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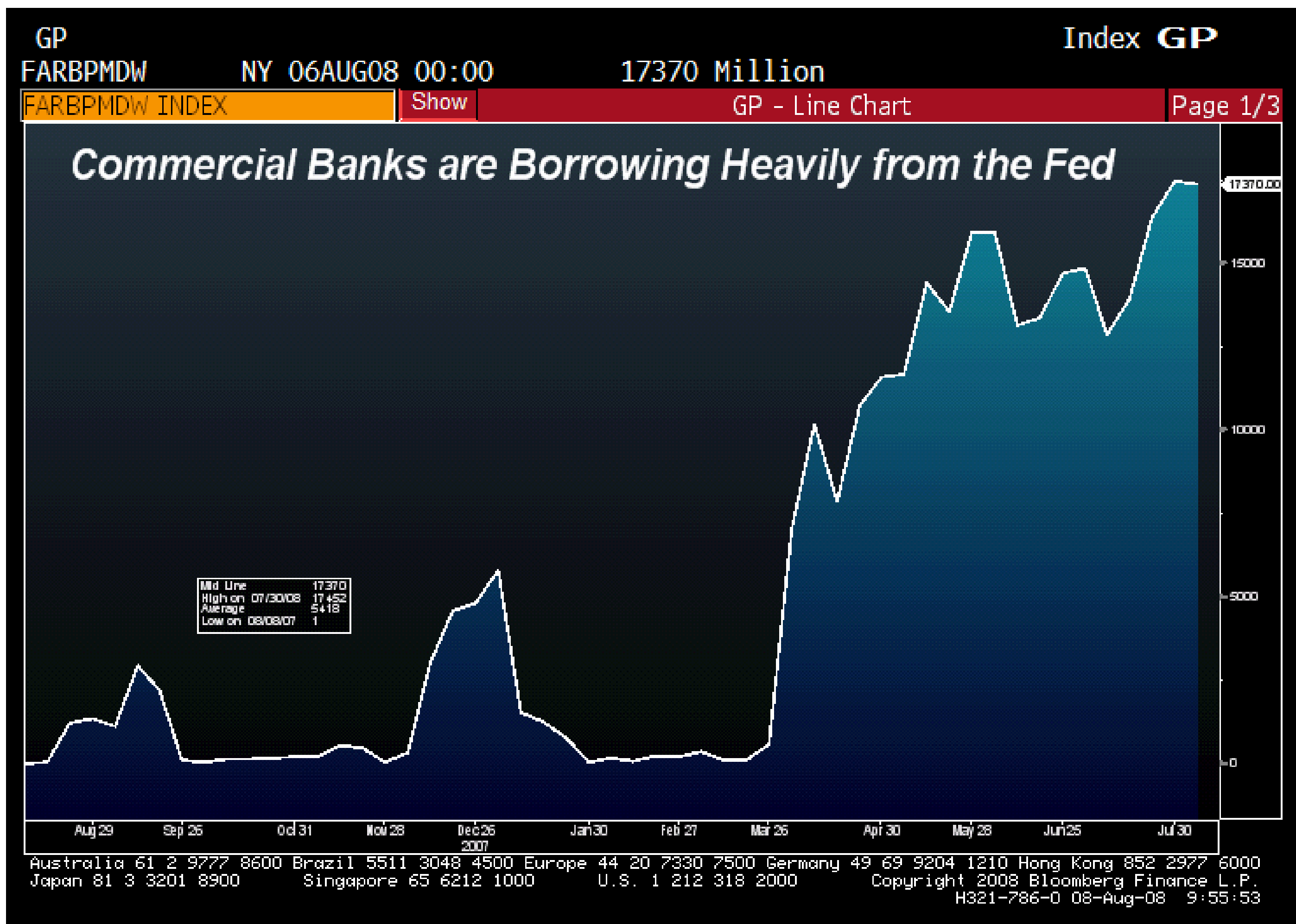
**Economics & Strategy**

# Stocks Rise, But Signs of Stress Remain

**Commercial banks are continuing to borrow record sums from the Fed's discount window.** Commercial bank discount window lending has held near $17.5 billion during the last two weeks, close to record levels. This -- along with widening credit spreads -- suggest financial strains remain intense.

