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MARKET CALLS

Good Things

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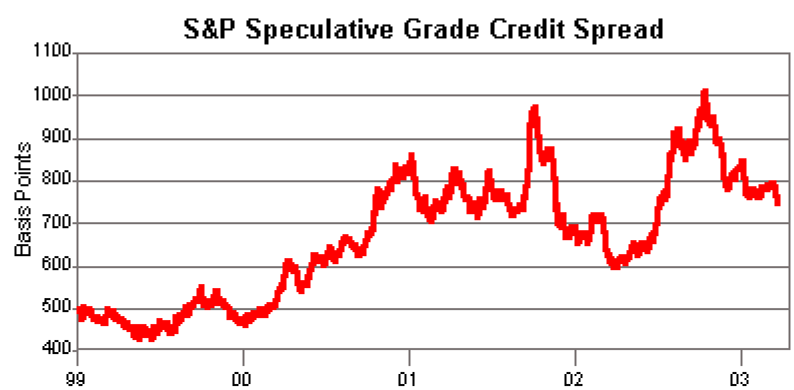
It's time for the recovery of risk tolerance, and that means more bad news for Treasuries.

It has now been little more than a week since the **Bush administration** moved to cut the Gordian knot of diplomatic paralysis and militarily confront the **Iraqi** regime, ending the spasm of uncertainty afflicting financial markets. But among the Wall Street economics establishment and its mouthpieces in the major media, skepticism remains rife that capital markets are pricing anything more than a relief rally, with little implication for underlying economic conditions. According to this view, the economy continues to suffer from the hangover of the late-1990s equity "bubble," and the familiar litany of excess capacity, elevated debt burdens, depleted savings, *etc*., *etc*., *etc*. One prominent Wall Street wag, reviewing the backup in Treasury yields since last week, downplayed the economic significance of the move because it only reflects an unwinding of risk-aversion, and not a "fundamental change in economic circumstances."

In fact, though, as we have explained in considerable detail, it is risk aversion that has been the primary obstacle to more robust expansion over these past many months. Essentially, the heightened risk premium in the cost of capital meant that an elevated hurdle rate of return was required to justify the commitment of investment resources, thereby restraining capital formation. During most of last year, our analysis was that a lack of confidence in **the Fed's** ability to sustain a reflationary monetary course was the leading factor explaining the paucity of capital being put at risk. In the past few months, however, even as it became clear that the Fed had adopted a clear-cut anti-deflationary posture, geopolitical tension has become the dominant factor hindering investor and business willingness to bear risk by committing capital to endeavors with uncertain future returns.



In other words, an unwinding of risk aversion is probably as positive an indication of restored expansionary impulses as one could currently hope to identify, and we see several. The stock market rally of 13.5% from last week's lows is one of the more obvious such indicators, implying a reduced cost of capital as the market absorbs the still-hefty risk premium in equity assets. Perhaps even more impressive, though out of the spotlight that shines so brightly on the daily permutations of the equity markets, has been the contraction of credit spreads, particularly in higher-risk debt sectors. Since March 11, the S&P speculative grade spread has tightened by more than 50 basis points.

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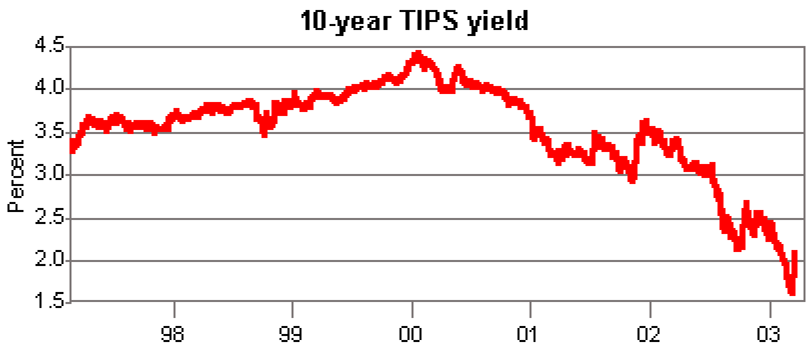
Although the bulk of this move has been accounted for by the sell-off in Treasuries, we continue to see considerable upside in junk bonds, and reaffirm our **Model Position long high-yield debt**. This sector held its own even in the midst of the equity market reversals of the past two-plus months, reflecting the debtor relief implied by the Fed's anti-deflationary stance. But as the accompanying chart suggests, current yields and spreads leave significant further headroom. That has highly positive economic implications because, as risk premiums in high-yield debt are being absorbed, a higher level of entrepreneurial activity with the greatest potential growth payoffs is being financed.



The other side of this growth bet that seeks to take advantage of unwinding uncertainty is a bet *against* those instruments that have benefited most from the recent risk abhorrence, and we are today opening a **Model Position short the 10-year Treasury bond**. To be sure, Treasuries have come a long way in a very brief period of time, with today's blow-out putting the yield -- at above 4.10% -- about 55 basis points from its lows early last week. But our supposition is that this sell-off still has a long way to go. Some guidance on that score is provided by Treasury's 10-year inflation-indexed note (TIPS), which has given back just slightly more yield than the nominal bond (60 bps) since last week. That suggests that the downside in nominal Treasuries is driven primarily by the potential rise in real yields, and the chart above is an indication that the normalization of real yields is not nearly complete. Restoration of the TIPS yield to a level around 3% appears eminently plausible. Holding constant a spread of 180-200 bps between nominal and TIPS yields, which has been the recent range, that implies a yield approaching 5% on the nominal 10-year. TM