WHEN RATES RISE
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The Federal Reserve is softening the financial markets up for higher interest rates. Will the markets merely dislike them or hate them?

IT IS a truth universally unacknowledged by investors that risk today is so little rewarded. Financial markets, especially the riskiest, have risen strongly in rich and poor countries alike over the past year or so, fuelled by extraordinarily low interest rates in America. But the day when the Federal Reserve raises rates is drawing closer. In two speeches to Congress this week Alan Greenspan, its chairman, said in his usual unflamboyant way that deflation was no longer a risk, that interest rates would have to rise at some point, and that banks were prepared for when they do.

Here's hoping. For it is debatable that financial markets and the banks that deal in them will turn out to be as relaxed as Mr Greenspan about a rise in the Fed funds rate from its current, derisory 1%. Enthusiasm for risky assets is waning in any case.

Even the Treasury market, where the world's risk-free long-term rate is set, is unenthused. Yields have been low partly because it has been enormously profitable for investors to take advantage of the near-record steepness of the yield curve (the difference between short- and long-term rates), and partly because of huge purchases by Asian central banks. But having fallen sharply after February's anaemic jobs report, Treasury yields have soared in recent days as one economic statistic after another has added to the impression that inflation, as well as growth, is picking up. The yield on ten-year Treasuries on April 21st was 4.42%, almost 80 basis points (hundredths of a percentage point) more than it was a month ago.

Most economists think that an appropriate yield on ten-year Treasuries would be 5.5% or so. A rise to anything like that level in the near future depends, among other things, on whether inflation really is picking up and on how swiftly the Fed raises rates to ward it off. It will also depend on whether Asian central banks think it wise to keep their currencies artificially low against the dollar now that domestic inflationary pressures are rising.

Still, as long as growth continues to barrel along, rates probably will rise. What effect will this have on riskier markets? Investment-grade bonds may fare as badly as Treasuries, because most of their return comes from movements in interest rates rather than in the extra yield--known as the credit spread--that investors get for buying a
corporate rather than a Treasury bond. They may fare worse, since the credit spread has fallen by more than half in the past year and has room to rise. Yields on junk bonds, especially the real rubbish, probably have further to rise, despite having risen recently.

As for equities, there is an entirely respectable view that since interest rates are rising only because of strong growth, shares will still do well: recovery should be good for profits, which are thought to have grown by almost a fifth in the past quarter. Not surprisingly, many brokers are arguing just that.

This is not being borne out by events, despite generally good company results. Spooked by higher bond yields, the S&P 500 has shuddered recently, and has fallen back to roughly where it was at the beginning of the year. Sectors most exposed to rising rates, such as real-estate investment trusts (down 13% from their high) and, for all Mr Greenspan's soothing words, banks (down 8%), have suffered. In part this may be because stocks are not cheap. NASDAQ, whose prices have long defied reason, has fallen by still more than the S&P.

The argument may anyway be flawed. According to research from Credit Suisse First Boston, stocks underperformed cash globally by 12% when the Fed tightened in 1994, and by 5.4% in the 1984 tightening cycle. CSFB points out that sectors that do badly when bond yields rise now account for a much bigger slice of market capitalisation than in the past. It is, of course, possible, say the bank's strategists, that equities could prosper. "But we tend to think that the risk of a subsequent crash would rise dramatically if that does happen."

SINKING OR SWIMMING?
With the exception of Japan, which seems to be detaching itself and at last to be enjoying a sustainable recovery (see article[1]), most rich-country equity and corporate-bond markets will take their cue from Wall Street. Whether the same is true of emerging markets is a moot point.

Emerging-market equities have had a fine run, helped by inflows (in Asia, record inflows) from rich-country investors, especially Americans. An index of such shares compiled by Morgan Stanley is up by 89% from its low in October 2002--and has risen by 10% this year (see chart). But emerging stockmarkets tend to do less well than their emerged counterparts after risk appetite has peaked.

Emerging-market bonds may do much less well (see article[2]). Historically, these have not been for the faint-hearted: the ups can be thrilling, but the downs are stomach-churning. So well have
emerging-market bonds performed in recent months that the spread over Treasuries of the widely watched EMBI+ index of emerging-market bonds is close to a record low. The upside, in other words, is limited.

The downside is much less so. In a report this month, the IMF went out of its way to show that the stellar performance of emerging-market debt was not based on improved fundamentals. "Research suggests that low short-term interest rates have been a key determinant of emerging bond spreads," it said.

Low rates have arguably been a prime determinant for risky-asset markets just about everywhere. They probably explain why yields on risky junk bonds are so nugatory. Investors have been fleeing rock-bottom interest rates for higher-yielding assets, or simply playing the difference between the two.

Nobody knows how many investors have been tempted to do this, nor how long it will take for rising rates to dull their appetite. But the most exposed are the big hedge funds and global banks that punt with borrowed money. Investment banks have increased the size of their trading positions threefold or more since the autumn of 2002. This is partly because they have devoted more capital to trading. But falling volatility in financial markets means their risk-management models assess the riskiness of these positions to be less. This means that they can have larger positions for the same amount of capital. Even though the Fed is widely expected to raise rates at some point, the incentive to keep generating profits is great--and every bank thinks that it will be clever enough to move first.

The biggest punters, according to a friendly risk manager who crunched the numbers on a comparable basis for THE ECONOMIST, are Citigroup, UBS, Goldman Sachs, Deutsche Bank, J.P. Morgan Chase and CSFB. Some have more capital to cushion them than others. The most thinly upholstered of the big players are Deutsche and Goldman.

If markets move sharply against them, banks and other similarly leveraged investors are forced either to dump positions or to stump up more capital. Almost invariably they choose the former, which can turn a fall in financial markets into a rout. This was what happened in 1998, after Russia defaulted. But Mr Greenspan probably knows that.