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Investment Strategy Bulletin

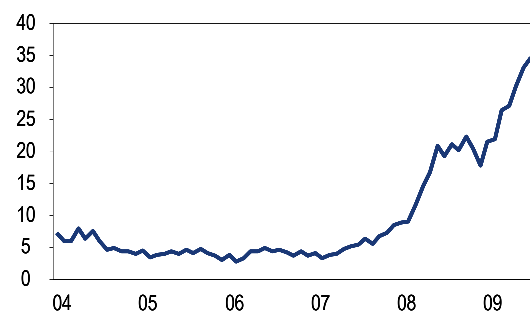
No easy way out

The US economy is hanging on a drip. To revive a disrupted system, the government and the Fed took unprecedented measures. As the economy is finally showing signs of resurrection, the question of when those extraordinary measures should be removed is gaining center stage. Regardless of *how* policymakers will manage the phasing out of the different programs – which in itself carries a great deal of uncertainty and risks, we think the exit *per se* of massive government support has the potential to trigger financial instability, if not, a serious relapse in economic activity. The main reason being that the true state of the economy and the financial system may well be much weaker than one thinks: whilst the private sector has not yet healed, the government sector - initially unscathed by the crisis - has become more fragile.

Amongst the main beneficiaries of stimulus programs are consumers, automakers, homeowners and banks. Starting with consumers, a timely distribution of tax refunds and benefits prevented a collapse in household spending. Likewise, the cash-for-clunkers program helped supporting automakers by boosting car sales. Still, the underlying weakness in retail sales gives a flavor of what to expect when the supportive effects of these measures will wane. The headwinds facing the consumer are powerful and will keep spending under pressure for a prolonged period: high unemployment, poor income growth, negative housing wealth, restrained access to credit, ongoing de-leveraging, to name a few.
Turning to Housing, the industry stands out as the most striking example of an artificially propped up sector in the economy, with all sides of the equation on a government drip. Demand is being supported by an USD 8'000 subsidy for first-time homeowners; whilst on the supply side, loan modification programs have put a de facto moratorium on foreclosures. Furthermore, the cost of financing has been kept down, not only thanks to record low Fed funds and Fed buying of US Treasuries, but also as the government and the Fed stepped in where private institutions and investors pulled back (mortgage securitization, refinancing, insurance of risky mortgages, buying of MBS and Agency Notes). The government had to double its initial capital commitment to Fannie Mae and Freddie Mac, and the FHA*, which has institutionalized poor underwriting standards by insuring mortgages with low down-payments (see upper chart), might need a bailout to absorb increasing losses. The risk to see a relapse in housing is still significant.
Which brings us to banks. Renewed weakness in housing would exacerbate the amount of losses (USD 440 bn based on our estimates, see lower chart) for which banks have insufficiently provisioned, at a time when tighter regulation and new accounting standards will require even stronger balance sheets. Under such circumstances, the prospects for any upturn in bank lending look poor.

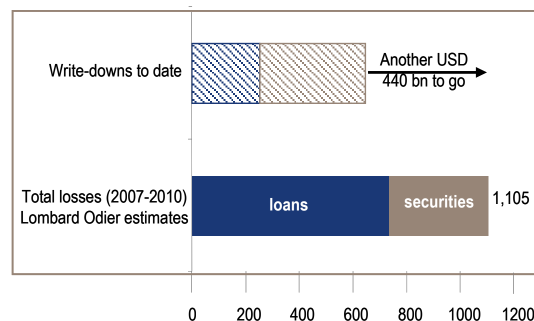
There is no easy way out. Though massive, we doubt that policy measures have yet succeeded in transforming the current rebound into a strong and sustained recovery. Even more, government intervention has come with a cost, that of making other institutions more fragile, at a time when policymakers' leeway is much narrower. We therefore remain cautious.

Volume of FHA*-backed mortgages ($bn)
Surge in volume is putting the institution's solvency at risk



*Federal Housing Administration

Estimate of total losses faced by US banks (2007-2010)
Banks will remain challenged by credit losses



Source: DataStream, Bloomberg, Lombard Odier calculation

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