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FED SHADOW

Where's the Risk?

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It was totally overlooked in the reporting on his testimony in the financial media, but one of the more telling moments in **Alan Greenspan's** Capitol Hill appearance last week came when he hit on what may be the primary reason the sustainability of the current economic rebound remains in doubt. "Improved profit margins over time and more assured prospects for rising final demand," the **Fed** chief told the **Joint Economic Committee**, "would likely be accompanied by a decline in risk premiums from their current elevated levels toward a more normal range." Note the use of the conditional "would" in Greenspan's phrasing: were the economy entering a convincing growth mode, risk premiums *would* be falling. Greenspan quickly turned to a discussion of the still-attractive returns available to be captured through high-tech capital investment once risk premiums recede. Nevertheless, the fact that they have yet to do so is an indication of the uncertainty that continues to attach to the outlook for "improved profit margins" and "rising final demand" -- or sustainable expansion.

That's consistent with the analysis we've presented over the past few months showing that in the face of all the chatter about a sustainable V-shaped recovery in the offing, the market's most sustained feature remains a pronounced risk aversion. Such risk abhorrence is incompatible with notions that the economy is now in the early stages of vibrant expansion. For one thing, the premiums still available across a range of risk-based financial assets would be rendered highly attractive were the economy actually poised for a durable growth breakout. And in the process of absorbing the risk premium that would be manifest as an effect of faster expected growth, the market would be laying the foundations of the more capital-rich environment capable of generating sustained expansion. The risk premium in the cost of capital remains at levels inhibiting not only the resumption of robust rates of high-tech capital investment. The high price of risk continues to stand as a direct impediment to the financing of innovative and entrepreneurial enterprise that is the lifeblood of any economic expansion. On that score, in a report last month I noted first signs of an easing in credit quality spreads in the high-yield debt market (see "Recovery Buster" March 15, 2002). In the weeks since, however, that progress has come to a halt, and spreads on net have actually widened slightly, with the S&P Speculative Grade Credit Index now standing at 615 basis points.

Though Greenspan would be among the last to admit it, the stubborn persistence of these conditions appears tied primarily to the lingering effects of the Fed's monetary deflation, relief from which various market-based price indicators suggest remains in doubt. The rise in the price of gold so far this year, to a range around $300 per ounce from below $280, is probably the best indication available of somewhat reduced scarcity in the market for dollar liquidity. As I pointed out in a *TrendMacro Live!* bulletin Friday, though, recent gold price volatility could be signaling a rising risk of price retrenchment. Broader commodity price indexes, meanwhile, have shown only tentative and halting signs of recovery. Through the end of March, for example, the CRB Spot Index, which excludes oil, had managed to rise by some 7% off its 24-year lows of last October. Since then, however, it has fallen back again and at around 216 the CRB Spot remains mired in a deflationary bog, down 10% on net since last summer, 25% below its levels five years ago. At the same time, the dollar's foreign exchange value, as tracked by the G-6 Trade-Weighted Forex Index, is down just 3% from near-15-year highs early this year.

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After the evaporation of some $3.5 trillion in equity market wealth the past two years, a direct consequence of the Fed's calamitous policy course, those indications are not likely contributing to a process of healing the market's wounded risk propensity. Essentially, the Fed-engineered excess dollar scarcity came at the expense of the nominal dollar revenue streams from which profits are derived. Unmet dollar demand was evinced in a falling turnover ratio (velocity) of money, showing through in a sharply slower pace of monetary transactions (see "Now What?" January 28, 2002). Between the third quarter of 1999 and last year's final quarter, the annualized growth rate of nominal GDP plunged from 6% to 1.5%. Continued indications of weariness in market-wide risk-bearing, then, can be seen as reflecting high uncertainty over the forward outlook for nominal growth, which by implication also suggests a dearth of confidence in the Fed's ability to maintain a non-deflationary course. That would also be consistent with a strong degree of skepticism about the sustainability of what is likely to be reported as a fairly strong first quarter in Friday's advance GDP report. As we've noted, that result has been almost preordained by the record volume of inventory liquidation recorded last year.

No doubt, Greenspan has committed more than his share of extremely costly errors over the past several years to put us in this spot, but at least he seems to understand which approach would be totally inappropriate to current conditions. Indeed, it would be difficult to imagine a less opportune policy response than if the Fed were now to initiate a precipitate and premature reversal of last year's rate cuts. That fear, in fact, could well be a marginal factor in maintaining elevated risk premiums, which may have been the target of Greenspan's efforts to soothe those concerns last week. Needless to say, we are wholly unpersuaded by suggestions that Greenspan's "dovish" tone was responsible for any decline in confidence in the dollar's purchasing power. Several analysts suggested that this rise in inflation risk was indicated by the one-point sell-off at the long end of the Treasury yield curve on the day of his testimony. More likely, long maturities were, for a brief period, bearing the brunt of position-shifting along the curve, as portfolios moved into the short end to take advantage of the further erosion of rate-hike expectations encouraged by Greenspan's testimony. In any case, whatever rupture of confidence Greenspan may have set off was extremely short-lived, as the long bond today, at about 5.66%, is trading at yields below those of the day prior to his appearance last week. TM