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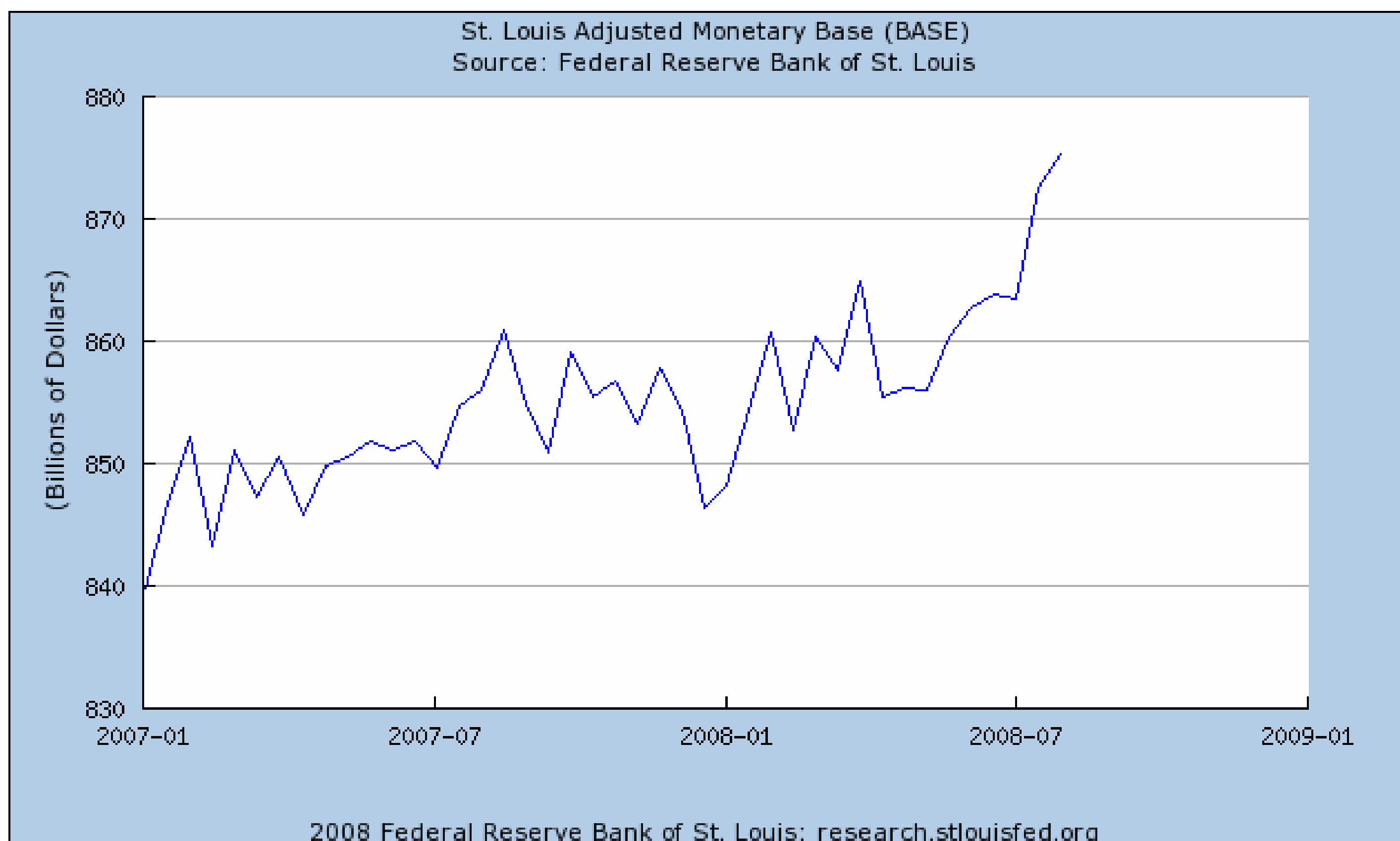
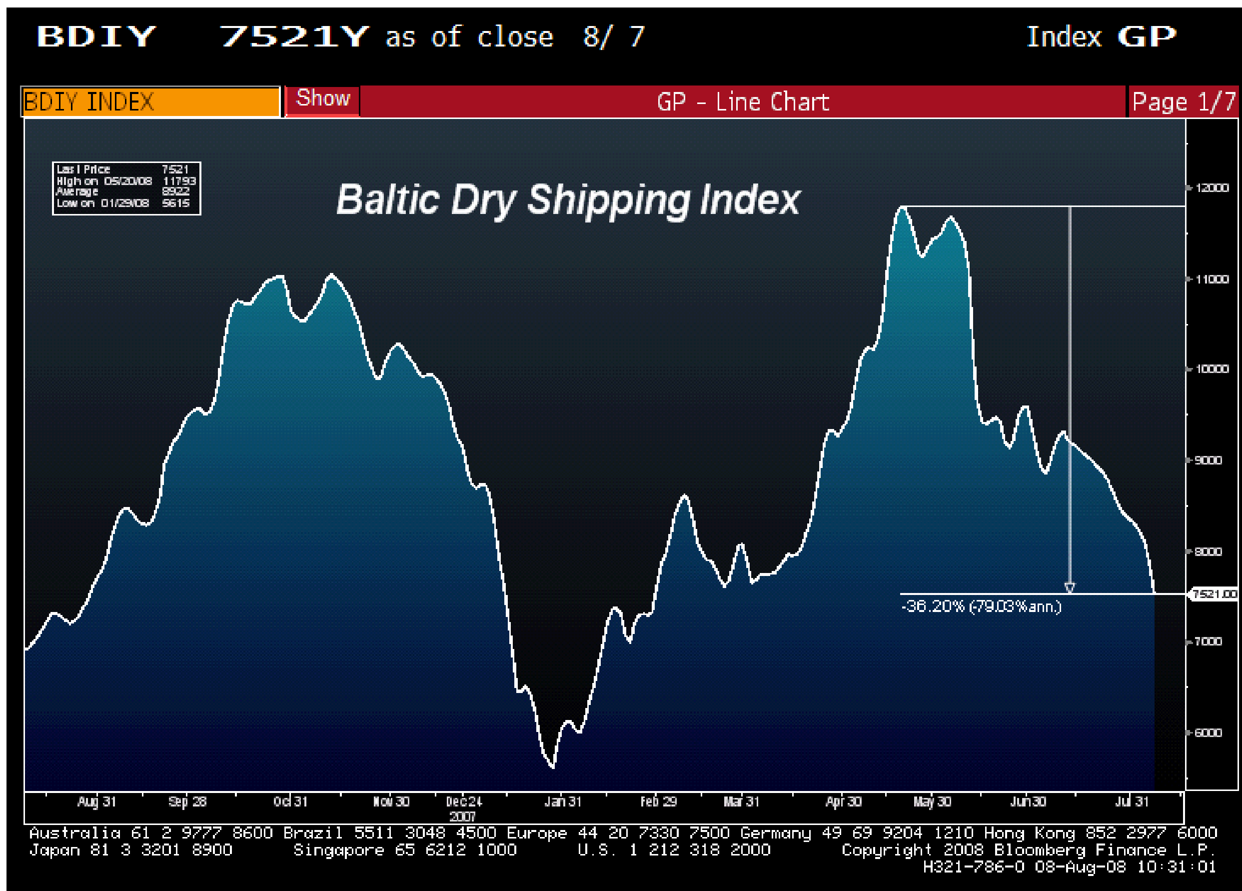
**Monetary base growth has shot up rapidly in the last few weeks,** rising at more than a 9% annualized pace since May (when credit spreads began to widen again). The acceleration in the base has been *entirely* driven by the currency component (which accounts for about 90% of the base, and is demand-determined). The public's demand for cash may have risen with news reports of recent bank failures and the corresponding stresses that have reemerged in credit markets.




