Did Rate Cuts Restore Appetite For Risk?

When American Federation of Labor founder Samuel Gompers was asked what labor wanted, legend has it he replied "more." If we asked any random sampling of investors what they wanted, the response might be just as simple and invariable, "lower interest rates."

Sometimes this is appropriate, and sometimes it is not. Just as labor unions discovered to their regret they could price themselves out of the market by their own successes, investors often find lower interest rates lead to nothing more than inflation and unsustainable market bubbles. In the fall of 2000, as was declared here, (see "Give Credit Where It's Due," October 25, 2000) lower interest rates were mandated by the increasing credit quality spreads in the corporate bond market. The Federal Reserve, for reasons best known to them, held off on cutting rates until the beginning of the year. We warned at the time:

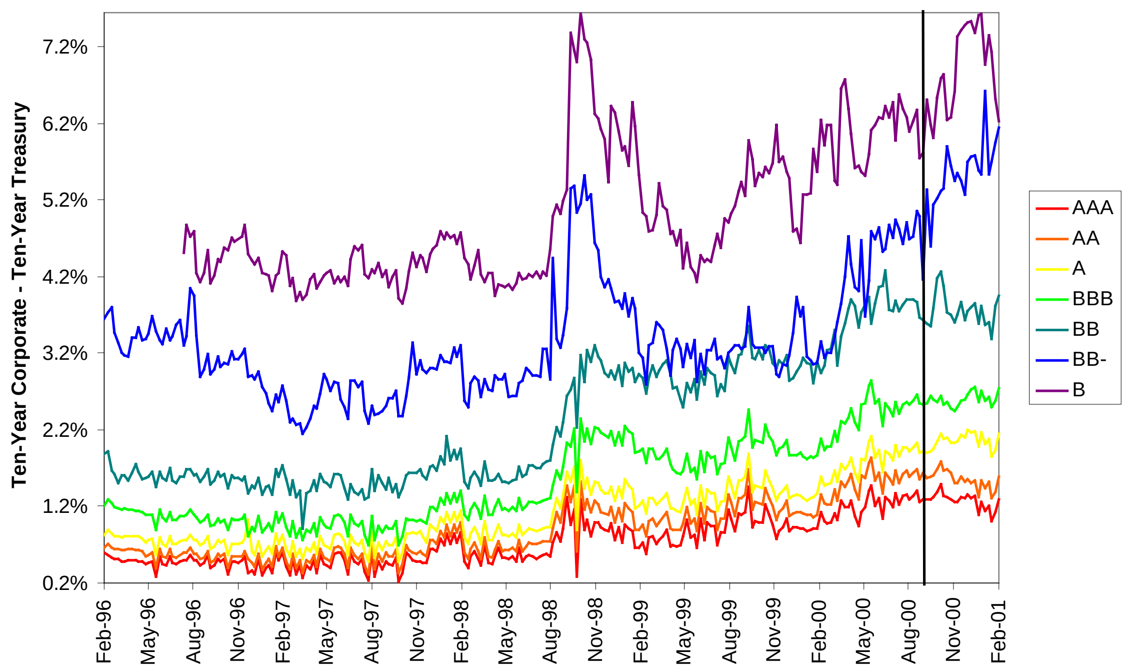
> Nothing is worse for any financial market than the dreaded credit crunch, the situation in which investors are unwilling to supply capital except at highly unusual rates of return. These periods are associated with financial institution failures, deliberate actions of the central bank, or with other 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.

The NASDAQ is off 37% from the time of that writing. It's time to update last fall's analysis in the aftermath of the Fed's policy change. Three questions arise. First, have credit spreads narrowed? Second, has investor appetite for risk been restored? Third, is another round of rate cutting justified by this measure?

If You Can't Say Something Nice...

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. This 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 movement of the spreads over the past four months is mixed at best. Values from the October 2000 analysis are noted with a vertical line.

