

Big Wave Commentary

The Fed Cuts and Here We Go Again

As my 12 year old son would put it, the stock market "is a beast." Translated, a "beast" means that it is "the one". The single, most important thing that makes all things right. The market has become the thing that drives all economic growth. It is so big and wields so much power that it is becoming the very centerpiece of the American economy. It measures our economic mood and confidence. Consumer confidence surveys correlate with it's up and downs. And now, with last months cut in prime lending rates, the Fed has come into the fold and must agree with my son, that the stock market is indeed "a beast."

It is my interpretation that the main reason behind the drop in the rates was the stock market and more importantly, the potential stock market reaction if the Fed did not cut them. The Fed is afraid of the market and to be honest, it has every right to be

The stock market's dollar value today is larger than the nominal GDP of the entire country. Total stock market capitalization stands around \$18.5 trillion dollars. The nominal GDP comes in around \$14 trillion telling us the market trades at about 135% of nominal GDP. To compare that number, in 1929, the market traded at 81.4% of GDP. The average over the last 80 years has been 55.8%. Only once, in March of 2000 did the market trade higher when it stood at a record 183%. So it is hard for the Fed not to look at this market and not be afraid of how it will interpret their policy decisions. After all, it is bigger than the economy and is 18 times bigger than the entire housing market that they were trying to save. So don't be kidded by what you hear on CNBC or read in the papers. The Fed did not lower rates to help out the little guy with subprime debt and an adjustable rate mortgage coming due (bond yields and mortgage rates actually went higher after the rate cut). No, they did it to help out the big guys, the banks and hedge funds of the world with large

exposure to financial market risk. They did it because they positively can not afford to have the stock market melt down.

So how does this play out in the future? My answer is probably how it played out in the past. We have seen this movie before.

In 1998, the Fed provided an emergency rate cut in response to the Long Term Capital Management collapse. There was an argument then, that we didn't need the cut and that the Fed was just pouring money into an energized economy that needed no extra stimulus. 30 trading days after that cut, the NASDAQ gained 23.2 percent and was on it's way to a tech bubble that eventually popped as we all remember. Fast forward to today. 30 days after this Fed rate cut, another market, the MSCI Emerging Market Index, has risen 25.8% and the emerging markets are now forming the infamous financial bubble. The game is back on.

The point here is that worldwide leverage is back in a big way. Fed policy which talks in public discouraging this leverage game, has again encouraged it, even fueled it. By lowering the short term lending rates and making borrowing money cheap again, people around the world start to exchange devalued assets and currencies, such as dollars, for other assets such equities, real estate, art and collectables, commodities or even other foreign currencies of higher value and quality. This exchange protects the purchasing power of their savings. The exchange of cash into assets then leads to rising prices. This exchange of cheap money to stronger assets took a 30 day rest, but is now continuing. Speculators are once again acquiring assets and foreign currencies with borrowed funds at artificially low interest rates which is once again driving up asset prices, some in a dramatic fashion.

The US is a credit addicted nation. Since 2000, the GDP has grown by 4.2 trillion while debt in this

nation has increased by 21.3 trillion. That works out to just 20 cents in GDP growth for each additional dollar in debt. By cutting borrowing rates 50 basis points, with probably more on the way, the Fed hasn't addressed the growing debt problem, it is still encouraging it. As long as the stock market continues to rise, and the Fed makes sure it is helping it do that, then the feeling among investors and analysts is that

all is ok and this subprime mortgage mess will soon be a thing of the past as the higher markets take care of business. After all, the market is the one. The market is the economy. The market is "a beast."

Dilbert probably said it best..."The key to happiness is self delusion."

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