

# Has the Global Credit Crunch Hit a Bottom?

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With the S&P 500 down by over 6% since the start of the year and inter-bank lending spreads still over four times their historical averages, these are hardly heady times for global financial markets. Yet despite the constant stream of bad news coming out of Wall Street, in some aspects, the worst of the credit crunch appears to be over.

Financial markets are unlikely to return to normal over the next few months, but there is a sense that, at the very least, the credit situation won't get any worse. Despite the fall of Bear Stearns, investors' deepest fears have not been realized and the global financial system is hit but not hobbled. Financial firms have seen their capital ratios bruised, but have been able to handily access global equity markets in order to recapitalize. Meanwhile, the Fed has also done its part through a series of well-timed targeted liquidity measures, including opening up the discount window to securities dealers.

## Getting Used to Bad News

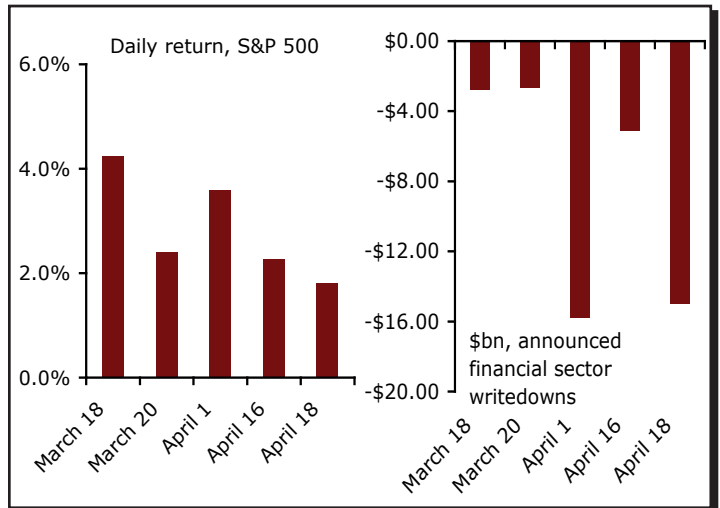
To be sure, the fundamental economic data will certainly get worse before they get better, but investors appear to be willing to look past that, even if they are not yet willing to bet on a full blown US economic recovery. There is clear evidence that expectations have hit a bottom and that markets are learning to live with significantly higher risk premiums and ongoing market losses.

Just how inured investors have gotten to the ongoing stream of billion dollar writedowns from global banks and brokerage firms can clearly be seen in the equity market's performance in the wake of these announcements. Over the past 30 days, five of the fifteen winning S&P 500 trading sessions came on days during which major financial institutions reported at least \$2 bn in writedowns (Chart 1).

Signs of market stress are still clearly visible, but have certainly moderated since spiking in mid-March. Spreads on highly rated corporate bonds are still close to the highest they have been since this latest crisis started (Chart 2), but after blowing out to record levels, spreads on both the investment-grade and high-yield CDX indices are the lowest that they have been since the start of the year (Chart 3).

Chart 1

### US Stocks Rose on Days with Big Writedowns



Equity market volatility has also dropped off significantly, and although financial stocks have certainly not rallied very much, they have managed to level off. Furthermore, if credit conditions continue to modestly improve, these same firms may even be able to avoid further mark-to-market writedowns next quarter as the value of the related assets bounces back from their March lows.

Chart 2

### Corporate Spreads May Have Plateaued

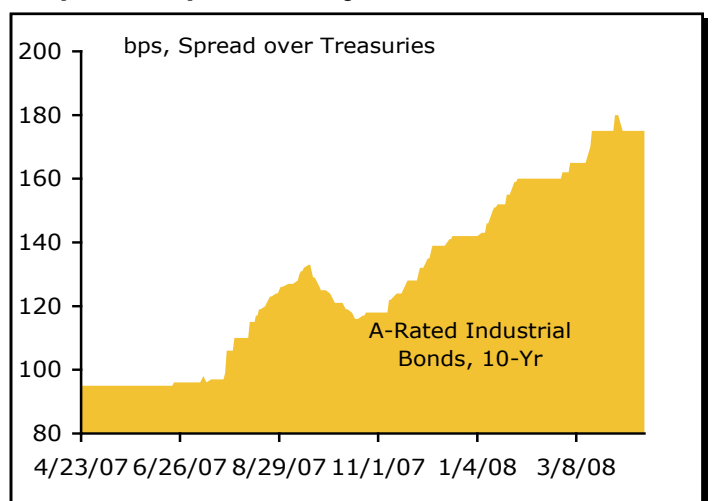
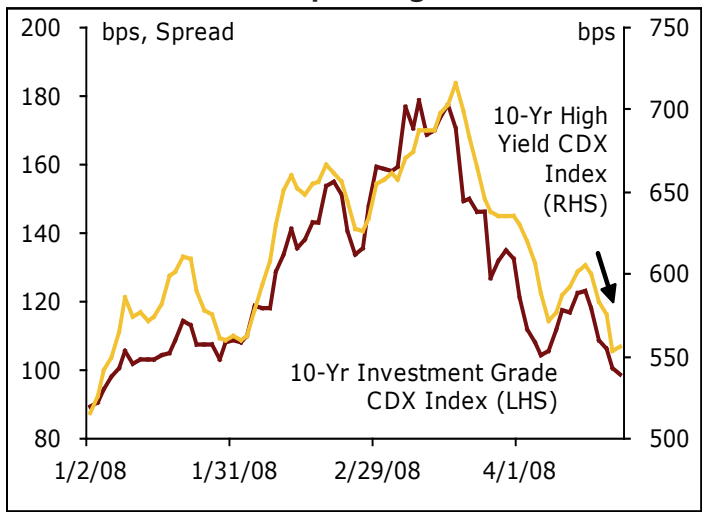


