

MACROCOSM

The Risk Aversion Hurdle

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As we noted last week, there is a fair degree of plausibility to the consensus view that the economy is close to entering a cyclical “recovery,” particularly if one accepts a minimalist interpretation that the economy is recovering as long as it is no longer contracting (see [“A Green Eyeshade Recovery,”](#) January 9, 2002). Such a minimalist recovery, though, would pale against the experience of the late 1990s, a period of wealth creation and capital formation that gave rise to a sustained improvement in productivity growth trends unmatched in the second half of the 20th century.

The expansion of the 1990s was fueled by the ready availability of risk capital, which is indispensable to sustaining robust growth rates in any era. And it is precisely that which is lacking now, and which dims hopes for anything more than a lackluster recovery. Yes, much can be said regarding the recklessness of that period, and there is no question that in the frothy environment of the time critical mistakes were made. But now, after being so decimated by the downturn of the past two years, the market’s risk appetite has yet to recover to the extent that would enable an imminent return to sustainable GDP growth rates of 3% or more. The economy’s anemic risk appetite can be seen in the depressed state of the market’s riskiest financing venues – high-yield debt, initial public offerings, and venture capital

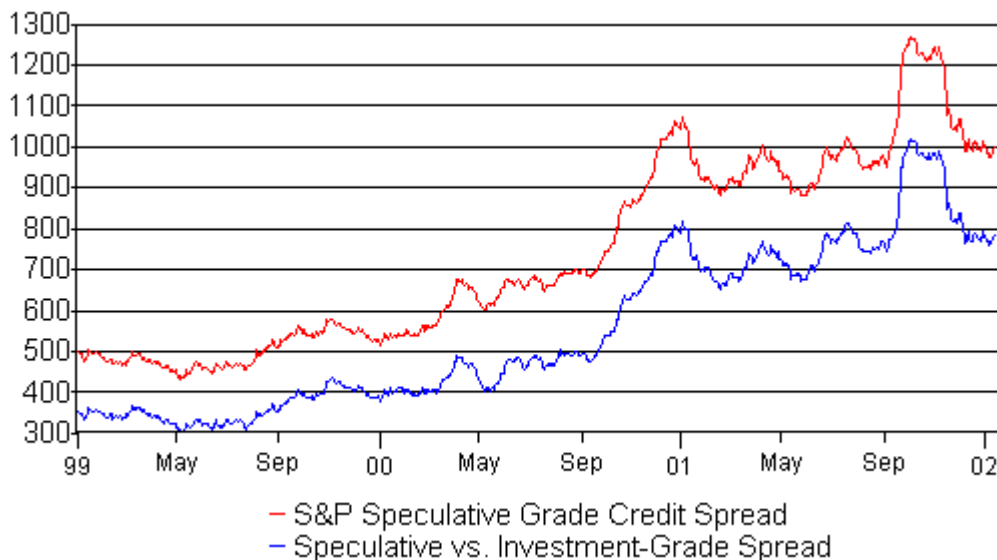
In our analysis, that is because the deflation risks imposed by a too-tight **Fed** have yet to recede sufficiently to facilitate the risk-based financing of entrepreneurial enterprises. At current levels against both foreign exchange and key commodities, the dollar has eased only slightly from its highest levels last year. After 475 basis points in Fed rate cuts over the past year, the dollar remains some 20-30% stronger in real terms than it was five years ago. When that kind of currency appreciation is sustained over time, all goods and services priced in that currency must eventually fall to equilibrate for the monetary shift. Some prices adjust faster than others, but deflation risk has the effect of increasing the uncertainty of future returns. That imposes an added risk premium to the cost of capital which falls most heavily on the riskiest assets and explains much of the risk aversion that the market continues to exhibit.

Consider the high-yield debt market, which on net has shown no recovery relative to pre-9/11 levels. At about 1000 basis points, the S&P speculative-grade credit spread remains about 500 basis points above long-run averages. True, the junk spread has recovered by some 270 bps from its highest point in the 9/11 aftermath. But that is explained in part by the backup in long-term Treasury yields since early November. Almost certainly, anticipation of a growth acceleration would be met with considerably more enthusiasm than has been registered to date in the junk bond space. The outsized risk premia made available by depressed market prices would certainly make for an attractive target were the risk/reward equation in more favorable alignment.

The chart below also suggests the extent to which riskier borrowers continue to be penalized relative to their investment-grade counterparts. At nearly 800 bps, the yield premium on speculative- versus investment-grade debt is nearly double its levels of two years ago. That can

be seen as indicative of the market directing capital toward “safe” destinations and away from its riskier but also potentially most productive, growth-enhancing uses.

