Financial markets

A question of perspective
Mar 18th 2004
From The Economist print edition

The outlook brightens for government bonds and darkens for riskier assets

TO NO one's surprise, America's Federal Reserve left short-term interest rates at a 46-year low of 1% on March 16th, again with heavy hints that they would stay there a while. Perhaps, indeed, for longer than many had thought: output, previously described as "expanding briskly" is now merely growing "at a solid pace"; and the Fed gave a nod to the weak jobs market that it had not given before. Some economists now think that rates will not be raised until the middle of next year.

Ultra-low interest rates pose a huge problem for investors and ultimately for the Fed itself. The central bank's stance has encouraged punters to take risks on an unprecedented scale. America's rock-bottom interest rates have unleashed a flood of money into risky assets the world over. Since late 2002 everything from rich-country shares to emerging-market bonds have soared as American investors, who save almost nothing, have sought better returns than the desultory ones available from popping their money in the bank.

The numbers are striking. Between the start of 2003 and its peak on March 9th, Japan's Topix stockmarket index rose by 35%, all because of foreign buying: domestic investors sold all the way up. At its high point in February America's S&P 500 was more than 30% up; NASDAQ, driven by hope and hype, climbed more than 60% by late January before taking a breather. Even European shares went up by 20% or so in a bit more than a year, depending on the measure. Germany's DAX gained more than 40%, despite the economy's flirtation with recession. The emerging-market equities captured
in the widely watched MSCI flew up by 50% last year (see chart 1).

Spreads of riskier bonds over riskless government debt collapsed just about everywhere. In Europe an index of liquid eurobonds, compiled by Credit Suisse First Boston, tightened against swaps (the rate at which the best banks lend to one another) by 70 basis points (bps, or hundredths of a percentage point) from their widest point, to 28bps in January. In America, the firm’s investment-grade corporate-bond index shrank from 247bps to 84bps over the same period. Junk and emerging-market bonds had their biggest and fastest-ever rally. Not a single issuer in J.P. Morgan’s EMBI+ index of emerging-market bonds saw spreads widen (chart 2).

What began as a legitimate search for higher returns following a collapse in prices in many markets led to valuations that stretched the bounds of credulity and made little or no allowance for error. No matter: even at the start of this year, just about every indicator of risk appetite suggested that investors were, if anything, more gung-ho than ever. Flows into equity mutual funds in America in January reached a size exceeded only in the first two months of 2000. The fund managers surveyed in January by Merrill Lynch were keener than they had ever been on shares, and loathed with equal passion the meagre yields on government bonds. Their appetite for risk has meant a buoyant start to the year for initial public offerings after a fallow 2003 (see article).

There were certainly good reasons for this enthusiasm for equities, beyond low interest rates and heady growth. Profits, especially in America, have been extraordinarily strong. Share prices have also been supported by greater certainty about those profits. A much-followed measure of this, the Chicago Board Options Exchange’s VIX index, which measures the volatility of options on the S&P 500, fell by more than half; by the middle of January it was at levels last seen in 1996.

**But what if?**

It is a good rule of thumb, however, that if things cannot get any better, they can only get worse. So it has turned out. To grim news about lack of job growth in America has been added grimmer news about the terrorist attacks in Spain, and surveys suggesting that consumers in both America and Europe are starting to fret. So are some economists, worried that last year’s sharp pick-up in growth in America and elsewhere might not be sustainable. Having started the year in bullish mood, investors have become more skittish too. In Merrill Lynch’s latest survey only 48% now expect the global economy to strengthen this year, compared with 74% in January.

And if it does not? Then government bonds are not as expensive as many had thought, and shares and corporate bonds are rather more expensive—and the riskier the asset and the loftier its price, the dearer it will look. Thus the prices of American Treasuries have soared and...
their yields have dropped. At the start of the year, ten-year Treasuries yielded 4.3%, which most investors thought absurdly low. They must think today's prices even sillier: recently the yield tumbled below 3.7%.

Admittedly, the Treasury market has been given a boost by foreign central banks, not least the Bank of Japan, which have been buying masses of American government debt as a by-product of huge intervention in the currency markets. Yields have also been driven lower by Freddie Mac and Fannie Mae, America's two mortgage giants, which have been forced to buy Treasuries as yields dropped, to replace the mortgages in their portfolios that have disappeared as homeowners have swapped them for cheaper ones. Many fund managers have bought out of simple fear that yields might fall further still. But for all that, the low yields on Treasuries contain an unpleasant message for investors that have been buying without heed to risk or price—that there is much uncertainty about future economic growth.

That message, and its corollary—that risk is ill rewarded—seems to be filtering through at last. From the middle of January, investors started to dump risky, generously valued assets. The pace has picked up in the past couple of weeks. Stockmarkets have been falling: the S&P 500 is now 5% off its mid-January high, and NASDAQ has dropped some 10%. The VIX has climbed sharply, and so have bond spreads—for investment-grade corporates as well as for the most toxic sort.

Stocks and bonds issued by companies most exposed to the business cycle and terrorism, such as airlines, have been hard hit. Investors are plagued by doubts about Detroit's Big Three carmakers. Spreads on their bonds have widened sharply, and those issued by Ford—the world's biggest issuer of corporate debt—have fared very poorly recently. Against stiff competition, the auto sector, down 17% so far this year, has been one of the worst performing in the S&P 500.

A storm in a teacup, or a prelude of worse to come? By historic measures few equity or corporate-bond markets are cheap; many are very expensive indeed. This makes it all the more possible that a virtuous cycle of rising growth and appetite for risk can turn into a vicious cycle of falling growth and aversion to risk—whatever the Fed does.