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U.S. MARKET COMMENT: A SNAPSHOT OF THE U.S. ECONOMY & CAPITAL MARKETS

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A Snapshot of the U.S. Economy and Capital Markets - Assessing Rising Risk-Aversion

The economy and capital markets were heading decidedly downward before September's events, and the terrorist attacks intensified the public's overall feeling of uncertainty and risk. While the post-September 11 panic selling has abated, markets are still pricing in considerably higher risk premiums than were priced in prior to the terrorist attacks. This increase in risk-aversion also affects economic growth and corporate earnings, because consumers are likely to grow increasingly cautious in these uncertain political and economic times. Below, we look at risk-aversion in the pre- and post-September 11 environments from several vantage points.

Panic Selling Subsides

Markets were volatile immediately after September 11, but they settled down a few days later. Gold prices jumped 5.6% in the week following the attacks, and then climbed another 1.3% through the end of the month. From September 11, the U.S. dollar (US$) fell 4.1% against the Swiss franc, 1.2% against the euro, and only 0.8% against the pound sterling. From its peak in July through September, the real trade-weighted US$ has fallen 1.4%, but the slide has been orderly, and its decline did not accelerate after September 11 (Table A).

The Federal Reserve and other major central banks at least partially allayed market fears by injecting massive amounts of liquidity into the global financial system. In the United States, the monetary base and free reserves skyrocketed, while growth rates of M2 and M3 also rose substantially. The Fed has begun to drain excess free reserves from the financial system, but further easing is broadly expected (Table B).

Consumers Seeking Cover

Economic recovery largely depends on consumers' ability to repair their balance sheets without grinding spending to a halt. Interest rates may be at 40-year lows, but reduced borrowing costs may not encourage debt-laden consumers to pry open their wallets. Even before the terrorist attacks, consumers were showing uncommon signs of caution and parsimony, and confidence has fallen still further since then. Consumer confidence, as measured by Ned Davis Research, has dropped significantly over the year-ended September 2001, hitting levels last seen in 1998 amid Russia's default and Long-Term Capital Management's failure, but it remains above 1990-91 recession levels (Table C). Discretionary spending is also down substantially from its 2000 high, and consumer retrenchment does not bode well for corporate profits, which have been growing at a declining rate since 1997. After-tax non-financial corporate profit margin growth has slowed from 7.8% in September 1997 to 4.7% by the end of June 2001 (Table C).

