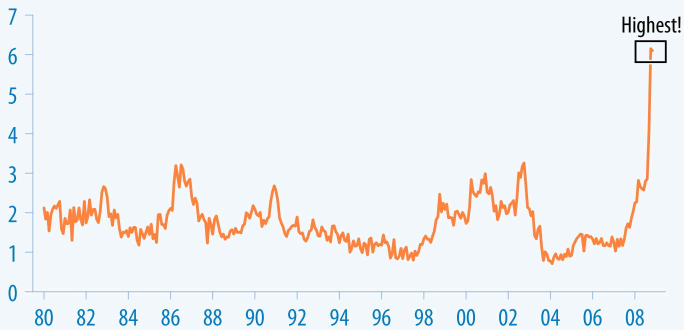
Housing Starts

CHART 2

STEEP PREMIUM TO BORROW

United States (ppts)

Corporate Debt Spread *



* Citigroup Corporate Bond Yield (BBB-rated) less 10-Year Treasury Yield

CHART 3

TED SEEING RED

United States (bps)

TED Spread *

* 3-Month Libor less T-Bill Rate

Broken Record(s)

Sal Guatieri, Senior Economist

Record books are being re-written on virtually every chapter of the U.S. economy and financial markets today. The extraordinary highs and lows are a testament to the enormous challenges facing policymakers and investors.

Starting with the challenges, the U.S. housing market is ground-zero for the current crisis. Never in the past sixty years have so few houses been built as in October (*Chart 1*). And while major progress has been made in whittling down the supply of new homes, resale inventories remain near all-time highs because of stagnant demand and record-high foreclosures. Consequently, resale prices have fallen 22% from their peaks, the biggest drop since the Depression (according to Case-Shiller).

The ongoing housing slump is making credit markets sicker, despite 16 months of intensive care by Drs. Bernanke and Paulson. Amid record mortgage defaults, more banks are tightening credit standards than at any time in at least the past 18 years. Investors are holding back too. Consequently, many companies are paying more to borrow today than when the Fed began easing last year, with corporate bond spreads at their widest since at least the early 1980s, eclipsing the previous 2002 peak by a factor of two (*Chart 2*). In October, the interbank market shut down when banks began questioning the viability of their counterparties after Lehman's failure. The three-month Libor-Treasury spread ballooned four percentage points above its long-run average, though it has recently halved because of the Fed's massive liquidity injections (*Chart 3)*.

Investors have gone from reaching-for-yield to running-for-safety, driving long Treasury yields to their lowest levels in nearly half a century of record keeping. Uncle Sam can borrow short-term funds virtually cost free, and is paying a minuscule 2.6% to borrow for ten years— good thing too, since the government has become both lender and spender of last resort. Last week's news that the government will purchase a half trillion dollars of mortgage-backed securities, combined with this week's news that it is considering a plan to reduce fixed mortgage rates, fed the biggest weekly decline (0.44 pt) in fixed mortgage rates in 27 years.

TABLE 1

ANGRY BEAR

S&P 500 – Peak to Trough Decline

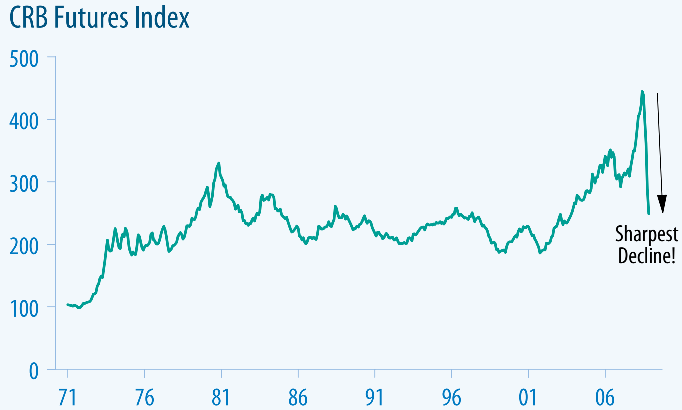
Year	Decline * (percent)	Duration (months)
2008	**-52%**	**13**
2001	-49%	23
1974	-48%	21
1970	-36%	19
1982	-27%	20
1990	-20%	5
1957	-19%	17
1953	-12%	8
1960	-12%	15

* pre-1970 calculations based on month-end

CHART 4

HOT COMMODITY... NOT!

