Get Ready To Rock

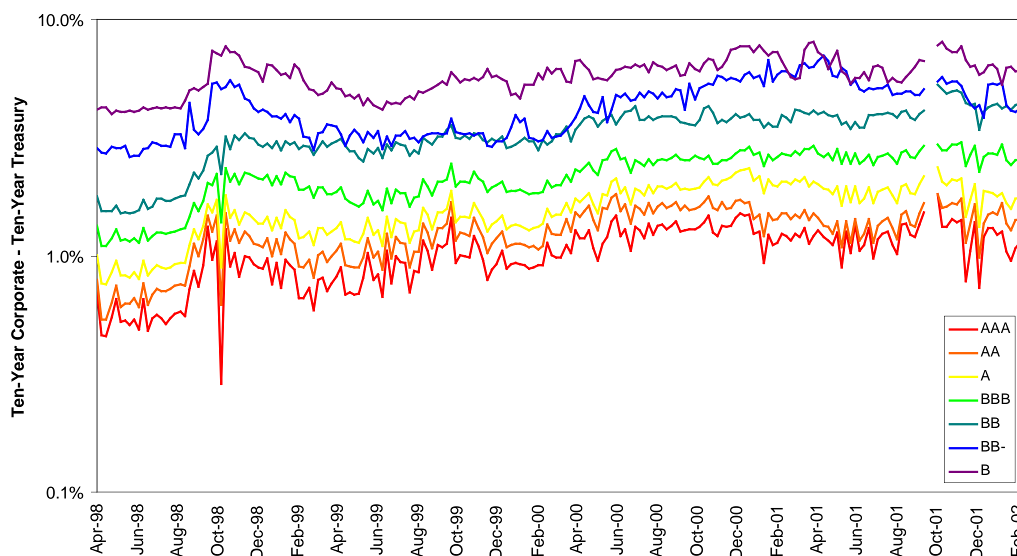
With apologies to both *Cool Hand Luke* and Alan Greenspan, what we have here is failure to exuberate. The macroeconomic news in the U.S. has been getting stronger to the point where no one should question whether the general recession is over, and yet the market has been struggling to get out of its own way.

I've said for years that when the technicals and the fundamentals diverge, you have to go with the technicals. Any windbag with a shoeshine and a business card can pontificate on what the market should be doing, but the technical structure of the market shows you what people actually are doing with their money.

If we view price as a convergent search process for value, we must accept the premise that the underlying economic value of any asset must lead price. Price must then catch up to value. Generally, price overshoots value, but that's another story altogether. While the meek are out there pretending they've inherited the earth and the bombastic have been getting rallies thrown back in their face for the better (worse?) part of two years, market tension is accumulating. The unleashing of liquidity and resolution of affairs to the upside will come with greater risk acceptance. Let's check out some credit market indicators to see if this about to happen.

Credit Spreads

We can compare the yields on various grades of corporate bonds with ten-year maturities, as provided by Standard & Poor's Creditweek, to the yield on the benchmark ten-year Treasury note. The two-week gap in September in the chart below is the result of the terrorist attacks. This credit spread measure is an excellent barometer of investor sentiment. As risk-seeking behavior diminishes, the spreads widen as investors demand greater expected return on their capital. A narrowing of credit spreads accompanies bull markets.



The spreads on investment grade bonds, those rated BBB or higher, rose significantly compared to their March 2000 levels. However, these spreads have narrowed considerably since the end of September 2001 despite an upturn induced by accounting uncertainties. Bond investors are different than their equity-besotted cousins: While a stock can capitalize hope, all that a bond investor can hope for is to get paid back. The self-delusive need not apply.

	Mar-00	Feb-02	% Increase		Sep-01	Feb-02	% Increase
AAA	0.99%	1.21%	22.45%		1.83%	1.21%	-33.75%
AA	1.23%	1.37%	11.55%		1.82%	1.37%	-24.59%
A	1.50%	1.74%	16.14%		2.36%	1.74%	-26.17%
BBB	1.99%	2.62%	31.77%		2.96%	2.62%	-11.39%
BB	3.25%	4.77%	46.85%		5.26%	4.77%	-9.26%
BB-	3.21%	4.40%	37.15%		5.47%	4.40%	-19.51%
B	6.18%	5.73%	-7.25%		7.80%	5.73%	-26.51%