Wary and Concerned

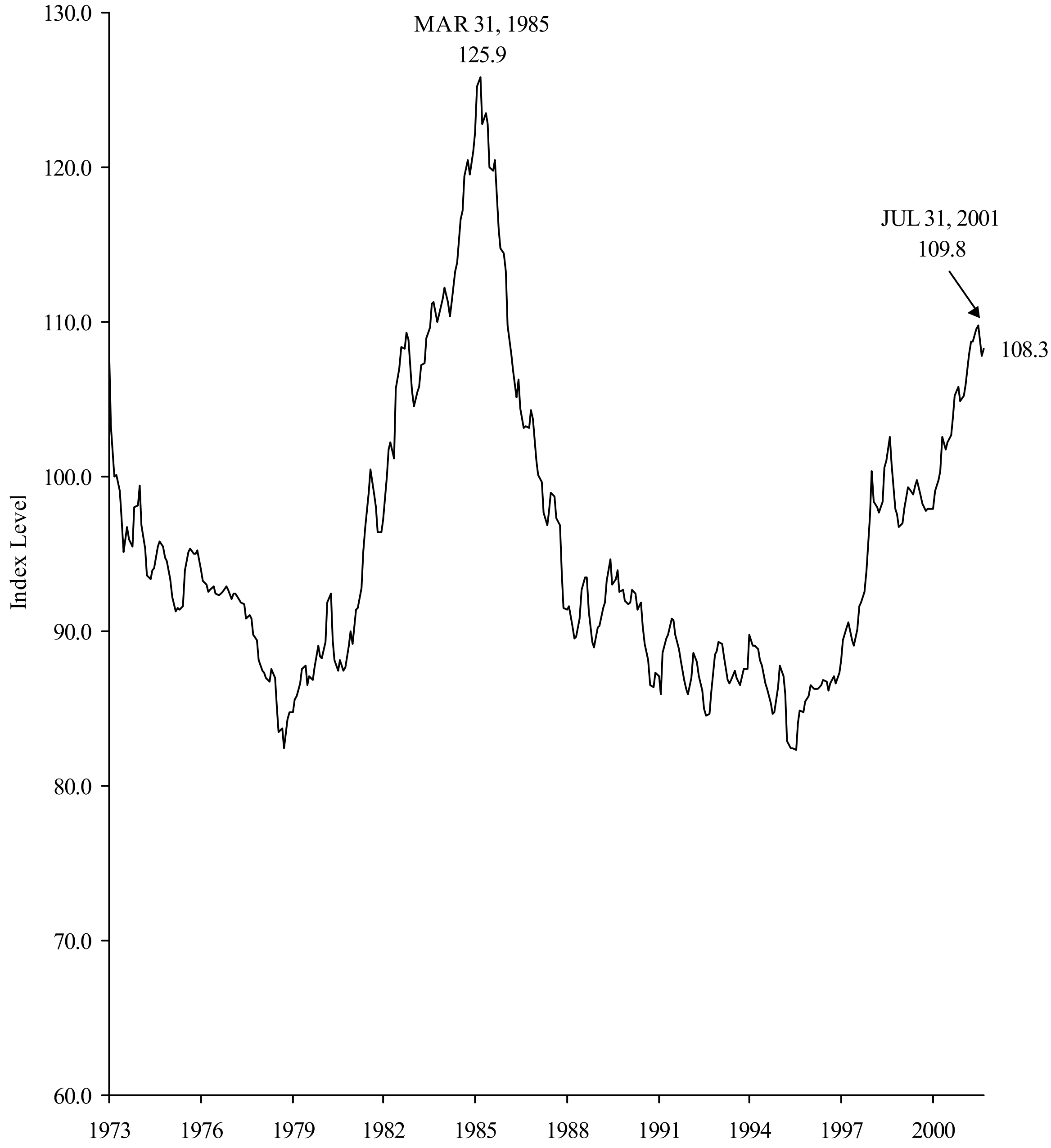
Bullish sentiment among investment advisors and mutual fund inflows have dropped off sharply in recent weeks, though they remain far above levels that would signify capitulation or extreme pessimism. Margin debt is down from its post-1965 peak of $278 billion as of March 2000, but is still very high relative to normative levels maintained for 30 years prior to the mid-1990s. The spread between yields of Moody's Baa-rated bonds and ten-year Treasuries, used by some as a measure of the equity risk premium, has reached levels not seen since 1982. Our own ex-ante measure of the equity risk premium, using our dividend discount model to solve for the premium over long-term AAA-AA corporate yields implied in S&P 500 equity prices, shows that the equity risk premium has risen to 2.7, a level that has not been visited since 1978. Insider selling net buying has declined somewhat but it remains high, suggesting that management is not optimistic that earnings will turn around anytime soon. (Note that these data are only through September 7. See Tables D and E.)

Investors sought refuge in the safe haven of U.S. Treasuries. Most of the rally took place in the short-end of the curve, with 91-day T-bill yields plunging almost 100 bps, from 3.37% to 2.40%; in comparison, yields on the five-year note fell 53 bps and ten-year note, 15 bps. In addition, spreads among investment-grade corporate bonds have widened, while those relative to ten-year Treasuries have blown out to levels not seen since at least 1979. Spreads on high-yield bonds have also widened dramatically, reaching their highest levels since the record highs of 1990 when the high-yield market imploded. (See Table F.)

Table A

REAL TRADE-WEIGHTED VALUE OF THE DOLLAR

January 1, 1973 - September 30, 2001



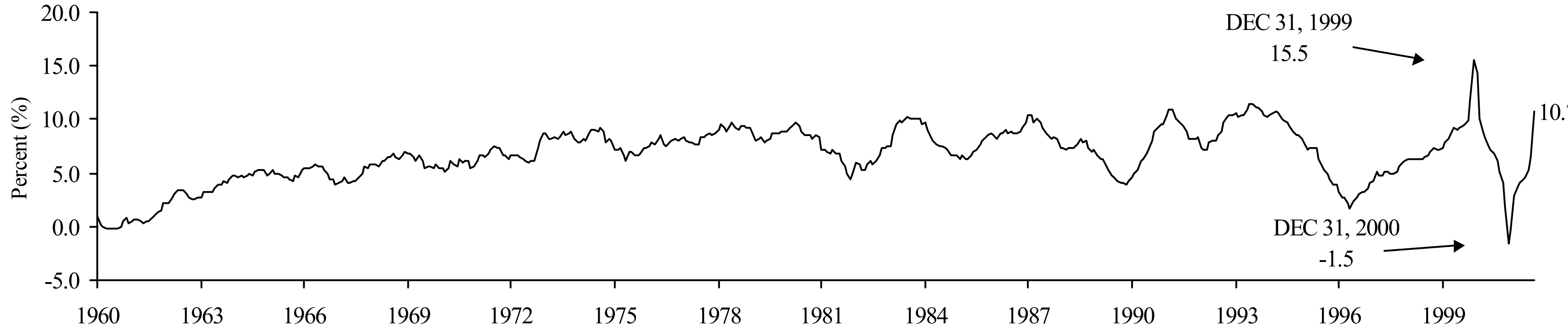
Source: Federal Reserve Board.

