Be Fruitful And Expand Multiples

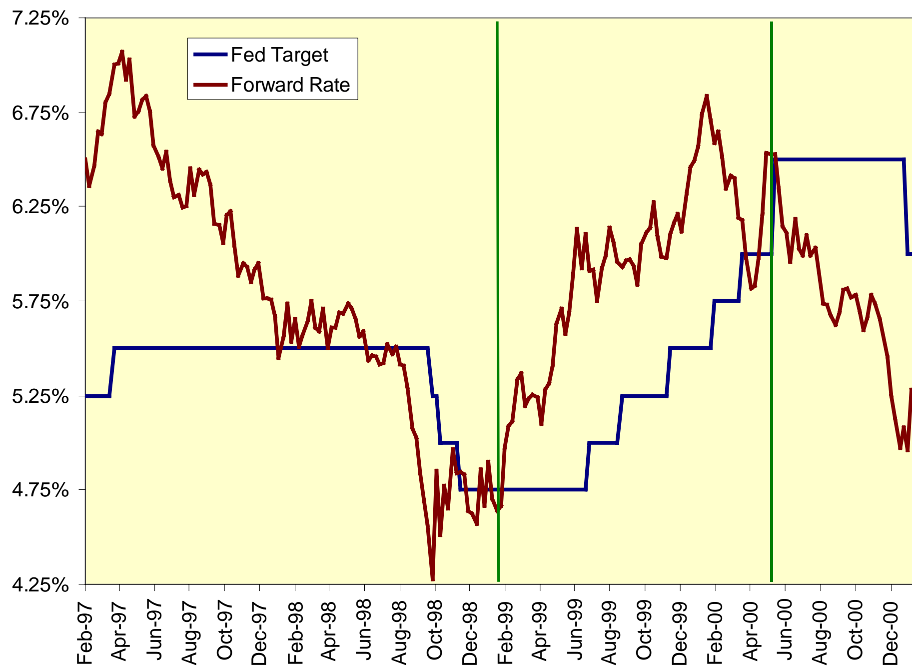
Now that we're actually in 2001, Stanley Kubrick's "2001: A Space Odyssey" doesn't seem futuristic, but it certainly remains a cinematic classic. Who doesn't recognize the booming bass drum from the movie's theme, "Thus Spoke Zarathustra?"

Why don't we set that drum up on Constitution Avenue outside of Federal Reserve headquarters for interest rate announcements – Thus Speaks Greenspan? – and really pretend that all of the sound and fury that goes into guessing the outcome of these affairs is justified? The sad truth, my friends, is the market does an excellent job of setting the interest rates that really matter, the longer-term rates on which capital budgets are based, and it does it well in advance of the Fed. The Fed can buy and sell securities in the open market to target the overnight fed funds rate, the rate at which banks borrow and lend to each other, but all other U.S. interest rates of longer maturity are set in global capital markets without central bank intervention.

The forward rate structure measures the market's expectations for rate changes; forward rates are the rates for borrowing or lending in the future we can secure today. For example, the forward rate between one and ten years is the rate at which we could borrow starting one year from now for the next nine years. How well does this forward rate anticipate changes in Fed policy?

Very well, and that is good news, as we shall see below.

The Market Leads The Way



A Step Ahead

Let's take two recent points where the market clearly and finally made up its mind about the future course of interest rates, late January 1999 and May 2000; we could extend this analysis back for decades and arrive at the same conclusion each time. In January 1999, the financial markets concluded that the Asian and Russian financial crises were contained. The Fed did not begin tightening credit until the end of June, and then only by a tepid 25 basis points. Given the long and variable lags with which monetary policy operates and the tendency of excess liquidity to find its way into financial assets before new plant and

equipment, can we ascribe the final stock market boom into early 2000 in part to the Fed over-supplying funds? In part, yes.

