The Economist

First the put; then the cut?

America's financial markets can now stop blaming the electoral impasse for their woes, and start focusing on deteriorating economic fundamentals

Dec 14th 2000 | NEW YORK | from PRINT EDITION


AP

WALL STREET had been hoping against hope that a result in the presidential race would spark a stockmarket rally. But on December 13th, as news spread that Al Gore had decided to concede, a surge in the New York and Nasdaq stockmarkets soon faltered. Could it be that all the talk by Wall Street's bullish share gurus about the damaging impact of presidential uncertainty was so much hot air? The real reason for the onset of a bear market in shares has been a sharp decline in the prospects of many American companies, as the economy has slowed and sources of fresh capital have dried up.

Profit warnings have become a daily ritual. One by one, companies that had seemed effortlessly able to meet analysts' expectations have delivered bad news, and most have been punished by investors for their trouble. As suppliers complain that bills are not being paid on time by well-known companies that are using every trick in the book to eke out their profits, can it be long before even Cisco issues a profit warning—and how will investors react to their current poster-child proving fallible?

Profits are "falling off a cliff", says Chuck Hill of First Call, a research firm. On October 1st, analysts were forecasting profit growth of 15.6% for the S&P 500 companies in the fourth quarter. Now they expect only 7% growth, with the outlook worsening by the day. Technology-company profits, expected to rise by 29% at the start of the quarter, are now tipped to rise by only 10%, says Mr Hill. January, when most results are announced, will be more miserable than ever—particularly if consumer sentiment continues to deteriorate. The University of Michigan survey of consumer confidence plunged sharply this month. November's retail sales figures, released on December 13th, were much weaker than expected.

Cometh the hour, cometh the man—or so investors hope. The "Greenspan put" is once again the talk of Wall Street. This mythical financial security first entered the investment lexicon after the crisis in 1998 over the collapse of Long-Term Capital Management, a hedge fund. The idea is that the Federal Reserve can be relied upon in times of crisis to come to the rescue, cutting interest rates and pumping in liquidity, thus providing a floor for equity prices. This is similar to a put option that guarantees investors a minimum price at which they can sell their shares.

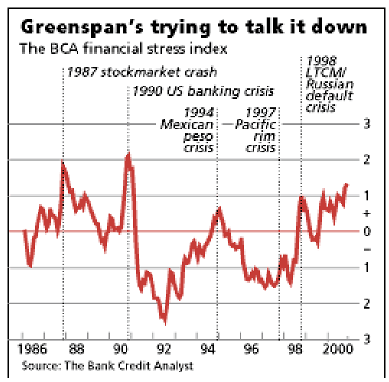
Belief that the put is again "in the money" was revived by the speech of the Fed chairman, Alan Greenspan, on December 5th, which was unusually clear in its up-beat, "I'm here" message.

Since then, futures prices have been predicting a 50 basis-point cut in short-term interest rates by April.

For all his talk of the perils of irrational exuberance, Mr Greenspan has been adept at pumping up share prices in the past. Yet this time may prove too challenging even for his magic. Rate cuts may cause the dollar to weaken, perhaps leading foreign investors to think twice before buying American assets. And if the confidence of consumers really has been dented, after being so strong for so long, they may not respond as readily to a stimulus as economic models predict—particularly if they start to worry about their record levels of debt.

Above all, the private firms at the heart of the financial system may have become too risk-averse to respond to rate-cut promptings. Banks have taken a close look at their loan portfolios and turned white with fear. Bank of America, one of the biggest corporate lenders, this week announced yet another $1 billion debt write-off and the departure of a number of senior personnel from its lending operations. Mr Greenspan's appeal—quite remarkable for a central banker in an economy that is already deep in debt—that banks "should now guard against allowing the pendulum to swing too far the other way by adopting policy stances that cut off credit to borrowers with credible prospects," may fall on deaf ears.

Prospects are even gloomier in the corporate-debt markets. Mr Greenspan is right that "the palpable fear that dominated financial markets" in the 1998 liquidity crisis is absent today—for one thing, financial institutions have more capital and a better idea of what risks are in their portfolios. But the Fed chairman is surely kidding when he says that "current circumstances are in no way comparable" to then. Actually, according to the Bank Credit Analyst newsletter's respected "Financial Stress Index", they are even worse: the risk of financial turbulence has not been this high since the American banking crisis in 1990 (see chart).



The implosion of the corporate-debt markets has now sucked in the hitherto low-risk commercial-paper market, in which investment-grade companies do short-term borrowing. Spreads between blue-chip commercial paper and slightly lower-grade paper have soared from 25 basis points on November 24th to around 100 points now.

Two main factors are at work, says John Hollyer, a fund manager at Vanguard. In the first place, the market has expanded rapidly—from $82 billion a year ago to $140 billion today—as firms squeezed out of the bond market have sought shorter-term alternative financing. And secondly, there has been a sharp decline in the creditworthiness of some hitherto blue-chip borrowers—notably Xerox, which may have avoided bankruptcy only by drawing down a credit line that it had the foresight (or good fortune) to secure in happier times. There were 19 downgrades of commercial-paper issuers during the first nine months of 2000; so far in the fourth quarter there have been 20.

Things are worse still in the high-yield ("junk") bond market. A new report by Moody's, a credit-rating agency, forecasts a sharp increase in junk-bond defaults over the coming year. Worse still, Moody's lists a large crowd of firms that will need to refinance their debt (bonds and bank loans) next year, and calls into question their ability to do so. There is every chance that this list will have a similarly depressing effect on the debt markets as a list of dot.com firms that were running out of cash, published early this year by *Barron's*, had on Nasdaq.

This is not a happy situation for a new president. Nor will Mr Bush's enthusiasm for tax cuts reassure investors. And if he seeks comfort from the fact that the Republican Mr Greenspan is still at the helm, trying to keep the economy and the markets out of trouble, he should not discuss it with his father, who still blames the Fed chairman for losing him the 1992 election.

from PRINT EDITION | Finance and Economics