Note: The index is based on a basket of non-U.S. currencies weighted by the dollar amount of trade with the United States.

Table B

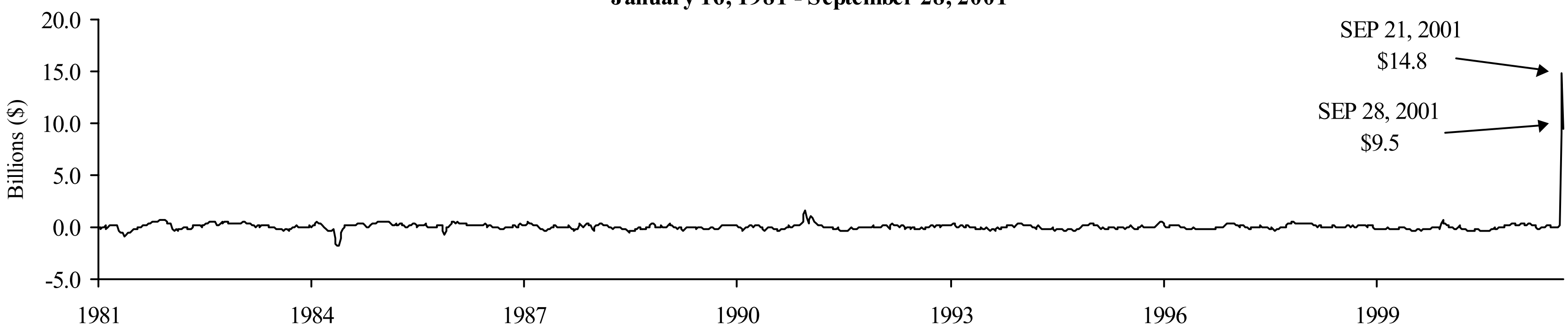
U.S. MONETARY POLICY
Nominal Monetary Base

