Market Observer

The U.S. Federal Reserve increased the Fed Funds rate by .25%, as widely had been expected, at the end of the second quarter of 2004. This was the first increase in U.S. administered interest rates since the Dot.com stock market meltdown of 2000. There was little excuse for the Fed not to raise rates.

Alan Greenspan and even the most negative financial commentators have to now admit that the world economic recovery has sustaining strength and breadth. Sure, there are things to worry about, but strong employment and spending give little reason to leave interest rates at absurdly low levels. The expropriation of income from savers being paid miniscule interest rates and the pass-through to consumers benefiting from cheap mortgage and consumer debt service is increasingly hard to justify. Sir Alan has definitely slain the deflation dragon. The question for the markets is what he does for his encore.

With low nominal and negative real interest rates, investors are attracted to many other investments with higher yields and risk. They are also prone to borrowing at low short-term rates and investing or lending long-term. As the Federal Reserve Chairman since 1987, Mr. Greenspan knows this. He remembers acutely the result of his aggressive interest rate increases in 1994. The dislocation caused by rising interest rates in 1994 resulted in the end of Robert Citron's derivative dalliances in Orange County and the Mexican crisis.

We expect that increased investor risk aversion will accompany rising interest rates in the United States and around the world. The rising tide of markets since the fall of 2002 has rewarded risky financial behaviour. This can be seen in very tight credit spreads and very lofty equity valuations.

Monetary Asphyxia?

Tightening monetary policy means there will be less investment capital for riskier investments as investors can obtain better income from Treasury Bills and bonds. The optimistic and the consensus financial market view seems to presently believe that "measured" Fed interest rate increases will result in what was called a "soft landing" in the 1990s. We are not so sanguine. It is the lack of oxygen that causes death by asphyxiation. Whether one is strangled slowly or quickly is a moot point if the outcome is the same.

The extraordinarily easy monetary policy of the last four years has made borrowing very attractive with interest rates at generational lows. Given prospective inflation in the 2-3% range, a "normal" interest rate environment should have short-term interest rates in the 4-5% area and long rates towards 7%. This represents a substantial increase from the current levels. Borrowers will see their interest payments climb, especially those who have stayed floating rate to benefit from the steep yield curve.

We expect the economy will sustain its momentum for the next year or two. The major effect of rising interest rates will be felt in asset prices. Profuse lending has caused large asset price increases in everything from residential houses to the stock market. Less money will mean less willingness to lend and less cashflow available to service rising debt payments. Call us "quantity monetarists" or simply old-fashioned, less money is not good news for lofty asset prices.

While it often takes a long time and much higher interest rates for asset values to generally decline, the effects at the margin are more rapid. Less liquid and more marginal assets are the most exposed to investors' decreased enthusiasm for investment risk. As we saw in the 2000 technology crash, higher servicing cashflows means that investors and their lenders can't necessarily look to capital appreciation to skate them onside. Less attractive properties, assets and projects are the ones that suffer the most when higher discount rates are plugged into valuation spread sheets.

Given the already expensive valuations on corporate bonds and equities, we think there is little upside to these markets in general. In Canada, we have already seen a substantial drop in the prices of Real Estate Investment Trusts as rising bond market yields compete for investor affection. We think flat to sideways equity markets are the likely and best case outcome from the adjustment to higher interest rates. One might think that Alan Greenspan has had ample time to prepare investors for a rising rate environment.

"Soft Landing" Fantasies

Financial commentators, however, seem to be clinging to their "soft landing" fantasy. We were quite struck by the visceral reaction to John Rogers Jr., CEO and portfolio manager of Ariel Capital Management, a very successful small and mid cap U.S.money manager. When he appeared as guest portfolio manager on **Louis Rukeyser's Wall Street** on **CNBC** on May 28th, his short-term forecast for the stock market was down due to rising inflation and yields. He had raised cash in his portfolios, not a normal investment stance for Ariel, as prices were expensive. The incredulous other guests sought redemption for their portfolios and bonuses from a longer-term and hopefully more bullish forecast. The look on their faces when he said that he expected flat markets over five to seven years suggested they had just found out he was an Ebola virus carrier!

CREDIT MARKET COMMENTS

23 Measured Increases?

We look to volatility along the way, but the bond market has seen its highs. The long end of the bond market is exposed to the repricing of inflation expectations. At the end of the Fed tightening cycle, short rates should be equal to long. Given peak long rates prospectively near 7%, that's an increase 5.75% or 23 "measured" increases of .25% from the current Fed Funds rate if Mr. Greenspan keeps his moderate ways!

We expect most of the increase to occur after the U.S. Presidential election. The speed of the tightening will depend on the momentum in the economy and inflation. If Britain is an indication, the red hot residential housing market might need more than "measured" policy to slow down. The Bank of England has been in tightening mode for some time but the housing market is still showing speculation. Edward George, the Governor of the Bank of England has taken to moral suasion to talk down prices without much luck.

We sound repetitive, but we worry about drop in mortgage pre-payments in the U.S. Mortgage market and the selling of bonds to shorten duration as interest rates rise and mortgage portfolio duration lengthens. We also think the U.S. dollar is exposed if the large U.S. trade and budget deficits continue after the November Presidential election.

Credit spreads stopped narrowing in the second half of 2004 and began to widen in June. New issues are not quite as enthusiastically received into the market and corporate bond investors are now questioning the tight spread levels given rising interest rates.

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