Corporate Bond Credit Spreads At A Ten-Year Horizon

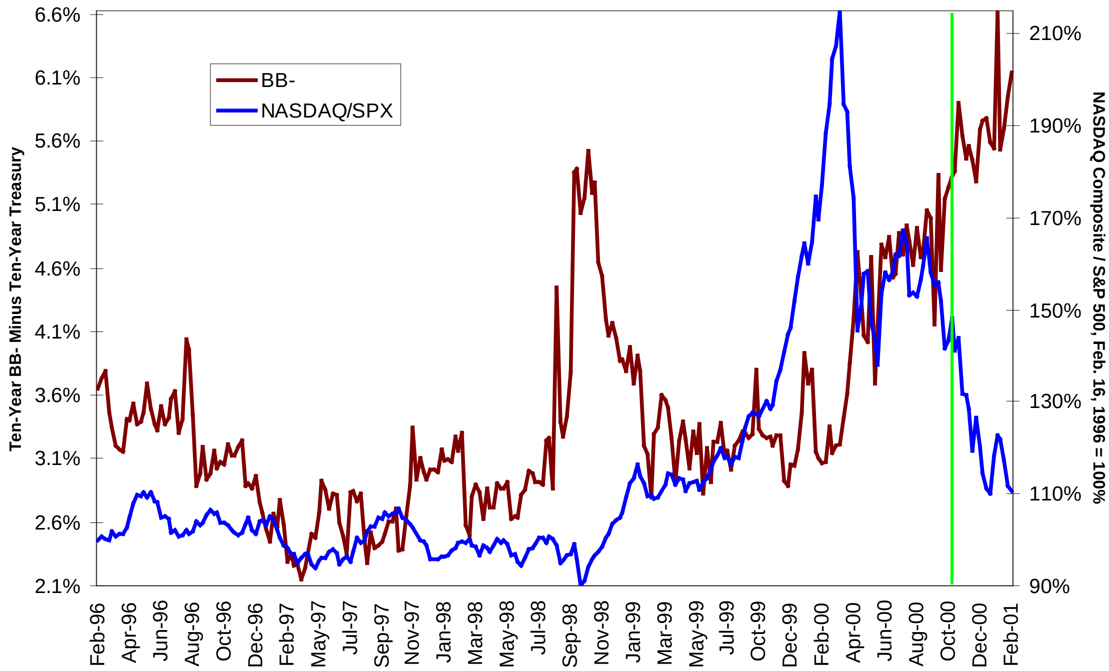


The spreads at grades BB and higher are roughly where they were in October. A modest narrowing of spreads in the immediate aftermath of the Fed's rate cuts in January is in the process of being reversed as the stock market declines resumed in February. The spread for BB- paper has exploded higher. Only the spread for B has started to narrow, and is approaching the spread for BB-. Only if these lower grade spreads both start to narrow will we be able to declare a return to risk-seeking behavior in corporate bonds.

... Then Be A Market Analyst In 2001

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 relationship is quite visible. The chart below is at once disturbing and encouraging: Disturbing in the horrendous flight from risk in both markets since last October, but encouraging in the sense that it sets the stage for the next rally – whenever that may come. The effects of the rate cuts can be seen as minor drops in the rate spread and a minor rally in the NASDAQ/SPX ratio by the end of January 2001.

Effect Of Credit Spreads On Equity Risk-Seeking



Where Do We Go From Here?

Viewed from the above perspectives, the Fed's rate cuts have not been effective. In fairness, any monetarist worth his salt – and this could be an oxymoron – would note that monetary policy operates with long and variable lags, which is a fancy way of saying we don't know what will happen or when. The commonly accepted lead time is six to nine months, which would put the start of any recovery in the third quarter of this year.

Monetary policy alone cannot produce risk-seeking behavior; this has been demonstrated in the U.S. during the 1930s and in Japan since 1990. In fact, the Greenspan Fed's previous rate cutting extravaganza in the early 1990s wasn't notably effective in igniting economic growth until markets were assured of fiscal discipline in late 1994 by the combination of Robert Rubin at the Treasury and a new Republican Congress.

So, should the Fed continue to cut rates? Yes, but only in an amount sufficient to accelerate the narrowing of credit spreads. Further cuts, as economists of the rational expectations school would note, will accelerate inflationary expectations without affecting employment and output. This is happening already: Since the Fed's first rate cut on January 3, the spread between normal and inflation-protected ten-year notes has risen from 1.506% to 1.78%. If business is bad for marginal firms, and this is what a recession is all about, then they won't be interested in borrowing for capital expansion, and lenders will demand higher yields. In other words, monetary stimulus will become ineffective.

Of course, Samuel Gompers never said "Only a little bit more." Maybe Wall Street should take the lead in the subtlety department, take a small rate cut, and focus on rebuilding the economy for the inevitable next boom. And a little patience won't hurt, either.