It's behind you

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LONDON AND NEW YORK

Should twitchy markets scare us?

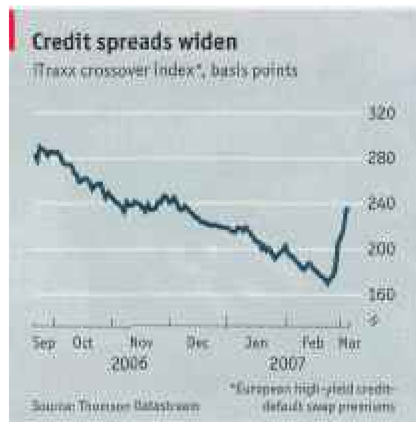
"THAT'S that coming over the hill W Is it a monster?" The Automatii an Indie-rock band, might almost hav written its recent hit with the stockmarke in mind. Most people struggle to muste much sympathy for overpaid Wall Stree traders when share prices are falling. Wha they worry about is a market decline tha seems to anticipate—or even cause-ai economic downturn. So the gyrations o the s&p 500 index probably matter less t the average American than the view o Alan Greenspan, the much-respected foi mer chairman of the Federal Reserve, tha there is a one-in-three chance of a reces sion in America this year.

Stockmarkets, with their habitual pei versity, took Mr Greenspan's remarks a the cue for a sharp rally on March 6th, evei though the great man's vaguer and les alarming comments a week earlier hai helped trigger a brutal sell-off. Perhaps ir vestors are paying more attention to th present Fed chairman, Ben Bernanke, wh has sounded more sanguine.

And yet the data have favoured M Greenspan. There has been a sharp fall ii HSBC'S activity-surprise index, which re fleets whether economic numbers hav surpassed or fallen short of expectation; A weaker-than-expected services-secto survey was followed by a surge in American unit labour costs, a fall in pending home sales and a 5.6% drop in factory orders, all seemingly negative indicators.

A look back at the past week or so suggests investors are indeed worried about economic growth. The assets that have sold fastest have been growth-sensitive ones—shares, commodities and emerging markets-whereas Treasury bonds have risen. Within Stockmarkets, defensive shares, such as food producers, have done better than cyclical ones, such as miners.

Market turmoil also matters because fi-



nancial services play such an important part in many developed economies. In America the industry makes up more than 30% of profits. Wall Street's big securities firms were on top of the world only weeks ago, basking in record profits and handing out bonuses to make Croesus blush. Last year was the best ever for the five biggest firms, which made combined profits of more than $30 billion.

But when markets started to fall on February 2yth, the shares of investment banks fell faster than the rest (although they also recovered more sharply on March 6th). Rising markets tend to be good for banks, boosting the profits of their trading arms and encouraging share and debt issuance, both of which earn fat fees; in falling markets the reverse applies. In addition, the turmoil in the subprime mortgage market, and the associated tightening of credit standards, may itself damage growth prospects, by hitting house prices and thus consumer demand (see page 69).

Fears over the banks' fate also showed up in derivatives markets. Moody's, a rating agency, recently pointed out that the credit-default swap (CDS) market—in which investors pay for protection against firms' failure to repay their debt—was giving Goldman Sachs, Merrill Lynch and

Morgan Stanley an implied rating only two levels above "junk". Though traders in the CDS market tend to be more bearish than bond investors, these are hardly encouraging signs. If the fears lead to lower actual ratings from agencies like Moody's, the banks' borrowing costs will rise.

The credit markets, to which the banks are naturally exposed, have long looked like an accident waiting to happen. In late February the interest-rate margins above Treasury bonds on high-yield corporate and emerging-market debt were very low by historical standards. Some narrowing of these spreads was justified by the fundamentals. Emerging economies are a lot stronger than they were ten years ago, with many enjoying current-account and budget surpluses. Surging profits have kept the default rate on corporate debt down to very low levels.

But investors probably became too complacent. According to Martin Fridson, a credit strategist, spreads in late February no longer reflected the return needed to compensate investors for the historic default rate on bonds. That is especially odd given that the credit quality of bond issuers has steadily deteriorated in recent years, as fewer and fewer companies have achieved the prestigious AAA rating.

Credit spreads have widened again during the sell-off. The cost of insuring against default in the European high-yield debt market rose by almost 50% in a week (see chart on previous page). Higher costs for borrowers could prove to be a drag on economic activity.

Another element of the financial sys-

Buttonwood | We all fall down

Why investors were not as diversified as they had thought

DON'T put all your eggs in one basket. Investors are taught at stockmarket elementary school that the secret to avoiding financial disaster is to make sure they diversify their portfolios.

But when markets plunged on February 2?th shelter was pretty hard to find. First China fell, then European markets, then Wall Street. Emerging markets suffered. Corporate-bond spreads widened (in other words, their prices dropped). Oil declined. Even gold, a supposed "store of value", took a hit. Only the yen and government bonds gained ground.