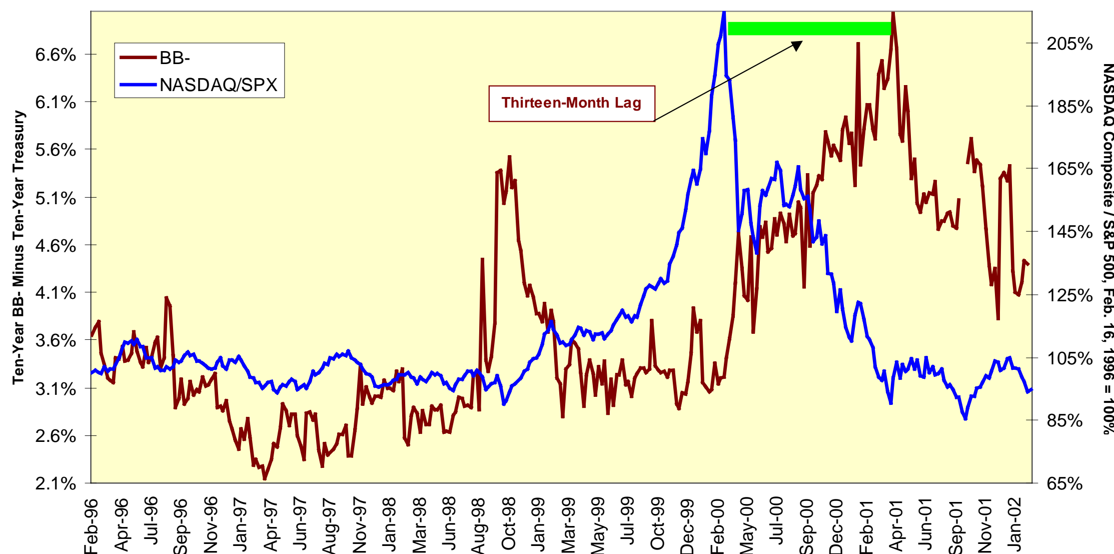
The spread on the lowest grade bonds, single-B, narrowed between March 2000 and February 2002, but this category is buffeted by large movements for a small number of illiquid securities.

Index Spreads And Risk

A second measure of risk-seeking behavior can be found in the spread between the NASDAQ and the S&P 500. If we compare the spread between ten-year BB- corporates and Treasuries against this stock index ratio, the inverted and lagging relationship is quite visible. The explosive October 1998 – March 2000 rally in the NASDAQ occurred alongside a significant drop in credit spreads at the BB- level. Both markets were willing to fund risky ventures.

Once the party ended, this credit spread started to expand and continued to rise into the April 2001 spike bottom in stocks. The BB- spread plunged in October-November 2001, the time of a sharp NASDAQ rally, and then into the start of the year. Barring another catastrophe on the order of Enron or another external shock, this spread should narrow as the economy strengthens.

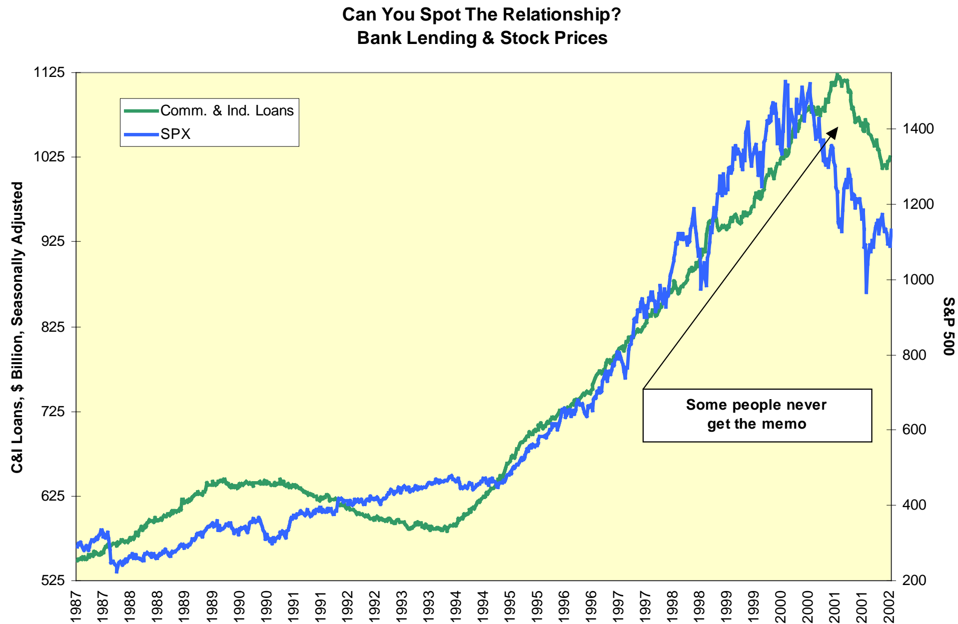
Even though technology and telecommunications are still mired in a slump, the conditions for investing in riskier equities appear to be in place. We're past the blood-in-the-streets point now, but investors in higher yielding bonds, convertibles, and small growth stocks should be rewarded.



Bank On It

Much has been made of bank credit being tight for lower-quality borrowers. This is to be expected. Bank lending is a lagging indicator of the economy. Well after business peaks, inventories are being financed and backward-looking financial statements remain strong. And, well after the economy rebounds, banks

who have been burned by late payments and defaults are reluctant to extend credit. Bankers, unlike investors, don't get rewarded for being the first one to buy.



The lagging relationship can be seen quite clearly in a comparison of commercial and industrial lending to the S&P 500. Bank lending won't pick up for months, but when it does, the extension of credit on top of the Fed's loose credit will expand the money supply and trigger what could be an explosive rally by the end of the year.

Earnings? Hey, we've earned this one.