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The Wages of Fear

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Rising risk aversion is alarming -- but it's also a gift.

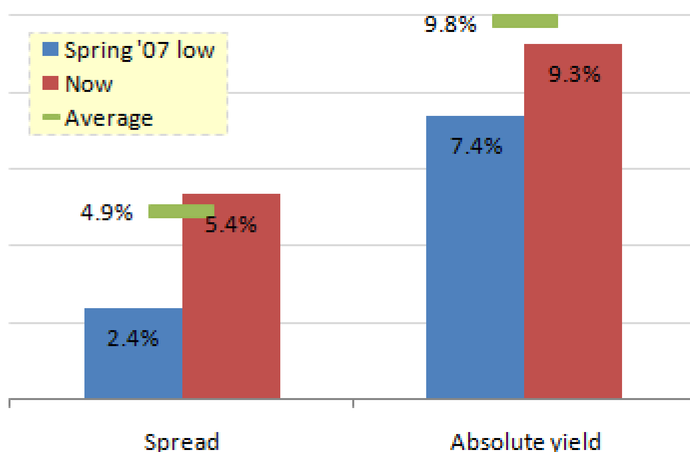
We're not joining the panicking crowd expecting recession, but we are becoming concerned about the likely hit to growth arising from the present mood of panic itself (see "Fear Itself" November 16, 2007). A full-blown recession is highly unlikely in today's environment of accommodative Fed policy, resulting in abundant monetary liquidity and low nominal and real interest rates. That likely provides a backstop against the worst-case scenarios being bruited about regularly in the marketplace of ideas. But ironically, the Fed's evident pessimism has contributed to a rising risk-aversion that we see reflected in both survey data and financial markets. As it expresses itself in retreating investment, hiring and spending activity, it's likely to brake economic activity from the very rapid growth seen in the second and third quarters.

Update to strategic view

US STOCKS, US BONDS: The record high equity risk premium, the relationship between the price of risky earnings and the price of riskless bond income, is a symptom of how growth expectations are out of whack with the very accommodative posture of Fed policy. This makes a compelling case for owning stocks and selling Treasuries. By historical norms, all but the most extraordinary risks are already priced in.

[see Investment Strategy Dashboard]

The interaction between an accommodative Fed and increasingly risk-averse sentiment can be seen in the market for high-yield debt. The *spread to Treasuries* of the Merrill Lynch High-Yield Index has risen from its cycle low at 2.4% on June 1 to 5.4% today -- a move of 3.0%, indicating a significant pullback from the unrealistically liberal risk tolerance in the heady days before the subprime crisis materialized in July. At the same time, the *absolute yield* of the index has risen much less, from 7.4% to 9.3%, a move of only 1.9%, because Fed rate cuts and expectations for further cuts have moved Treasury yields far lower than they were in July. So while risk aversion is on the



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rise, the Fed's accommodative posture has kept the *absolute cost* of risky financing from rising to prohibitive levels. Even without the assist from the Treasury curve, today's high-yield *spread* is not growth-prohibitive -- at 5.4%, it is only modestly above the long-term average of 4.9%. But *with* the Treasury assist, the *absolute yield* at 9.3% remains below its long-term average of 9.8%, a position that is modestly growth-positive. By way of context, in late 2000, yields rose to above 15% and presaged a recession -- and that was in a tight monetary environment most unlike the accommodative one in which we find ourselves today.

For investors, risk aversion has its advantages -- it gets you paid for the risks you take. It was difficult to construct a scenario sufficiently rosy to justify owning high-yield bonds at a spread to Treasuries of 2.4% last June. But remarkably, even starting with that poor remuneration for risk, and even in the face of rapidly rising spreads and absolute yields in the midst of a credit crisis, an owner of the Merrill Lynch High Yield Index has suffered only a 2.8% loss on a total return basis. So today's high yield spread of 5.4% suggests, on the one hand, a worrisome aversion to risk. But on the other hand, it also suggests a level of reward that will make risk-bearing attractive and feasible, especially in an environment being flooded with monetary liquidity by the Fed (see "Fed Liquidity Runneth Over" November 7, 2007).

Similarly, we can view the decline in equities from their all-time highs six weeks ago with alarm, as a harbinger of economic weakness. We are not turning a blind eye to that interpretation. At the same time, with Treasury yields as low as they are, and with only the smallest decline in consensus forward earnings -- virtually none at all if the financial sector is excluded -- the decline in stocks has created an historic opportunity to be remunerated for risk-bearing. We pointed out last week that the equity risk premium, the spread between the forward earnings yield of the S&P 500 and the yield of long-term Treasuries, was at its highest level since accurate data became available in 1984 (see "Time to Earn the Panic Premium" November 13, 2007). As of this writing, stocks have moved lower, and the risk premium has become even more attractive.

S&P 500 total return, based on equity risk premium, 1984 to 6/2007					
Average	1 mo	3 mo	6 mo	9 mo	12 mo
Risk premium > 1SD	1.4%	4.2%	8.2%	13.1%	17.2%
All periods	1.1%	3.3%	6.8%	10.4%	14.1%
Worst	1 mo	3 mo	6 mo	9 mo	12 mo
Risk premium > 1SD	-3.1%	-3.3%	0.7%	3.6%	5.4%
All periods	-21.5%	-29.5%	-28.4%	-28.2%	-26.6%

Historically, whenever the equity risk premium has been extremely elevated, it's been a time of fear and uncertainty, yet a time when that fear and uncertainty were more than fully compensated. Since 1984, from periods when the equity risk premium was more than one standard deviation above its mean, subsequent periods have, on average, produced above-average performance. It's very much worth noting that the *worst* performance following periods of an elevated risk premium has not been bad at all. For example, the worst 1-month performance was a loss of only 3.1%, and the worst 12-month performance was a *gain* of 5.4%. At the extremes, the equity risk premium is a panic premium. It has always paid to bet against it.

BOTTOM LINE: The record high equity risk premium, the relationship between the price of risky earnings and the price of riskless bond income, is a symptom of how growth expectations are out of whack with the very accommodative posture of Fed policy. This makes a compelling case for owning stocks and selling Treasuries. By historical norms, all but the most extraordinary risks are already priced in.