This marching-in-step has been described by Henry McVey, a Morgan Stanley strategist, as a "market of one". Diversification did not bring the benefits that investors might have expected.

Perhaps it should not be too surprising that, according to Merrill Lynch, over the past five years the Russell 2000 index of small American companies has a 94% correlation with the S&P 500, the main Wall Street index. More alarmingly, international stockmarkets have not offered any diversification either: they have shown a 95% correlation. Yet more startling are the figures showing that hedge funds have recorded a 94% link with shares. Even property has been following Wall Street 81% of the time.

Why should this be? The obvious explanation is the much-touted "excess liquidity" that has been driving up one asset price after another. There is a healthy debate about how to measure this liquidity, or indeed whether the term has any real meaning. But most people agree that the savings surpluses in Asia and the oil exporters have played an important part in fuelling financial markets. JPMorgan estimates that global liquidity increased by $3.9 trillion between 2002 and 2006, of which around 50% came from Asia and 40% from the oil producers.

The bulk of this money went at first into risk-free assets such as Treasury bills and bonds. That drove down the yield on such assets. So other investors were then naturally tempted to look elsewhere for higher returns.

Meanwhile, pension funds have been trying to reduce the bets they have made on shares. This combination has unleashed a "chase for yield" as any asset with an above-average income (or which offered the prospect of above-average returns), has been driven up in price. More speculative investors have been tempted to borrow at the risk-free rate and invest in risky securities, one version of the talked-about "carry trade".

As more money has chased these risky assets, correlations have risen. By the same logic, at moments when investors become risk-averse and want to cut their positions, these asset classes tend to fall together. The effect can be particularly dramatic if the asset classes are small (as in commodities). A few sellers can have a big impact on prices.

This makes it hard to say which asset market is leading the sell-off, whether it is China tripping up Wall Street, or the yen/dollar rate pulling down corporate bonds. Investors are rather like those circus acts who spin plates on top of poles; once one plate starts to fall, the performer must rush to attend to it, risking that others will fall while his back is turned.

The growing importance of hedge funds also makes a difference to correlations. Hedge funds have two important characteristics: they aim to produce absolute returns (in other words, they hate to lose money), and they borrow to enhance returns. That combination makes them quick to cut their bets when prices move against them. In the old days, when pension funds dominated the market, they could (in theory) ride out fluctuations, because of their long-term horizons.

The result, suggests Tim Bond, a strategist at Barclays Capital, is a market with long periods of subdued volatility, as asset prices slowly rise, interspersed with violent corrections, as in May 2006 and the recent sell-off.

How, then, can investors find true diversification from the stockmarket? One answer is to look for assets, such as weather derivatives, that have not yet been discovered by the herd. Another is to use the oldest trick in the book and buy Treasury bonds, the safest of safe havens. Over the past five years Treasury bond prices have tended to move in the opposite direction to shares.

This was not always so. During the 19905, when inflation and short-term rates were falling around the world, stockmarkets and government bonds tended to move together. That pattern changed after the dotcom bubble burst, as investors fled for safety.

The recent outperformance of Treasury bonds shows that the markets are really worrying about economic growth, rather as they did in 2000-02. Were inflation the scare, investors would be buying commodities. So before investors diversify, they should choose which risks they are trying to avoid.

tern that has caused concern is the "carry trade", where investors borrow low-yielding assets to invest in higher-yielding instruments. Japan's low interest rates have made the yen the chief target for the trade in recent years.

When the storm broke, investors reversed their bets. The yen, which briefly touched 122 against the dollar early last month, rose to 115.2 on March sth before easing back. The big gains for the yen were against currencies where the "carry", the differential with Japanese interest rates, is large—the Australian and New Zealand dollars and the pound (see next page).

It is tempting to believe the yen's movements have been fuelling recent events. But that may be simplistic. Stephen Jen, a currency strategist at Morgan Stanley, believes the equity and credit markets were the main arenas for a rethink on risk. Once these markets stirred, hedge funds were compelled to exit their riskier trades wherever they could. The liquid currency markets were an obvious place to start.

In any case, hedge funds were not the only ones who had been nudging the yen lower. A big part had been played by Japanese savers searching for higher returns overseas. They might limit the yen's rise. David Woo at Barclays Capital reckons that, each time the yen strengthens towards 115 to the dollar, Japanese funds will find it hard to resist the temptation to buy "cheaper" overseas assets-and start bidding down the yen again.

Sinking subprime mortgages, risky credit markets, reversing carry trades-any one might be the harbinger of bad economic news. Many monsters turn out to be a figment of the imagination, but this one seems more solid than most. •

Fonte: The Economist, v. 382, n. 8519, p. 67-69, 10 Mar. 2007.