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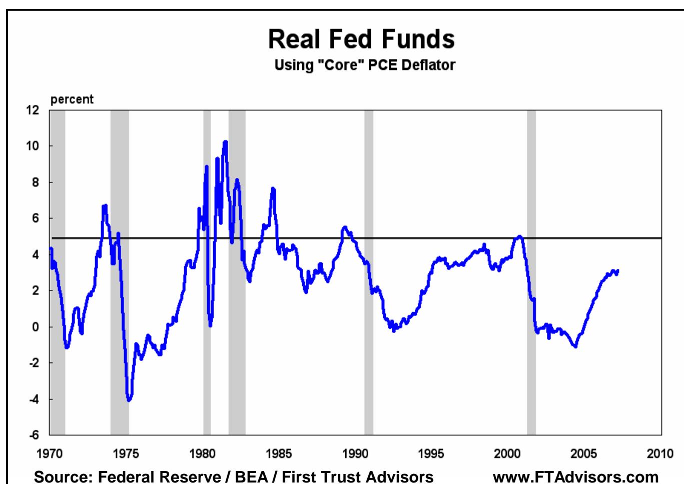
The Hypochondriac Market

Here we go again. Jittery financial market participants have extrapolated a case of indigestion, and some heartburn, into the "big one." But, recent market action looks much more like a panic attack than a heart attack.

Yesterday's market sell-off (small cap stocks fell 3%, and the Dow Jones Industrial Average was down 226 points), has convinced many that problems in the sub-prime market are spreading.

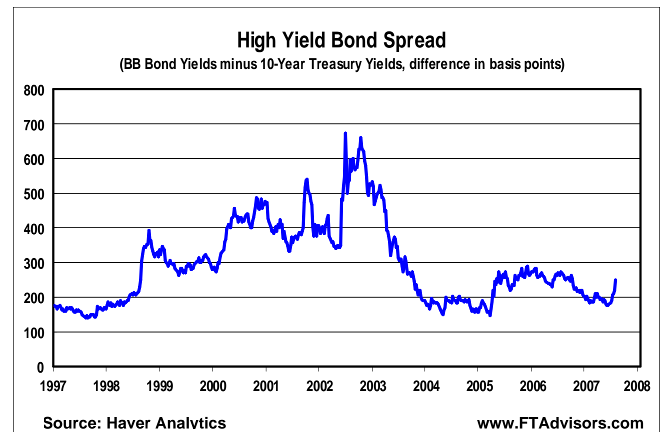
Significantly worse than expected Q2 earnings at Countrywide Financial, and problems in financing a few large leveraged business deals, have caused pessimistic market participants to fear an economy-wide credit crunch.

Clearly, this year's increase in long-term interest rates could throw a wrench into some leveraged deals. But the current financial environment does not reflect conditions normally associated with a credit crunch. For example, it is in no way comparable to the one that existed at the time of the infamous failed leveraged buyout of United Airlines on October 13, 1989. That failure precipitated a one-day drop of 6.9% in the Dow, which presaged a recession in 1990.



Most people do not remember, but in 1989, the Federal Reserve lifted the federal funds rate to 9.75%. After subtracting inflation (as measured by the "core" PCE deflator), the real federal funds rate was over 5% in 1989 when the United Airlines deal fell apart.

Also during the late 1980s, US government policy was forcing the S&L industry to suddenly divest itself of its high-yield bonds. This draconian policy change led to an investor stampede that pushed bond spreads markedly higher and hindered financing across a broad range of industries. This junk bond sell off came at the same time tougher capital standards at commercial banks (from the Basel I Accords in 1988 and FDIC reform in 1991) rendered it more difficult for firms to get loans from traditional sources of capital. This "perfect storm" of policy changes caused a true credit crunch.



Today's issues don't come close. Although risk spreads have widened, they remain very narrow in an historical context and do not signal impending economic problems. The high-yield bond spread, which we calculate as the yield on BB-rated Bonds (Source: Merrill Lynch) minus the yield on 10-year Treasury securities, was 249 basis points last week versus 176 bps as recently as May 2007. This spread is below the March 2005 – September 2006 average, and below the 294 bps average of the past 10 years.

The real (inflation-adjusted) federal funds rate is only 3.3% - the highest so far in this business cycle, but well below the 5% level that has preceded every recession since 1970. And while tax hikes and regulatory expansion are being discussed, they remain a distant risk and face a high likelihood of veto.

The bottom line is that fears about the underlying health of the economy and financial markets are more about hypochondria than reality. The Fed is not tight, just less loose, the economy is strong, tax rates are low, and corporate earnings remain robust. Let's not confuse indigestion and heartburn with the "big one."

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