January 31, 1960 - September 30, 2001



Free Reserves

January 16, 1981 - September 28, 2001

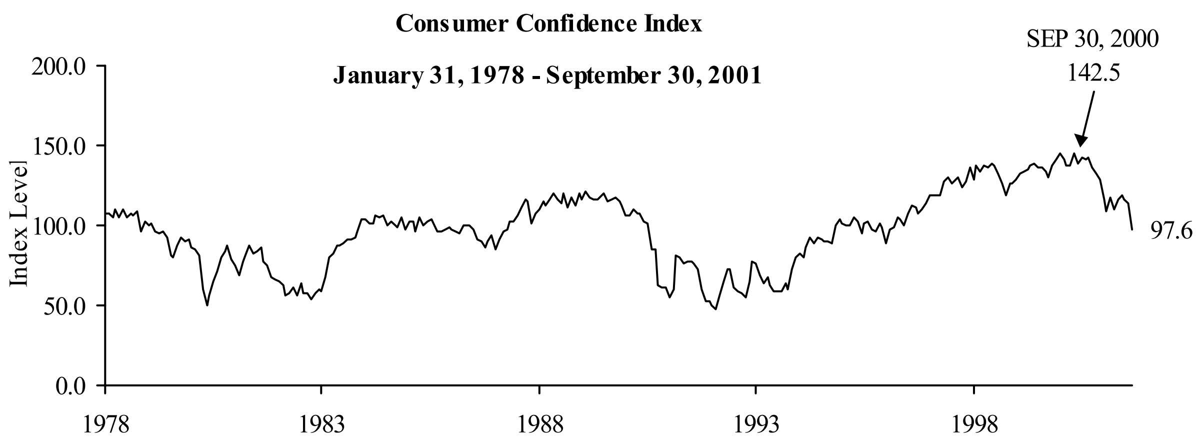


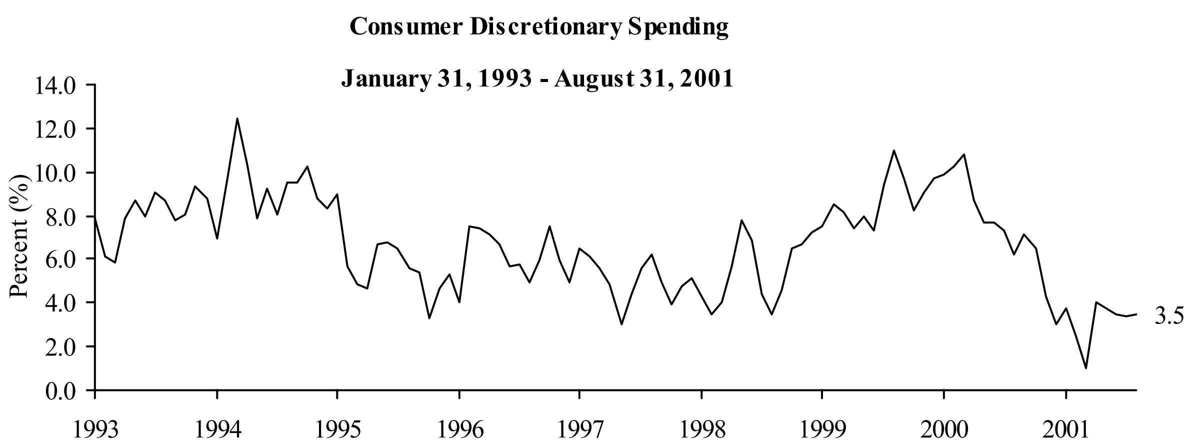
Sources: Datastream International and Ned Davis Research.

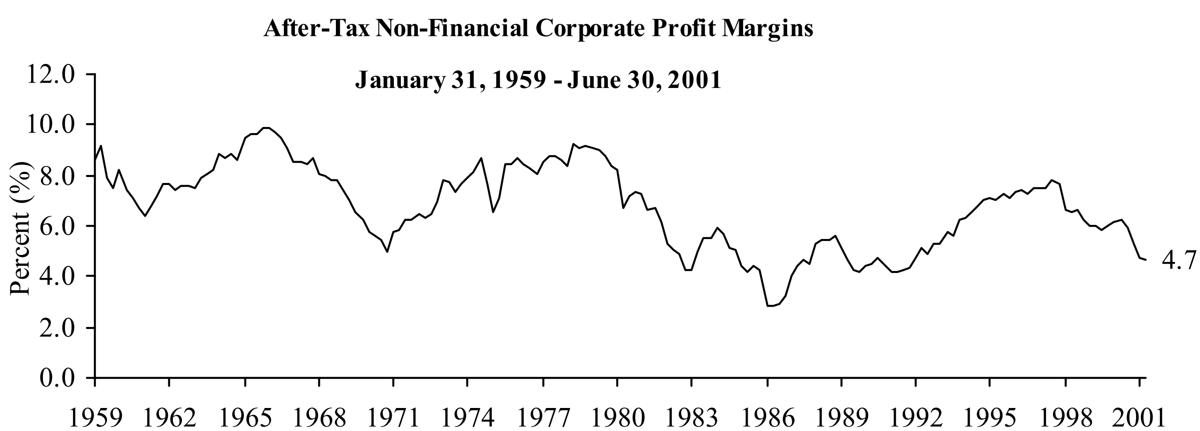
Notes: Top graph represents rolling year to year growth of monthly data. The data in the bottom graph are normalized by subtracting the 52-week smoothing from the five-week smoothing. When the five-week smoothing rises faster than the 52-week smoothing, the exhibit indicates that Federal Reserve is accelerating its easing program. Conversely, when the five-week smoothing falls faster than the 52-week smoothing, the indicator suggests that the Federal Reserve is becoming increasingly restrictive.