(1967 = 100)



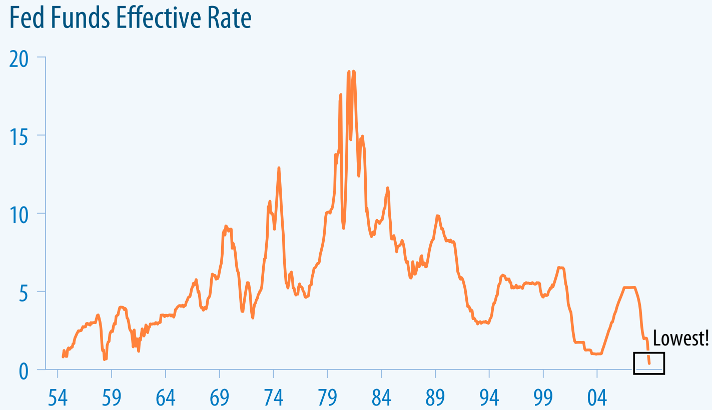
With the Treasury party in full swing, stocks are suffering their worst hangover in nearly 80 years. The 42% slide in the S&P 500 this year has stocks tracking the biggest annual decline since 1931, erasing all gains over the past eleven years (excluding dividends). The 52% slide from last year's peak to the November 20 low marks the worst bear mauling in the post-war period (*Table 1*). With stock dividend yields above long Treasury yields for the first time since 1958, stocks appear to offer good value (provided Treasuries aren't the next bubble). Volatility has also been unprecedented, with the VIX options-based measure recently spiking to four times its normal level. Some analysts estimate that only the 1930s were more volatile.

Over $8 trillion in equity wealth has melted since October 2007, more than in the crash of 2000-2002 when stocks slid 49%. Including the roughly $2 trillion decline in real estate values, the unprecedented loss of wealth is equivalent to what U.S. consumers spend in a year. Consequently, real personal spending fell at the fastest rate in almost three decades. With business spending and construction also in the tank, the U.S. economy is likely contracting at the fastest rate since the deep 1982 recession. The current 12-month long recession is expected to surpass the 16-month downturns of 1973-75 and 1981-82, marking the longest contraction since the Depression. The rest of the world isn't faring much better either. According to the IMF, next year could bring the first annual decline in developed world GDP since WWII.

There's nothing like a recession to douse the inflation flames. An unprecedented halving in commodity prices in just five months has erased six years worth of gains (*Chart 4*). This helped drive consumer prices to their biggest monthly decline since 1938 (the last time the U.S. had serious deflation). Meantime, core prices fell for the first time in 26 years because of aggressive retail discounting.

Tough times call for aggressive actions. The monetary policy response to the crisis is without precedent. The Fed reduced its target rate by 425 bps in the past 13 months, a rate of decline surpassed only once (in 2001) since record-keeping began in the early 1980s. While the *effective* fed funds rate fell faster in the 1974 and 1982 recessions, never in the past half century has it been as low as it is today (*Chart 5*). (Many other central banks have taken an axe to rates as well, with the Bank of England chopping 250 bps in the past month alone to 1951 lows.) Of course, low interest rates don't help much when the credit pipes are frozen. Thus, the Fed is increasingly lending either directly (via the commercial paper facility) or indirectly (via purchases of asset-backed securities) to

CHART 5
CHEAP MONEY
United States (percent)



businesses, consumers and home buyers. All this liquidity has lifted the monetary base into the stratosphere, up 75% in the past two months (the most since at least 1961). On the fiscal side, the new Administration could unleash a record amount of fiscal stimulus (up to $700 billion or nearly 5% of GDP) in the New Year.

Bottom Line: Extraordinary moves in equity and credit markets suggest investors anticipate a long recession, as hinted by recent economic data. This means more aggressive policy actions are needed to limit the risk of a more severe outcome. Look for the Fed to extend its credit easing on both the rate and quantity fronts, purchasing Treasury notes and possibly some corporate bonds too, while committing to hold rates low for some time. Assuming the economy arises from the sick bed later next year, corporate bonds could provide healthy returns.