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Young 'Clouseau' appears on the scene

French junior trader brought global markets to edge and shocked Fed into action

SUMMING IT UP

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The year started on a sour note. January will go down in the books as one of the worst starts to a year on record. For the month, the S&P dropped 6.1 percent, with the NASDAQ down 9.9 percent. The market ended the month down about 11.5 percent from its October highs. The month would have been worse except for a late month rally, which cut the losses.

The slide started just before year end and continued with a vengeance through the first several weeks of the month. A sharp sell off in Europe and Asia on the Martin Luther King holiday prompted the Fed to cut interest rates by 75 basis points in an intermeeting rate cut, which came only five business days before the regularly scheduled meeting. At their regular meeting, the Fed cut rates an additional 50 basis points, to bring the total cuts for the month to 1.25 percent. These cuts stimulated the markets, as they took comfort in the Fed action.

Gross domestic product for the fourth quarter of 2007 fell to .6 percent, down from 3.7 percent in the prior quarter. Unemployment rose. Home prices continued to fall. Foreclosures rose. Consumer confidence declined. Banks and consumer discretionary stocks were especially hit hard. The markets felt that the Federal Reserve had not acted with sufficient vigor, and worse yet, the Fed might not understand the severity of the problems.

Oddly, the actions of a junior trader on the arbitrage desk at Societe Generale in Paris may have shocked the Fed out of its torpor. As strange as it seems, an unknown trader with a small book to work with, who never made more than $70,000, brought global markets to the precipice, shocking Fed into action, even though it was a U.S. market holiday.

It appears that an important factor in the Fed decision to cut rates 75 basis points was a sharp sell off in the Asian and European markets during the Martin Luther King holiday. A contributing factor in the sell off was thought to have been associated with the efforts of Societe Generale to square its books after it was discovered that an arbitrage trader in the bank had exceeded his authority and lost about 1.5 Billion Euros in his positions.

In an effort to square its positions, the bank apparently added to the losses, until the total loss was about $7.2 billion, the largest single trading loss in banking history. Since the trader apparently did not profit from these trades, there is much speculation about why he did it. I have my own theory: It was those punishing 30 hour work weeks that Frenchmen are required to work.

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Fed Chairman Bernanke had gone to work on this holiday to clean up his desk, when he learned of the crisis. A telephone meeting was held, and the announcement of the rate cut preceded the market opening the next day. Quick action may have saved the day as the U.S. markets opened with a sharp sell, with the Dow off trading down as much as 581 points. By the end of the day, losses had been cut 128 points.

The next day, still more damage was to follow as rumors of the downgrade of mortgage insurers surfaced. A meeting was called by the insurance commissioner of New York, to shore up the insurers. Although the meeting did not result in a decision, the mere fact that the meeting happened caused the markets, which had been down 300 points, to end up 300 points on the day.

The ensuing 50-basis-point rate cut enabled the markets to end the month on an upbeat note and save further losses, for now.

The rapid rate cuts signaled a new approach for the Fed. Discarding the "too little too late" approach of his predecessor, Alan Greenspan, Bernanke opted to buy some insurance by front-end loading interest rate moves. This strong approach has gained approval of the markets, but the Fed is still draining money from the money supply, which offsets their interest rate actions. Liquidity problems in the credit markets are also a drag on the economy.

At the moment, the market is focused on the fate of the monoline insurers, which insure bonds against default. The insurers themselves have come under pressure because of perceived risk to their ability to back the bonds they have insured because of lack of capitalization, and this casts doubt on the valuation of many bonds. Should more bonds have to be marked down, a whole other round of write-offs would have to occur, and financial institutions would find themselves with further losses. At this writing, feverish activities are occurring to keep this "other shoe" from dropping on the financial markets.

Non-farm payrolls fell 17,000 in January. With the housing market in chaos, putting stress on the financial sector and consumers, the labor market is the last support for the U.S. economy. People need to be employed to keep spending. The Fed has its job cut out for it.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.