Chart 3

**Credit Conditions Improving**



The implications for Treasuries are significant. Bonds have sold off across the curve and the spread between 2s and 10s has narrowed by 50 bps over the last four weeks. There are those who would like to attribute this move to soaring inflation concerns as crude oil nears US\$120/bbl and rising food prices spark riots across the globe. However, although inflation is certainly a persistent and global problem, the recent moves in the yield curve have more to do with scaled-back risk intolerance than rising prices. After all, inflation expectations as measured by the TIPS market are low by historical standards, and even lower than they were in March (Chart 4).

Chart 4

**Inflation Expectations Tame in the TIPS Market**

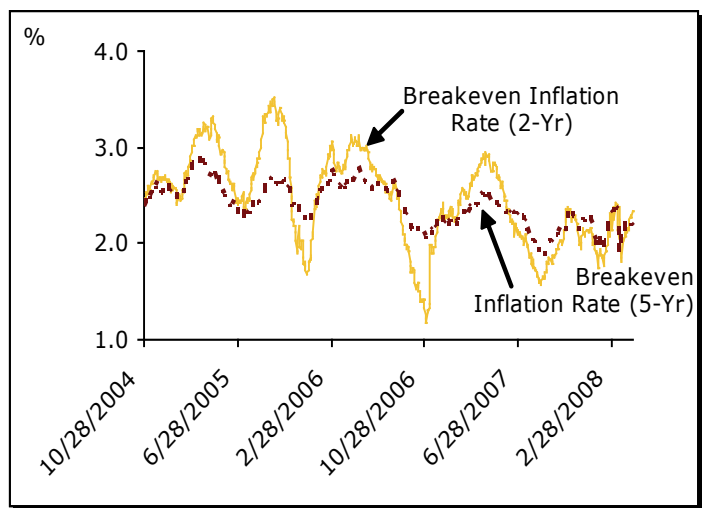
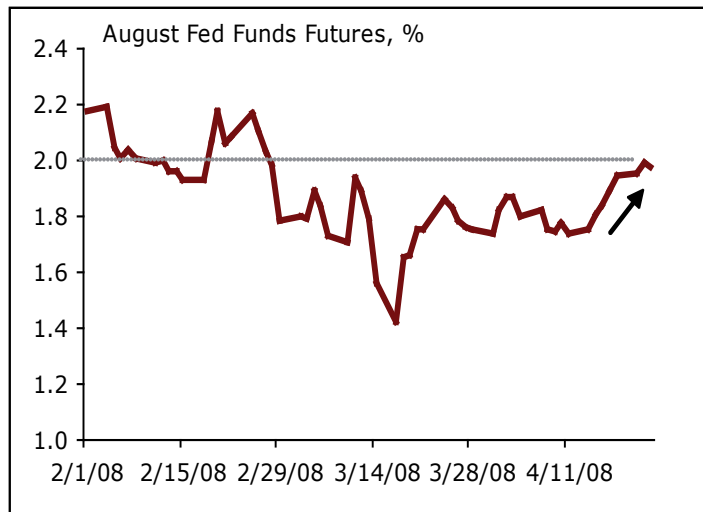


Chart 5

**Market Now Believes Fed to Stop at 2%**



**Easing Will Surpass Expectations**

Turning to monetary policy, only a month ago the fed fund futures market was pricing in a better-than-50% probability of sub-2% Fed funds rate by August, but that prediction has now slipped to around 20% (Chart 5).

Considering the financial and economic risks still ahead of us, our view on administered rates is a little more circumspect, but is also more optimistic than it was a month ago. We continue to call for rates to drop below 2%, but there is no doubt that a calmer market environment will make it harder for the Federal Reserve to drive its target rate below 1.50%, especially as the voices of the FOMC's inflation hawks get even louder.

Still, despite meager market expectations, more significant monetary easing is still par for the course, in no small part because the economy demands it. Policy makers will likely have to move in smaller 25-bp increments, but they will still need to continue to ease the pressure on floating rate borrowers, especially homeowners. Defaults continue to rise and according to the Case-Shiller home price index home values are not just continuing to decline, but are dropping faster with each passing month.

When all is said and done, the second-quarter will likely bring a significant decline in real GDP growth in the US, and be the low point of the current recession. However, it appears that it will also mark a stabilization-point, if not yet the turning-point, for the nine-month old credit crunch. Both the markets and the economy will take some time to fully recover, but an end is finally in sight.