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MACROCOSM

Stirrings

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The market's awakening isn't about last quarter's earnings -- it's about the gradual return of the preconditions for growth.

As the broad equity market climbs back toward levels reached in the early days of the year prior to being buffeted by mounting geopolitical uncertainty, the sustainability of the move remains subject to considerable skepticism. After a three-year bear market marked by any number of failed rally attempts, such caution is understandable. Certainly, to the extent this rebound can be explained as a response to first quarter earnings results that simply managed to surpass worst-case doom-and-gloom expectations, it's no cause for unrestrained celebration.

To be sure, there continue to be sticking points in the political-economic environment that leave us hesitant to offer any "bull is back" guarantees -- the machinations on **Capitol Hill** over **President Bush's** tax-cut proposal being one obvious example. But we also see increasingly encouraging signs of life in indicators of grassroots, entrepreneurial activity that were rendered dormant for so long by the tsunami of risk abhorrence. We are dubious that relief over last quarter's earnings turning out better than expected has been the marginal factor allowing the market to maintain its run-up of some 14% off last month's lows. Rather, with the end of the long waiting game over **Iraq**, investors turned their gaze toward brighter prospects on the horizon. Those encouraging forward-looking indications have allowed the market to absorb a rising proportion of the still-hefty risk premium in asset values, implying a lower cost of capital and helping foster somewhat improved economic sentiment. The market, in other words, has been moving up far less on the strength of last quarter's earnings than on anticipation of *next* quarter's, the quarter after that, and so on.

Over the past few months we have pointed to the recovery of the high-yield debt market as an early indication that even in the midst of the broad market's paralyzing risk aversion, signs of an emerging recovery in expected returns were becoming visible. Indeed, high-yield debt has so far been the "asset class of the year." Our **Model Position long high-yield bonds** is now up 10.1% on a cash basis since its inception on January 6, 2003 (and up 386% on a futures basis). The S&P Speculative Grade credit spread -- at less than 675 basis points -- is now at its lowest levels since last June, having tightened by nearly 50 bps in just the past month. We also suggested that the steady absorption of the exorbitant risk premium in junk debt implied that a source of capital to finance higher-risk endeavors with the greatest growth potential was becoming available. Just released figures on first-quarter issuance bear that out as, according to **Thomson Financial**, 95 deals worth some $27 billion came to market in the first three months of the year. That already amounts to nearly half of the $59 billion in new issuance for all last year, and is a pace that would exceed the $100 billion level last seen in1997 and 1998. In fact, new junk issuance hasn't topped $80 billion since 1999, when $87 billion was offered. In our model, the market's capacity to absorb risk is indispensable to a robust pace of expansion characterized by income expectations rising steadily into the future. The comeback of the junk bond market is an unalloyed positive in that regard.

We are also heartened by an apparent brightening in the outlook of grassroots entrepreneurs. A survey of small business owners by **American Express** found more than half planning near-term capital investments, most for new technology. More than a third also plan to hire new employees within the next six months, the majority of which will be used to build volume in existing businesses. While these may not represent ground-level readings of a new boom in the making, against the overwhelming negativity of recent months, it's a promising sign that, at the margin, entrepreneurs are preparing to grow again. TM