# The party's over when the music stops

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*...Life is just a partyAnd parties weren't meant to last. They say two thousand zero, zero, party over,Oops, out of time!So tonight I'm gonna party like it's 1999!(Prince, 1999)*
Those words, written in 1982, proved prophetic. In 1999, markets went on a millennial party.

It was fuelled by the cheap money that central banks, led by the US Federal Reserve, felt obliged to extend to the market to help it escape the mess it had itself created - the 1998 Long Term Capital Management debacle.

That party ended in 2000. Gravity returned, tech stocks fell back into orbit and lots of money was lost in a three-year bear market. Meanwhile, the cheap money the Fed injected to avert deflation inflated another bubble: in housing.

Now, stock markets are betting on a repeat, as equities have rallied. They have done so because the short-term money markets suggest a total lack of trust among the big banks that form the foundation of the world financial system. It is the money markets' worst impasse at least since 1998.

Issuance of commercial paper - short-term borrowing central to many financial institutions - is drying up, while Libor, reflecting the interest rates at which banks lend to each other, is spiking upwards.

This is because, as George Magnus of UBS puts it, the market is trying to transfer various bad assets from the "secondary sector " - hedge funds, private equity groups, and the various specialist vehicles that banks set up to service them - to the "primary sector ". Those bad assets will have to move to banks' balance sheets.

Once there, they will be transparent and confidence can be restored. But putting them there requires huge amounts of cash. That has pushed up Libor rates.

Now the bet is that the Fed, and other central bankers, will be forced into a repeat of 1998: cutting rates to provide the extra cash markets need to ease through the crisis. In the process, they could fuel a boom in stocks.

Teun Draiisma, European equity strategist at Morgan Stanley, predicts that the forthcoming party for the stock market will indeed be like 1999.

Relief that crisis has been averted will mix with easy money and underlying fundamentals that do not look so bad.

"Bulls will say that this uptrend is unbeatable, after all the trouble that has been thrown at it, " he says. He adds that would end in inflation, higher rates and a bust. But shorter term, the result, if we get through this crisis, could be "a mania of epic proportions ".

The Fed has done its best to avoid promising a cut in rates, and fighting the Fed is a dangerous game. But this week, the European Central Bank and the Bank of England were forced by the market conditions to leave rates unchanged. They had signalled an intention to raise them.

When Ben Bernanke and his fellow governors meet later this month, they will know that expectations of a cut are so prevalent that to do anything else would prompt a dramatic fall in the markets.

Further, the Fed should be concerned about problems in the money markets and about any risks to the real economy. So it is a good bet that the Fed will cut.

What are the risks to this scenario? First, we might not get through this crisis without a severe impact on the economy. The odds favour wobbling through, but there is a risk that cheap money does not do the trick, as it did in 1998.

Also, the parallels with 1998 are not perfect. LTCM was huge, but it was only one player and investors generally knew the extent of their exposures.

This time around the problem is more diffuse, largely because Wall Street went to such great lengths to structure products that included any number of different forms of credit.

As Alan Rohrbach, of Rohr Capital Markets in Chicago, puts it, the 1998 crisis was based on the major banks and securities firms outsourcing the trading risks they would otherwise have taken in-house, and making a bad bet on one big fund. Central banks could solve this by aiding the big banks.

Now, investment banks are packagers of risk that has largely been passed on to investors and (in the US) mortgage debtors. Thanks to the ingenuity of the Wall Street machine, many did not know what they were buying. With the problem now so widespread, it is not clear that cheaper money will resolve it.

In addition, the US economy was looking strong in 1998 (and Asia was reeling after the crisis of the previous year). Now, the situation is the reverse.

Another risk is that the Fed refuses to cut rates. Chris Watling, of Longview Economics in London, says this would be a "Volcker Moment ". Former Fed chairman Paul Volcker decided to make a stand in the 1980s and squeeze inflation out of the system, even at the cost of a recession. Similarly, Bernanke could decide to squeeze asset bubbles out of the system once and for all.

His rhetoric (or lack of it) of late suggests this is unlikely. But he knows what happened in 1999 as well as anyone else. If the Fed does have to ease, and crisis is averted, it might act aggressively to stop another bubble developing.

So we may not get to party like it's 1999.

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