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## From Wall Street to Main Street

**Rick Kilbride**

Head of Fixed Income Managed Accounts

The economy is crawling. Measures of GDP indicate growth of 0.6% (quarter over quarter, annualized) for each of the last two quarters. This is more indicative of a slow spot than a recession. Yet the consumer is having a tough time; the contribution of personal consumption to the economy's anemic growth has been declining. Net exports have done a reasonable job of offsetting the declines in residential construction, but that is changing as we pay more and more for imported fuel. A small swing this way or that in inventory building and the GDP numbers could have been negative. Does it matter? Maybe it does only in the context of what is ahead. If growth does pick up from here, then we just went through a couple of tough speed bumps.

To look at the markets, that is what appears to have occurred. Some of the April economic data was better than feared. It was also a very good month for risk takers. The S&P 500 index climbed 5%. High yield bond indexes gained over 4%. Money markets priced in an end to the easing process. Perhaps the big "take away" is that the market has re-priced its prior view that the economy could go over a cliff. While markets have a history of rallying before the all clear signal, this one gives pause. The problem is not on the business side. Balance sheets are in good shape, productivity is still advancing and labor costs have been well handled.

It is also true that tax rebates will soon provide a non-trivial lift to consumer spending. Yet the ability of the consumer to handle rising food and fuel prices while their home values decline is uncertain. Inflation adjusted take home pay is flat over the last year. The positive side of that is that an inflationary spiral is not likely to occur if wages grow slowly. That said, fuel and food price pressures could cause significant retrenchment in other parts of the consumer basket. Autos have now followed housing into recession. The markets appear to have shrugged this off, perhaps

without a thought that things still could get worse. Maybe this view reflects a sense that eventual government programs to rescue the housing market will work out successfully. The problem with this thinking is that, like the unwinding of Bear Stearns, stopping a problem doesn't mean that fundamentals immediately improve. It could be a long stretch before we find ourselves in better times. Therefore, it may not be a good thing that a tough economic outlook is no longer priced into risky assets.

The contagion that hit Wall Street came from leveraged exposure to non-transparent asset valuations. The revolving margin calls that resulted occurred in an environment where fear overwhelmed risk taking, causing market after market to unravel. "At-risk" capital dried up. The Fed got very creative, with rate cuts and liquidity measures, to stabilize the situation. Fortunately, banks and other financial institutions have been able to source new capital, though at steep prices. Much of this capital came as equity, and therefore subordinate to bonds in the capital structure, which is not a bad thing for the fixed income markets. But the problem going forward is the ability of financial institutions to provide financing for economic growth. While the financial system has been supported by the Fed's actions, the banks are not yet healthy. This is the still unfelt impact on Main Street. The latest survey of bank loan officers reported continued tightening in lending standards across a wide range of loan categories. The banks are still pulling back, hoarding cash, uncertain about what degree of leverage will be appropriate going forward, and uncertain about needed capital. Lending standards are tighter for commercial and industrial loans, credit cards, consumer loans, and most categories of residential mortgages. A paucity of credit availability is a strong headwind facing the prospect of stronger economic growth. ■

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