Table C

MEASURES OF CONSUMER CONFIDENCE, SPENDING AND CORPORATE PROFIT MARGINS







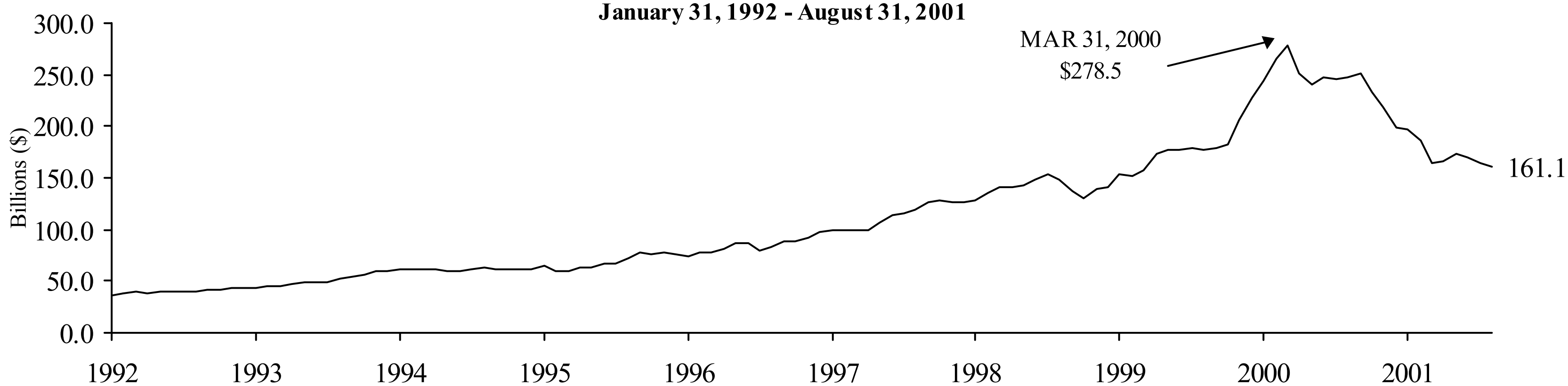
Sources: Datastream International and Ned Davis Research.

Table D

NYSE MARGIN DEBT AND INSIDER TRADING

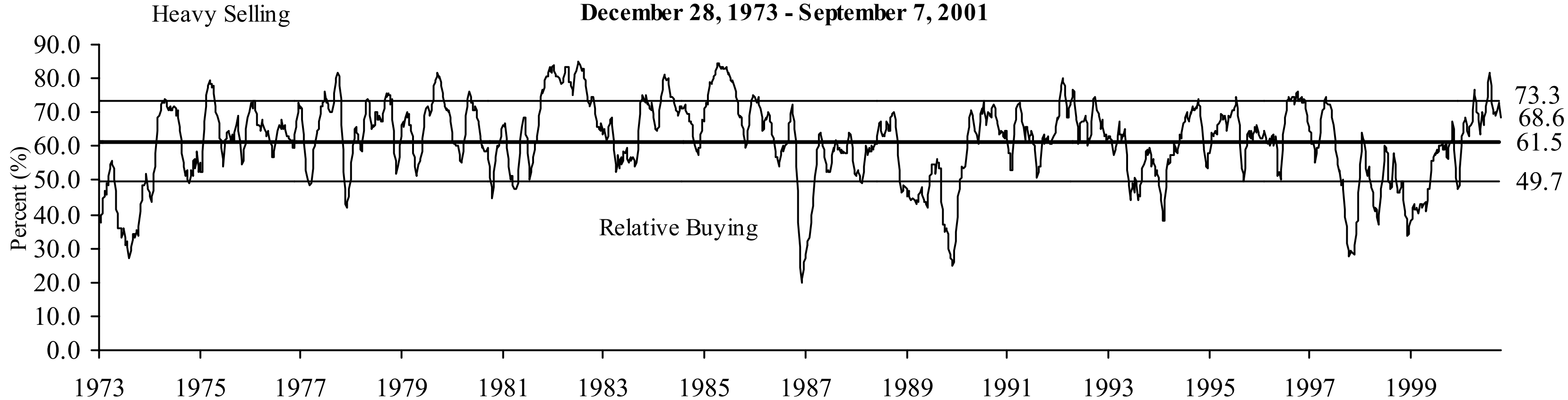
NYSE Margin Debt

January 31, 1992 - August 31, 2001



Insider Trading

December 28, 1973 - September 7, 2001



Sources: Ned Davis Research and New York Stock Exchange.

