Credit Spreads Start Flashing Red

John Maynard Keynes called them "animal spirits." Ronald Reagan extolled the virtues of the entrepreneur. In 2001, Alan Greenspan and his Merry Pranksters grabbed the same risk-promoting baton when they began their historic and recently ended rate-cutting campaign.

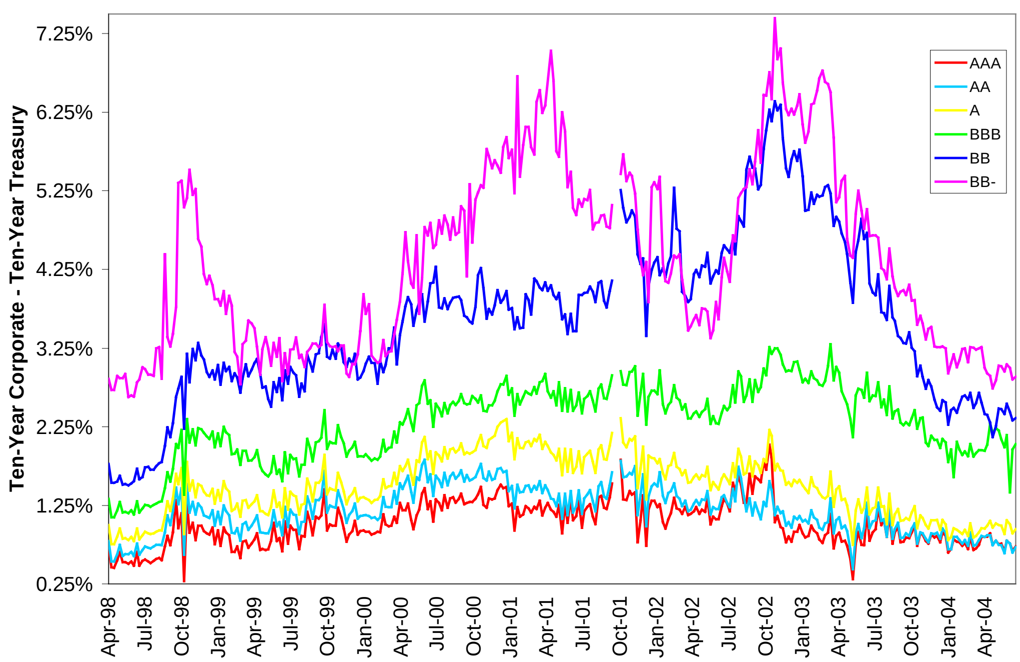
No evidence yet exists the Federal Reserve is trying to slow the economy down. Even if the federal funds rate rises to the 2% level embedded in the December federal funds futures contract it still will be below the rate of inflation and remarkably stimulative by historic standards. But the Federal Reserve does not control the economy like a puppet on a string, it can at best try to create an environment influenced more heavily by other factors and hope for the best.

We need to see whether some of these other factors, such as geopolitical risk, higher energy prices and the emergence of China as one of the world's most significant economic players have influenced America's appetite for risk as measured by credit spreads. The thesis here is simple: If investors are not willing to assume greater risk in bonds, which stand senior to stocks in the corporate credit hierarchy and which have a vastly different risk and reward structure, they will not be as willing to increase stock market multiples.

Nothing Happened Over The Past Six Years

The history of corporate credit spreads as measured by the Standard & Poor's Credit Week indices over the past six years, the point at which the S&P 500 first crossed today's levels, is telling. We begin with a period of credit spreads sufficiently narrow as to have Alan Greenspan warning bankers about their credit standards. This soon became a moot issue with the Russian default and collapse of Long Term Capital Management later in 1998. By November of that year, the Federal Reserve used the excuse of too-wide credit spreads as justification for their third 25-basis point cut in the federal funds rate.

