



Max Bublitz

It's a cruel, cruel summer

This period of monetary tightening has ended with a pop – just like all the recent ones

Well, so much for summer doldrums. The above-mentioned song title is more apt (any chance to make a Bananarama reference should be considered a gift). In my last column I wrote about the market's fascination with liquidity, and what might cause it to change. But who could have imagined that the change from fascination to desperation would culminate in such a dramatic meltdown?

Writing after a weekend of reflection, I'm struck by a number of things. First of all, there's this nagging feeling that things are finally starting to follow script. Every monetary tightening cycle in recent memory has ended with some sort of financial calamity. We can recite them by rote: the bursting of the dotcom bubble, the mid-90s derivative mess (remember Orange County), the S&L blow-up... it's how monetary cycles end: tighten until something breaks. This year's version has all the makings of a reality show: *When Acronyms Attack*. And strange as it may seem, the events of this summer have kind of legitimised this tightening cycle – a rite of passage, if you will.

These cyclical credit crack-ups tend to have a lot in common. Right at the top of the list of similarities is the use of leverage, and how it inexorably exaggerates a market's natural flow between greed and fear. Greed-induced leverage grows slowly as risk gets relegated to an afterthought. But when fear returns – and it always does – levered overcrowded momentum trades get unwound at dizzying speeds as risk gets shorn.

These transitions are emotional affairs and elicit kneejerk responses from all sides. Liquidity dries up as lenders stop lending, borrowers stop borrowing, and markets freak out. Margin clerks rule, Wall Street disappears, and doomsayers move front and centre. In hindsight, it's obvious that investors (and rating agencies) were not altogether clear about the risks they had taken.

Oh yeah, I almost forgot... and the Federal Reserve eases. Remember, however, that easing is never a one-shot deal. It's

always a process, and like cockroaches, there's never just one. The credit markets must go through a process as well, of normalising the pricing of risk as investors seemingly rediscover it and get painfully reacquainted with its impacts. This one was long overdue.

Much ink has been spilled about how oblivious to risk the markets have been over the last few years, so I'll spare you the rehash. But the point is that seizure is not the normal state of affairs. Markets will begin functioning again. When, and at what price level, is currently being probed.

Out of control

That credit crises are similar is not to say they are identical. This one differs importantly from its earlier brethren in that so much of today's credit creation process lies outside of the banking system, and thus outside of Fed control. The current crisis is further differentiated by the fact that markets have become increasingly interconnected through the proliferation of both derivatives and those who traffic in them. They have combined to make markets more prone to emotional spasm, with more compressed timeframes than past credit cycles.

As a result, the Fed is obliged to play a different role than during earlier episodes. Not only must it provide the obvious benefits of injecting liquidity into the monetary system when the economy weakens, but a subtler and increasingly important aspect of a central bank's job these days is to help take some of the emotion out of the price-discovery process for those outside the banking system. That is exactly what the Fed attempted to do on August 17 when it began this cycle's version of easing. But when CNBC is focused on Libor instead of stock market cheerleading, it's clear that the Fed has a lot more work to do.

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