TrendMacrolytics

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Risky Business

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The market price of risk isn't zero anymore -- that's no threat to growth.

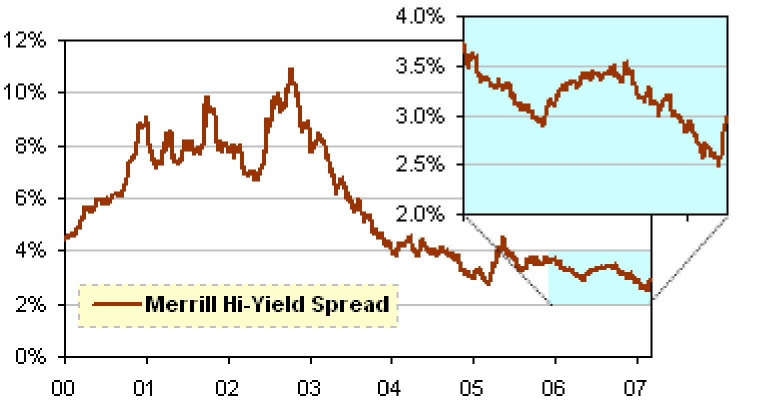
Update to strategic view

US MACRO: The turbulence of the last two weeks has resulted in a substantial repricing of risk back toward normal levels, coming from an unsustainable peak of risk tolerance. So far we don't see this normalization process reflecting outright risk aversion that could threaten the capital formation process that underlies growth.

[see Investment Strategy Dashboard]

The spike of fear that hammered markets last week seems to be receding to tolerable levels, but the volatility surge appears to have left in its wake a more reality-based pricing of risk that likely will have some staying power, keeping high-risk asset classes from challenging their best levels, at least in the foreseeable future. But while this risk repricing suggests the onset of a less free-wheeling speculative environment, at this point we do not see it developing into an episode of risk aversion that would represent an emerging threat to continued growth. The potential for such an inflection point remains real, but is most likely to ensue as a consequence of a turn to tighter monetary conditions, and that remains some months off.

Whatever the cited explanation for last week's events -- a potential China meltdown, the rumored unwinding of the yen carry trade, or renewed recession worries -- the bottom line effect was an apparent awakening to the extent of the market's markdown of risk. In our model, we regard a healthy appetite for risk as indispensable to economic vitality. However, when a quest for risk runs to extremes it can carry the seeds of a potentially destructive blowback. The Asian financial crisis last decade, for example, was significantly exacerbated when the unbridled enthusiasm which had seen prices soar for the region's sovereign debt turned to a frenzied race for the exits when the risk of currency devaluation spread like wildfire. In retrospect, it was obvious that these assets had underpriced for risk in what was widely considered at the time a no-lose, one-way bet.



THE PRICE OF RISK MOVES TOWARD NORMALITY FROM UNSUSTAINABLY LOW LEVELS

While in the present environment the rally in high-risk asset classes

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had not yet quite approached that over-the-top quality, it was reaching levels that were becoming difficult to justify on the fundamentals. The Merrill Lynch high-yield debt spread, for example, had ranged mostly between 350 and 400 basis points from early 2004 through the first three quarters of last year, a level of risk preference that can be considered consistent with low default risk in an environment of stable, healthy, economic growth. Since early last fall, however, the spread had contracted by more than 100 basis points to below 250 bps at its best levels last month. In the pullback of the past several sessions, it has widened out by nearly 50 basis points. While we would not rule out some further spread widening in this risk-repricing process, neither do we see any sign of an extensive retreat from risk.

Just as the blowout of the high-risk debt spread early in this decade reflected the scarcity of liquidity engendered by the deflationary posture of a too-tight Fed, the recent spread narrowing was one of the more obvious indications that the Fed's liquidity stance remains quite accommodative. This still accommodative policy setting also stands as a stark reality check on the notion of rising recession risk. Recessions are generally caused by overly tight Fed policy. At this point, not only is the Fed not tight, it continues to feed a liquidity excess pointing toward higher core inflation rates. The most sensitive indicator of the Fed's liquidity posture, the gold price, fell last week in the midst of the general market turbulence. We viewed that, however, as a short-run response to various trading exigencies rather than a diminution of inflation risk. Since the market turbulence subsided early this week, gold has rallied back by about $15, and at $650 gold is trading some 80% above its 10-year moving average.

Here and there we continue to hear arguments suggesting that the housing slump represents a deflationary influence which will ultimately compel a Fed easing response. But this is a mischaracterization of the forces at work. When the Fed went into its hyper-accommodative posture in 2003 and 04, cutting rates to 1% after perceiving a potential deflationary "liquidity trap," the housing market and mortgage borrowers were frontline beneficiaries. With the Fed reversing course and hiking rates to 5.25%, there's no doubt a certain amount of pain is being absorbed in a sector that had been feeding at the Fed's trough. But that doesn't mean the Fed has gotten objectively tight. It only reflects that a market which had capitalized on the ultra-low rate environment is now going through an inevitable adjustment process.

BOTTOM LINE: In some ways, the market appears to have been chastened by its panic last week, and a repricing of risk has been seen in some of what had been the most high-flying market sectors. In an absolute sense, indicators suggest the market's risk preference remains quite robust, which also suggests the economy is at little risk of a growth retrenchment. However, the market may be entering a more cautious phase in which a more normal compensation for risk will be reasserted. TM