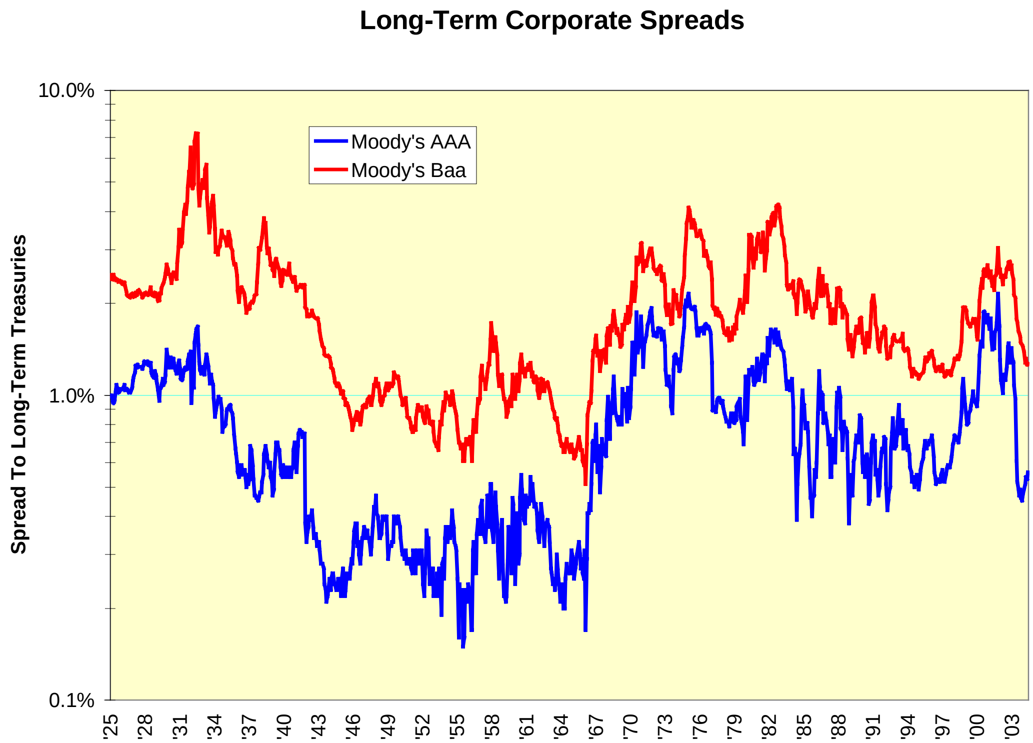
Corporate Bond Credit Spreads At A Ten-Year Horizon



Spreads narrowed into May 1999, the point at which the Fed began to unwind their post-LTCM rate cuts. Spreads then widened into May 2000, the last of the rate hikes of that cycle for issues rated BBB or better; the spreads for BB and especially BB- issues continued to move higher through the 2001 phase of the bear market in stocks. The two-week gap in history is the direct result of post-September 11 disruptions. Spreads exploded higher with the

Enron and Worldcom debacles in 2002, and then contracted sharply in 2003, with the lowest-quality issues seeing the biggest compressions.

We are now seeing spreads at pre-crisis levels of 1998, which certainly is consistent with an economy out of recession and with a very positively sloped yield curve with a still-accommodative monetary policy. Can it get any better than this?

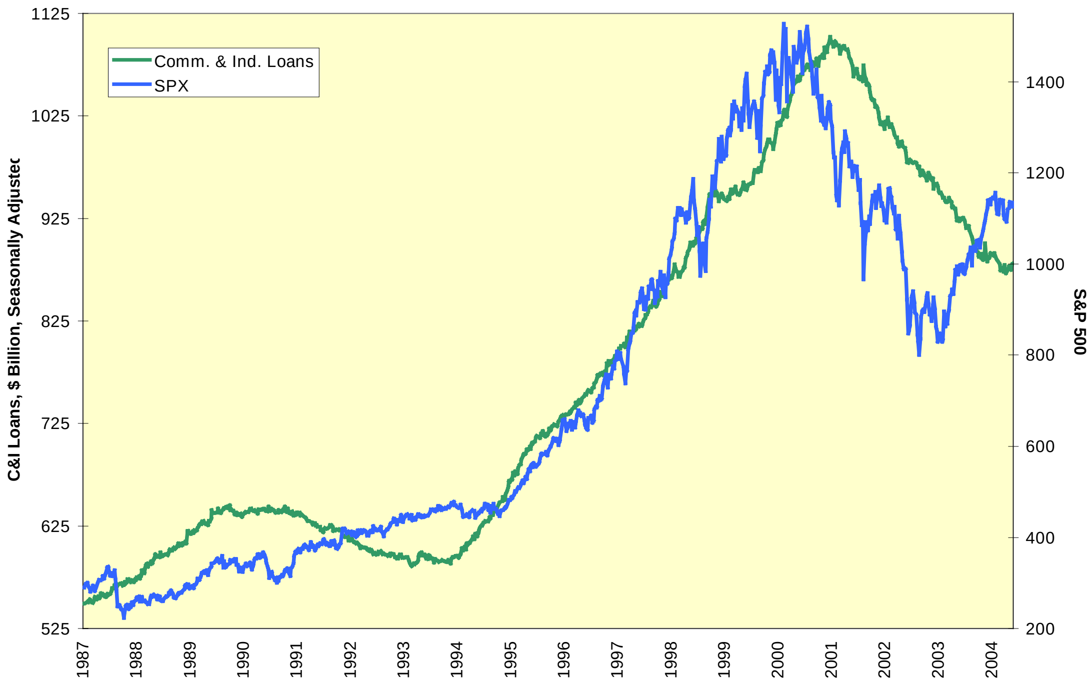


Yes, but unlikely. Present spread levels are close to the low end of the range prevailing since the upturn in inflation and interest rates in the mid-1960s. That period coincided with the growth of federal deficits produced by an expensive and interminable war, a lack of spending discipline by both the Congress and the president and an accommodative monetary policy.

