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IPOs Say Go

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The talk remains gloomy -- but the encouraging action in IPOs and high-yield debt speaks louder than words.

Amid stubborn skepticism over the strength and durability of this economic expansion and its corresponding equity rally, important affirmation of an upbeat outlook is coming from a financial market sector largely abandoned in the post-"bubble" environment of intense risk aversion. The market for initial public offerings, virtually inert for most of the past three years, is springing back to life.

The past two weeks have seen the pricing of six new offerings, raising a total of $1.2 billion, with another dozen or so now slated to come to market within the next few weeks. While present conditions hardly represent a return to the go-go IPO days of the late 1990s, the signs of progress are unmistakable. Before this month, only 24 new listings had been priced this year. The second quarter was the worst in some 30 years, with pricing of just five issues for a total of $1.6 billion -- the last two weeks alone have almost matched that

The nascent revival of the IPO market is a strong rebuttal to the dour sentiment lingering in significant segments of the "mainstream" analyst/pundit community. In fact, here and there we see scribblings suggesting that the recovery of IPO activity is itself an indication of a worrying decline of investor skepticism that could bode ill for the sustainability of the equity market at current levels. This reflects a fundamental misreading of the forces at work.

The ability of immature, entrepreneurial enterprises to again begin accessing the capital markets for equity financing indicates that the market's growth-critical risk tolerance is being restored. The market, in other words, anticipates that the risk in these new equity issues will be compensated by higher returns, which in the aggregate translates into faster expected growth. There is, moreover, a crucial self-reinforcing quality in restoration of the market's risk tolerance. By extending its appetite for riskier assets, the market is reducing the cost and increasing the availability of risk capital, the mothers' milk of the innovative activity which drives all growth.

The long-awaited signs of recovery in the IPO market could represent final confirmation that the prohibitive risk premia in the cost of capital imposed by deflationary monetary error and paralyzing geopolitical uncertainty have been absorbed, allowing capital formation to flower again. Since early this year, we have closely followed the rally in high-yield debt, which as the asset class most devastated by **the Fed**-engineered deflation was also the first to feel the effects of deflation relief. As well, the recovery in capital expenditures, led by the high-tech sector, indicates that expected returns -- and confidence in those expectations -- have recovered sufficiently to encourage the resumption of fixed investment activity. New-issue equity financing, however, among the least secure of all investment options, would figure to be the last to respond, especially considering the shroud of fear that enveloped the IPO market in 2001 and 2002.

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These encouraging signs of recovery in the market's wealth-creating animal spirits, however, also serve to underscore their vulnerability to some of the mistaken policy options now in play. Investing in high-risk equities is primarily about investing for the prospect of real, after-tax, capital gains. Expected gains, however, are highly sensitive to the interaction of the capital gains tax rate and the rate of inflation, since capital gains are not indexed for inflation. No doubt, the lowering of the nominal cap gains rate from 20% to 15% in the tax bill enacted last spring was a meaningful factor in the swing of the aggregate market portfolio toward riskier assets. An increase in the inflation rate from 1.5% to 3%, however, would nullify the impact of the nominal rate cut on the real effective cap gains rate. A 4% inflation rate would mean a 60% higher real cap gains tax burden. In this context, it's clear that the Fed's continued courting of inflation risk, as well as the **Bush administration's** toying with the destructive notion of "competitive" exchange rates, could impose costs that would come at the expense of the risk taking so critical to robust economic expansion. TM