Speculative Grade Credit Spreads *in basis points*



Certainly, the telecommunications debacle of the past year cannot be ignored as a factor in the overall performance of the junk market. But it's not likely that the disaster in telecom debt can also be blamed for stanching the flow of risk capital through initial public offerings and venture funding. Here, we note that the market's aggregate risk preference has an important self-fulfilling quality as a gauge of growth prospects. Without a vibrant capacity to absorb risk, immature entrepreneurial ventures that are the drivers of economic expansion will lack access to the capital they need to fuel the innovative activity that has the greatest growth payoffs. And completing a virtuous cycle, those very payoffs create incentives for the next round of risk-taking.

While the IPO market saw a moderate bounce back in the final quarter of last year, with 32 new listings raising about \$11 billion, fourth quarter offerings were distorted by 9/11. The attacks caused a more than month-long hiatus of new issues for the first time in more than 25 years, pushing into the fourth quarter a number of IPOs that otherwise would have come to market in the third. For the year, only 97 companies went public with \$36 billion in proceeds – the first year since 1979 that saw pricing of fewer than 100 IPOs. The total amount raised was the lowest since 1995, when 574 offerings brought \$32.5 billion. Thus far in the new year, initial indications are not auspicious. No new offerings have been priced to date, and the one potential blockbuster deal on the calendar – the **Verizon Wireless** issue which had been expected to raise \$5 - \$8 billion – has been taken down due to falling wireless stock prices. In the growth-critical tech sector, only four small firms are currently scheduled to come to market, raising a paltry \$425 million. Last year saw 26 technology IPOs, after 149 tech listings in 2000.

Until a more active new-listings market takes hold, it also doesn't bode well for the outlook for venture financing of start-up enterprises at the grassroots of entrepreneurial capitalism. According to the venture-capital research firm **VentureOne**, only 21 venture-backed companies went public last year, raising \$1.7 billion, “roughly 90% declines from 2000 in both offerings and

amount raised.” In the fourth quarter, eight venture-backed IPOs raised \$751 million, accounting for a “mild uptick” in a year that was “one of the worst in recent times for venture-backed liquidity,” according to the firm. Without a more friendly environment for IPOs, it’s not likely that funding at the other end of the venture capital pipeline will pick up either. Preliminary data shows that total venture investment last year came to some \$35 - \$40 billion, down about two-thirds from 2000.

Bearing all this in mind, it also is undeniably the case that from an asset-allocation perspective, significant opportunity can be found in this environment. Junk debt at current levels certainly appears to provide ample compensation for the attendant short-term risks, with a strong upside potential over a somewhat longer-term horizon. We would treat with some caution, though, reports suggesting that a bull run in junk is now baked in the cake based on indications such as the recent inflow of cash to junk bond mutual funds. A similar bulge in fund contributions was seen last January during a brief junk bond rally set off by initiation of the Fed’s rate-cutting campaign. Junk hit its highs for the year in that month, and anyone who bought in at the 2001 top is now carrying a loss of some 8%, according to the high-yield analysis firm **KDP Investment Advisors**.

It’s highly debatable whether the opportunity in the high-yield debt market extends to equity sectors that have booked gains of 40% or more over the past few months. Indeed, the fourth quarter’s tremendous equity rally – especially in technology stocks – might be thought to be an anomaly in market-wide risk preference. As my **Trend Macro** colleague **Don Luskin** has detailed, by most valuation metrics stock prices reflect earnings growth expectations that would be difficult to meet even under the most bullish recovery scenarios (see, most recently, [“Don’t Blame the Long Bond,”](#) January 7, 2002). On its face, that would suggest the equity market is placing a large bet on highly uncertain expectations of future income streams – its risk appetite, in other words, is quite strong. But that must be weighed against evidence from the highest-risk market segments which continue to give such lackluster readings. Were earnings multiples now priced into stocks truly pointing the way toward a sustainable growth breakout, it’s doubtful that other gauges of the market’s risk preference would remain so subdued. It seems more likely, in fact, that as the market continues to absorb the reality that a slow slog back toward vibrant economic health is the most likely course going forward, equity sectors carrying the highest valuations could continue to face rough sledding ahead.

The outlook for recovery in the market’s risk propensity hinges critically on the Fed’s ability to overcome its deflationary policy bias, but market-based indicators of this possibility remain tentative and inconclusive. Although gold – the most monetary of all commodities – has shown an upward tilt in recent days at around \$285 per ounce, trading activity has been characterized by a high level of technical noise. Otherwise, there is little if any evidence in the Fed’s operations to suggest it is shifting to a more generous stance of liquidity creation, redressing the scarcity of dollars relative to demand. A recent rise in the monetary base has been seen in some quarters as such an indication. But we can find nothing to suggest that the central bank is doing anything more than meeting the demand for base money, which typically rises when the Fed cuts rates. Since late summer, for example, the base has grown at an annualized rate of about 10%. But that has been entirely explained by an increased demand for currency in circulation, *i.e.* pocket money. Meeting the demand for greenbacks is essentially a clerical function of the central bank, and has no effect on the supply/demand balance in the market for dollar liquidity. **IM**