The Vietnam-era experience, if repeated, would put upward pressure on credit spreads. Stock market historians - and aren't we all these days? - may note how the period of high and rising credit spreads between 1966 and 1982 coincided with a 16-year trading range in current dollar terms and an absolute slaughter in constant dollar terms.

A second source of upward pressure on credit spreads would derive simply from increased credit demands in the economy. The past three years witnessed one of the most profound declines in commercial and industrial loan demand on record; this was due to slack demand for new plant and equipment and better management of inventories. This downturn finally seems to have ended more than a year and one-half after stocks bottomed.

Credit Demands Finally Follow Stocks Higher

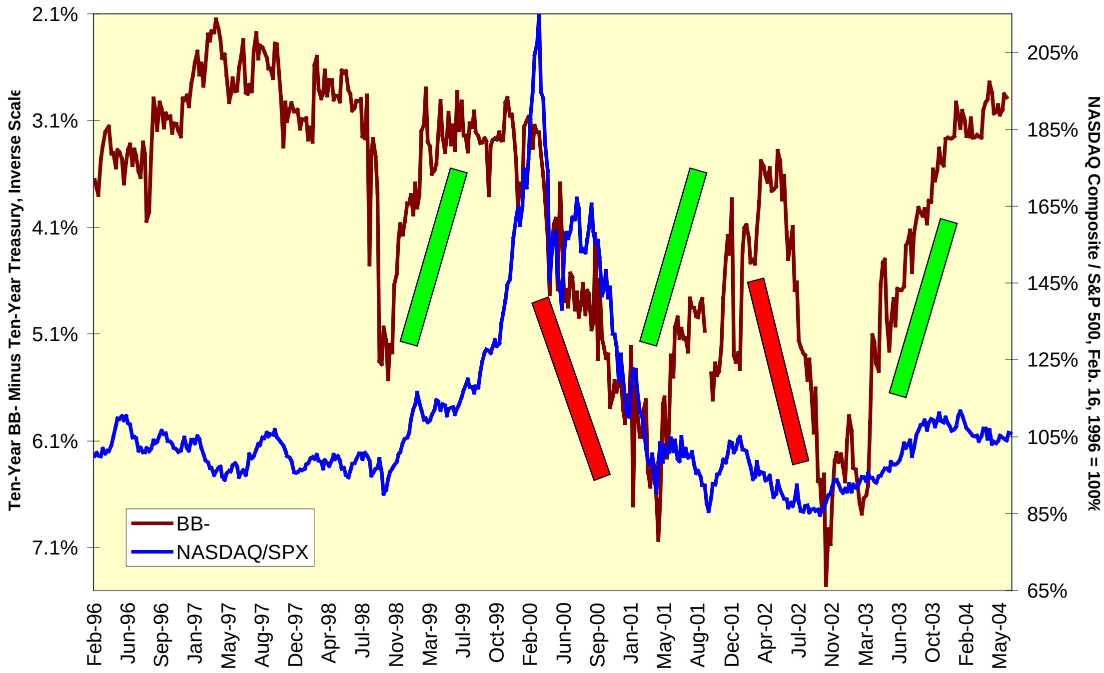


Implications For Equities

The reflation trade of April 2003 - January 2004 saw stocks ride contracting credit spreads higher. While some uncharitably characterized that rally as a flight-to-garbage, the data do not support this conclusion strongly. The last six years have witnessed three periods of narrowing BB- spreads, 1998-1999, mid-2001, and 2003. Only one of those contractions, 1998-1999, led to a major rally in the Nasdaq relative to the S&P 500. The contraction of 2001 had no effect, while the 2003 episode led to a mild relative Nasdaq rally.

The opposite is not true. The two periods of widening BB- spreads, 2000-2001 and 2002, both coincided with major flights away from the Nasdaq relative to the S&P 500.

Risk-Taking Has Yet To Resume In Stocks



Given that last year's contraction in credit spreads did not lead to a stronger rally in more speculative stocks and that we have pushed the contraction toward its limit, it is only logical to caution against accepting more stock market risk at the moment. Simply put, if we were going to see a pop higher from narrower spreads, we would have seen it by now. This is not a bearish call per se; it simply is a forecast that investors are unlikely to be rewarded for assuming additional risk.