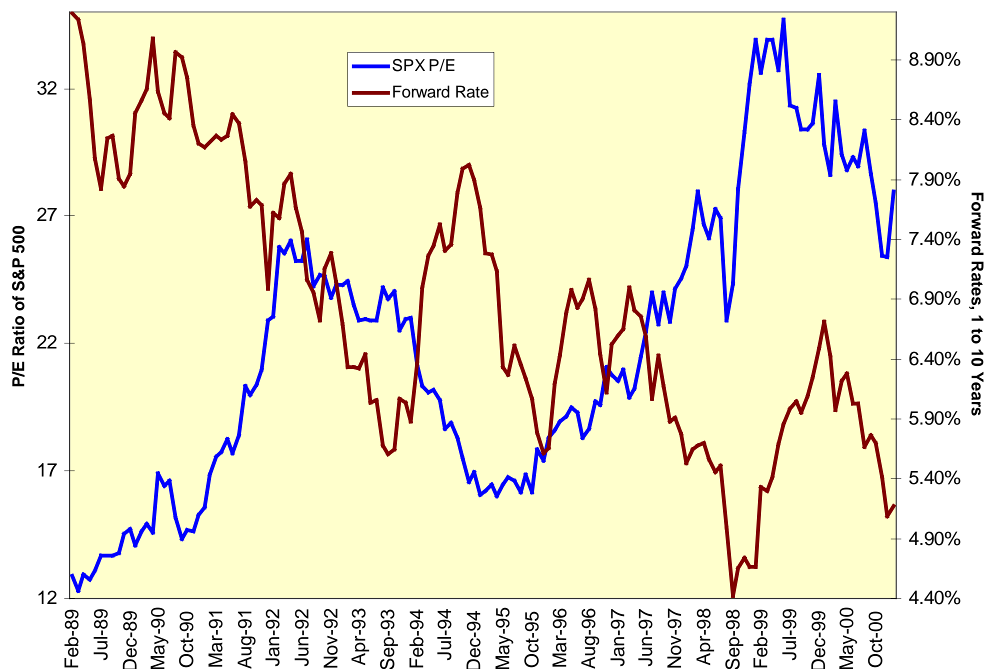
Forward rates began falling in January 2000, well in advance of the Fed's last set of rate hikes and nearly a year in front of its first rate cut in this cycle. Since the market had second thoughts in April 2000 – you remember the unpleasant events of that period, don't you – we'll mark the change in opinion from May 2000. Between then and the start of 2001, forward rates fell by more than 150 basis points while Alan and his Merry Pranksters were still blowing smoke about the inflationary menace.

Interestingly enough, forward rates have crept higher since the start of the year, even as the Fed has cut the funds rate twice. Either the market is anticipating, correctly or incorrectly, an economic stabilization or a surge in credit demands following the fiscal stimulus of a tax cut. If the market is correct, the Fed is once again late to the party, and no one should be surprised.

Forward Rates And P/E Ratios

A market economy is a gigantic confidence engine; we reinforce each other's behavior both to the upside and to the downside. Our willingness to take risk shows up in P/E ratios and in corporate bond market spreads to Treasuries, amongst other indicators. Since the inverse of a P/E ratio, the earnings-to-price measure, approximates the yield on equities before we adjust for anticipated earnings growth, forward rates should have an inverted leading relationship for how much risk we are willing to assume.

Forward Rates And The Appetite For Risk



Since the beginning of the last pre-recessionary rate cutting cycle in 1989, forward rates have been in a general decline with two prominent exceptions, the 1994 and 1999-2000 tightening cycles. Each time forward rates began to decline, P/E multiples started to expand in about six to nine months. Given this information, the January 2001 P/E expansion was right on schedule.

Good News Ahead?

Last year's forward rate decline, this year's expansion of the money supply, and the prospects for both domestic tax cuts and lower interest rates internationally provide an excellent backdrop for a stabilization

of the economy and hopefully for renewed profit growth. None of this will be easy, of course. Capital budgets are a function of confidence, and until planners feel better about spending on new plant and equipment, new technology equipment in particular, we won't get back to that glorious New Economy boom destroyed so unceremoniously by you-know-who.

But we'll get back on our feet again, we always do. And then we ought to think whether we need central banks dictating overnight rates in the future when the market itself does just fine. Ask not for whom the drum beats, Alan, it beats for thee.