Give Credit Where It's Due

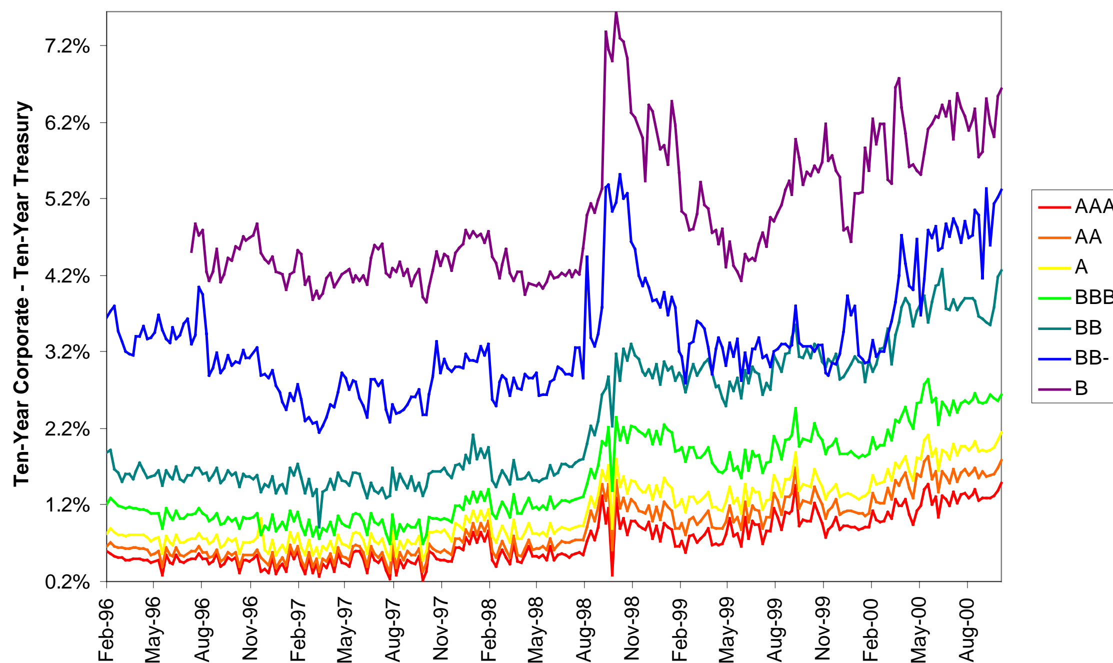
Fewer things are more important to the launch of a new venture or the expansion of an existing firm than its cost of capital. In retrospect, much of the Japanese economic miracle could be attributed to an artificially low cost of funds as Japanese savers plowed trillions of yen into low yielding Postal Savings Accounts.

A soaring equity market is just as potent for lowering financing costs, as many speculative new ventures found to their delight during the recent Internet boom. Not only can you persuade eager stock investors to share your risk but unlike the case for bond investors, you don't even have to pay them a thing if the venture folds. As venture capital funds started to dry up, many firms turned toward convertible bonds in the hope that the bond with its coupon would be converted into equity.

Established firms don't like issuing new equity for several reasons. First, it dilutes the holdings of existing shareholders. Second, interest paid on corporate bonds is tax deductible, while dividend income is taxed twice. Third, issuing new equity places the firm and its existing shareholders in the awkward position of being short a call option against its future earnings: If the firm's prospects are good, why are they willing to sell the upside to you?

No Crunch Time, Yet

Nothing is worse for any financial market than the dreaded credit crunch, the situation in which investors are unwilling to supply capital except at highly unusual rates of return. These periods are associated with financial institution failures, deliberate actions of the central bank, or with other external shocks, and their effects on equity markets and macroeconomic growth are uniformly bad. It is not unusual for a true credit crunch to produce a drop of 40-60% in senior stock market averages.



