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Vicious Cycle Visions

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This recession will end like they all do -- when risk premia coax capital back to work.

The credit market freeze continues to show encouraging signs of thawing, with LIBOR funding rates falling sharply and the TED spread down more than 250 bp from its panic-induced peak above 450 bp last month. But the crisis of confidence spurred by a brush with financial cataclysm is now reverberating through the real economy, with a sharp slowing in all facets of economic activity (see "Fear Itself, Volume 2" September 23, 2008. Fear of the worst can become self-fulfilling for a time, but we expect that the economy's self-healing powers will assert themselves in due course, paving the way toward revitalization.

Update to strategic view

US MACRO, US BONDS: In a recession it always seems that there is no escape from the vicious cycle of contraction. But without monetary deflation, recovery will come when risk premia are sufficiently attractive to coax even risk-averse capital back to work, eventually leading to a restoration of risk-bearing capacity. At record highs, risk premia in corporate bond markets across the credit spectrum are surely at levels approaching the irresistible -- levels at which, even as bad news continues to pour out, prospective returns overwhelm prospective risks.

[see Investment Strategy Dashboard]

In an atmosphere of such widespread gloom, it's perhaps understandable that even the most pessimistic assessments can seem plausible. Now gaining some credence is the idea that the economy is entering a self-perpetuating vicious cycle, with no end possible until complete collapse occurs, with a number of observers suggesting that the logical endpoint is outright depression. In any downturn, there are characteristics of a vicious cycle at work, with declines in business and consumer spending leading to production cutbacks, which leads to job losses and falling income, which further reduces spending and production, and so on. This is what is now being experienced. But not all vicious cycles lead all the way to ruin -- in fact, all recessions have this dynamic at work within them, and they generally manage to resolve without turning into depressions.

Key documents

"The Debt-Deflation Theory of Great Depressions" Irving Fisher, 1933

From our Client Resources page

The classic exposition of this dynamic was made in 1933 by the great monetary economist Irving Fisher, in a paper called "The Debt-Deflation Theory of Great Depressions." Writing from the depths of the Great Depression, Fisher aptly recognized the critical role of monetary deflation in perpetuating the vicious cycle of debt liquidation and economic contraction, and he correctly blamed the Federal

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Reserve for having permitted the deflation of the early 1930s to occur. It is noteworthy that the present-day Fed has not made a deflationary error in the current cycle. From the moment the economy entered mere slowdown, the Fed started to ease -- and that from a posture that was not especially tight to begin with. Now that the slowdown has become a recession, the Fed has already long held real interest rates at negative levels. While the sharp drop in oil prices may produce several months of apparent deflation, at least statistically, the underlying reality is that monetary conditions are the opposite of deflationary -- if anything, they are inflationary.

So this vicious cycle will be broken, as vicious cycles always have been, by the re-emergence of the market's capacity to bear risk. As risk abhorrence eases and the opportunity to realize an attractive return is reasserted, fresh supplies of capital will become available -- having not been destroyed in this downturn by monetary deflation -- powering a resumption of productive economic activity. Some analysts are propagating the notion that the credit upheaval has been such a blow to confidence that it will take several years for normal levels of risk tolerance and entrepreneurial activity to resume. We don't buy it. The natural condition of economic actors is to take risk and seek to prosper through entrepreneurship and innovation. Those are the building blocks of economic growth. Yes, those animal spirits have been undermined by the recent turmoil, but they haven't been extinguished. As long as the market's stability is sustained, basic levels of confidence will be restored and risk-taking activity will resume.

Certainly, some eye-catching opportunities to capture extremely elevated risk premia have become apparent. It's well known that the junk bond market has gotten slaughtered, with the Merrill High Yield Index spread still running at near-record highs above 1,600 bp. It's also the case that spreads even on investment grade debt have blown out to depression-like levels. The AA 10-year spread is now at 255 bp, versus about 75 bp prior to the outbreak of market turmoil last year. One leading indicator of the corporate credit market, swap spreads, suggest that a rally may be in store. Two-year swaps have dropped nearly 60 bp from their peak above 160 bp last month. While that's still high by historic standards, the narrowing of the spread is a key sign of the healing process at work in the credit market.

One wild card in the outlook is politics, particularly the plans of President-elect Barack Obama (see "Bearack Obama" October 31, 2008). Restoring the market's risk-bearing capacity would in no way be aided by Obama's campaign pledge to raise tax rates on "the rich," in as much as it would reduce the after-tax return to risk taking. Since the election, he has at least given the impression of keeping his options open on the issue, which may be the most that can be expected from him at this point (see "It Ain't My Job" November 10, 2008).

BOTTOM LINE: In a recession it always seems that there is no escape from the vicious cycle of contraction. But without monetary deflation, recovery will come when risk premia are sufficiently attractive to coax even risk-averse capital back to work, eventually leading to a restoration of risk-bearing capacity. At record highs, risk premia in corporate bond markets across the credit spectrum are surely at levels approaching the irresistible -- levels at which, even as bad news continues to pour out, prospective returns overwhelm prospective risks.