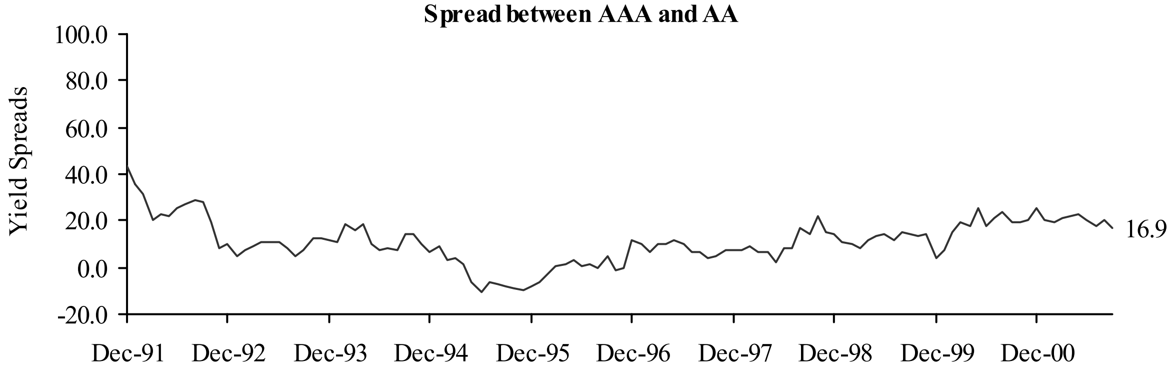
Note: The bottom graph represents a ratio of sales to total open markets trades on the basis of a five-week average.