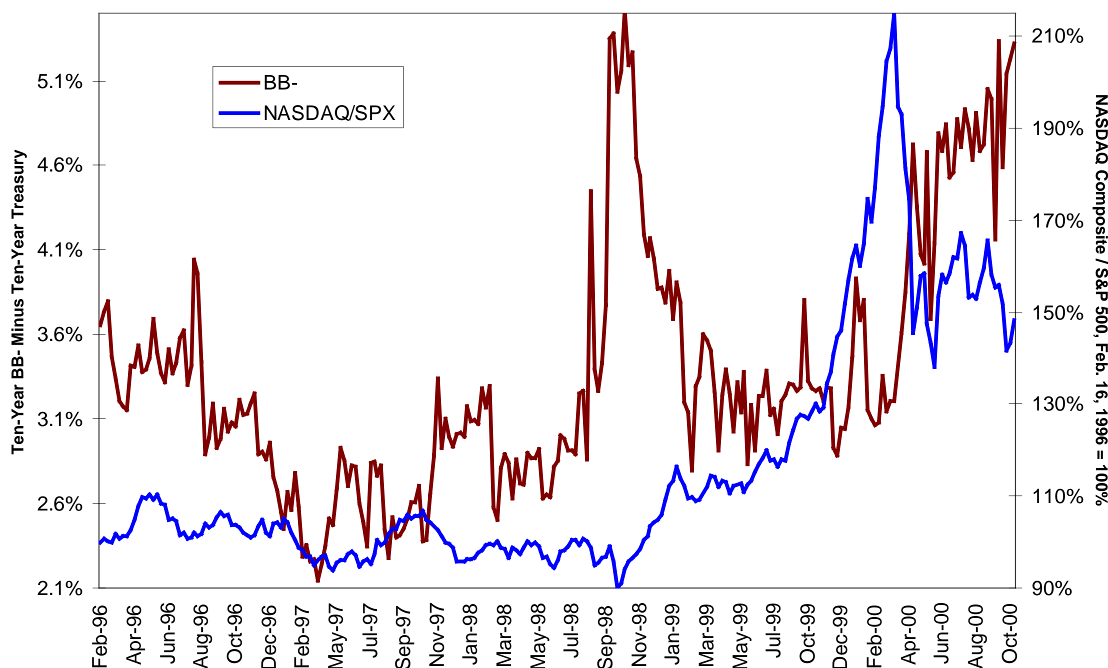
If we measure the availability of credit to the corporate sector by the spread at which firms of a given credit quality have to pay relative to the Treasury rate, we can derive an excellent barometer of investor sentiment.
Using Standard & Poor's Creditweek data at the ten-year maturity for various credit ratings since the data was collected on this basis in February 1996, we can deduce several developments. First, the spreads for AAA and AA credits were quite low all the way until the middle of 1997. They rose briefly with the onset of the Asian crisis, and then fell as central banks pumped liquidity into the global financial system. Next, the spreads shot higher during the Russian crisis and Long Term Capital Management debacle in 1998; the weakest BB- and B sectors were affected

the most. Finally, none of the spreads reverted quickly back to their 1997 levels. Since the Federal Reserve and other central banks began tightening credit in mid-1999, the spreads have trended higher for all credit qualities, with the weakest ratings once again affected the most.

Credit Spreads And Stock Investor Behavior

Unsurprisingly, credit spreads have a direct effect on the willingness of investors to seek further risk in equities. If we compare the spread between ten-year BB- corporates and Treasuries against the ratio of the NASDAQ Composite to the S&P 500, this becomes quite visible. Prior to October 1998, the NASDAQ did not outperform the S&P 500 systematically; indeed, it had only gained 90% as much as the S&P 500 as measured from February 1996. Once spreads started to come down, however, the NASDAQ embarked on its run toward 5,000 in March 2000.

Long-term interest rates peaked in January 2000. Between that point and the Fed ending its tightening in May, the BB- spreads widened over 163 basis points. The NASDAQ, replete with firms dependent on risk-seeking investors, is still more than 30% off its high.



The level of Treasury rates won't do these firms any good. Their credit rating is much lower. These firms require lower credit spreads, not only to lower their cost of debt capital, but to open the flow back into the equity market as happened in October 1998.

When the Federal Reserve cut interest rates for the third time in November 1998, it specifically cited wide credit spreads in justification of its action. Given that credit spreads are now at or above November 1998 levels, should the Fed's response be to relax credit conditions? Let's weigh some evidence:

1. Evidence is mounting of slowing economic conditions;
2. The stock market indices are hovering near their lows for 2000;
3. The U.S. dollar soaring against all of our major trading partners currencies;
4. Fiscal policy remains constrictive by virtue of the federal surplus; and
5. All non-energy commodities are still in bear markets.

The answer from these quarters is yes, interest rates should be cut. Our growth, our productivity boom, and our global technological leadership demand it.