**There is a strange, ongoing disconnect between credit and equities.** Credit spreads have risen in an across the board fashion since May. As we have detailed previously, current coupon mortgage spreads have shot above 200 bps, the highest sustained levels since just before the run on Bear Stearns. If this were an isolated event, it would be highly unusual for swap spreads, junk bond spreads, corporate spreads, and inter-bank lending spreads to all march higher in sympathy. The sharp rise in discount window lending activity -- and the parallel pickup in the demand for cash -- also cuts against the idea of an isolated credit event. Perhaps the spreads are telling us something about additional financial shoes to drop in credit cards and auto paper.

**So what explains the buoyant stock market?** Probably the big fall in crude oil, which will help to limit stresses on firms and households directly related to surging energy prices. While the drop in crude is welcome news on that front, there is a crucial caveat: it may be in large part occasioned by weakness in 65% of the global economy. Leading indictors of economic activity have collapsed in the Eurozone, U.K. and Japan. And the

second half picture in the U.S. remains dim in our view. This accounts for nearly two-thirds of global GDP and could be helping to pull crude oil lower. Surely the political shift towards drilling and exploration -- and against “speculation” -- may have had an impact, but this doesn’t explain the 36% collapse in the Baltic Dry Index from its May peak. It also doesn’t explain the 14% drop in the JOC-ECRI Industrial Commodity Price Index from the highs seen in April. Softer global growth would seem to be a more logical culprit.




**Conclusion:** Commercial banks are continuing to borrow record sums from the Fed’s discount window, a sign of substantial ongoing financial stress. Wide spreads on mortgages, swap securities, junk bonds, corporate credits and interbank lending rates also make the case for intense financial stress. Perhaps this is why monetary base growth has shot up to a 9.4% annualized growth rate in the last few weeks as precautionary liquidity demands rise with the level of financial uncertainty. Against this backdrop, however, stocks are rallying, likely due to the large (and continuing) fall in crude oil. Thus, the strange disconnect between credit and equities continues -- a disconnect we do not believe can continue indefinitely. Either the credit markets will turn around (confirming the signal from stocks), or equities will again hit an open elevator shaft and head lower. It would be highly unusual for the credit markets to *lag* the equity markets. Previous divergences have usually been resolved with equities giving way to the signals from the credit markets.

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