Table E

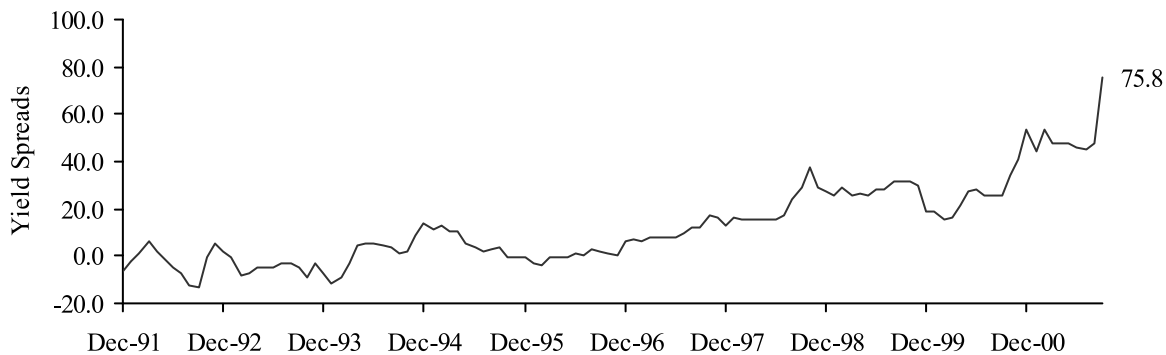
SPREADS FOR VARIOUS QUALITY BONDS

December 31, 1991 - September 30, 2001

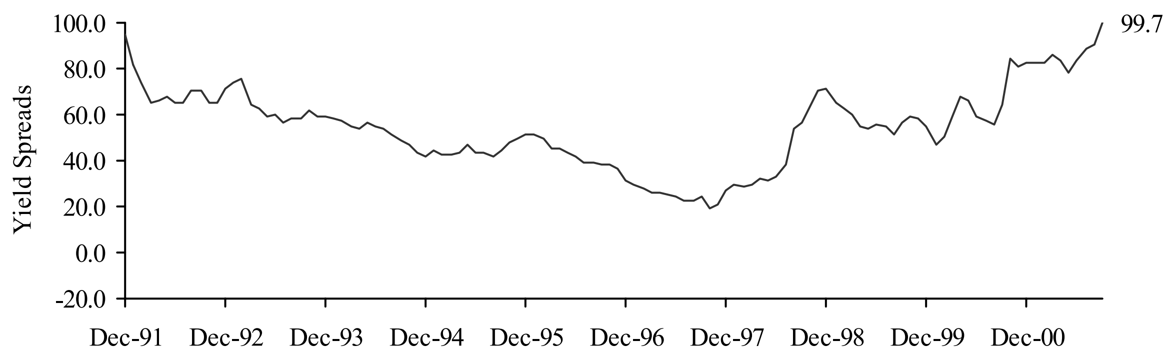
Spread between AAA and AA



Spread between AA and A



Spread between A and BBB

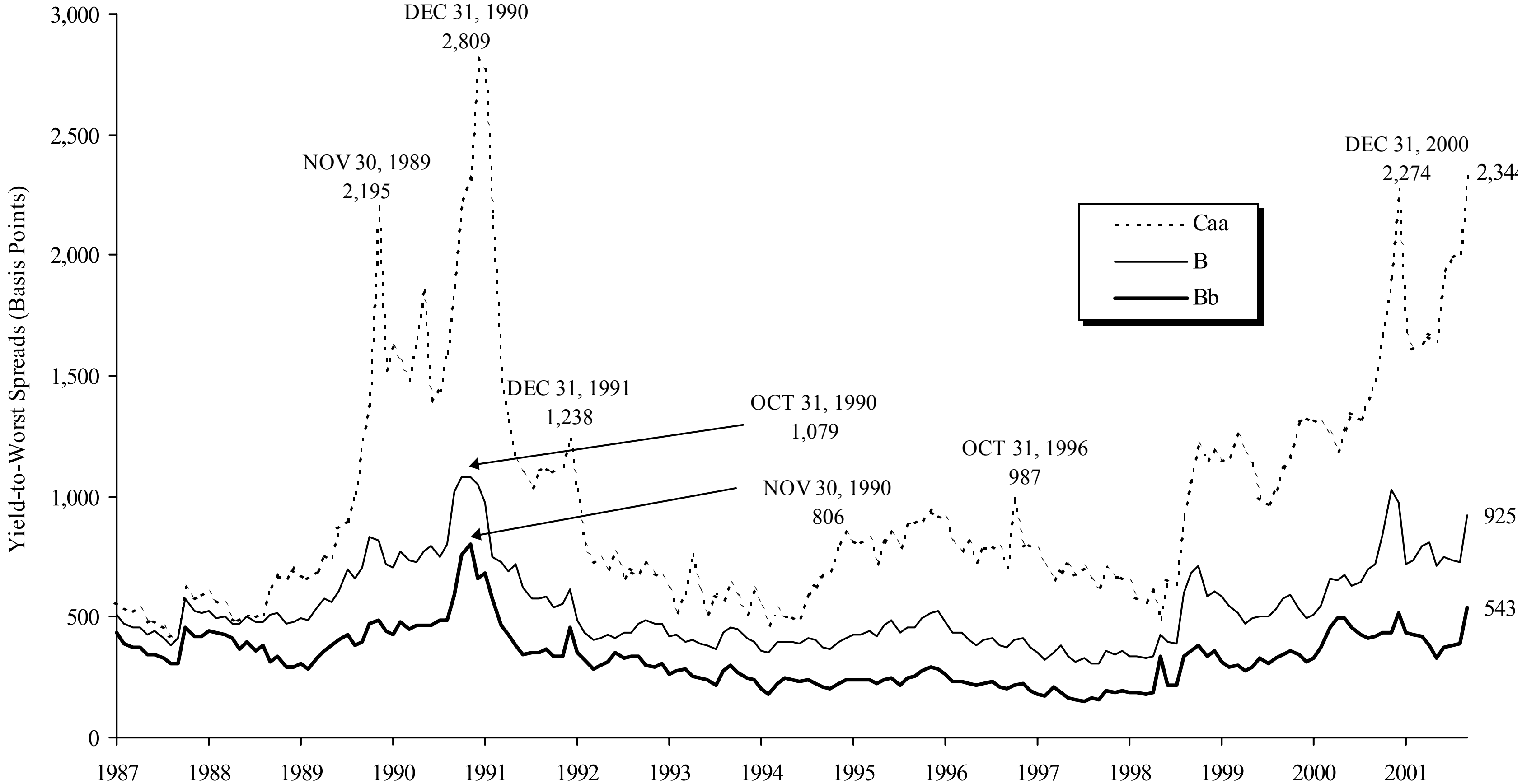


Sources: The Bloomberg and Datastream International.

Table F

YIELD SPREADS FOR SELECTED HIGH-YIELD BOND RATING CATEGORIES RELATIVE TO TEN-YEAR TREASURIES

January 31, 1987 - September 30, 2001



Sources: Datastream International and Lehman Brothers High-Yield Bond Department.

Note: Yield spreads are based on the difference between the weighted-average yield-to-worst (the lower of yield-to-maturity and yield-to-call) for each high-yield rating category and the yield-to-maturity for ten-year Treasury securities.

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