The parable of the cats
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The financial markets are fretting about a record oil price, the prospect of slower growth, a wobbly dollar and much more

BUTTONWOOD’S cats are normally the very picture of somnolent peacefulness. Last night, however, the purrs turned into deep growls, and the growls, all of a sudden, into a whirr of fur and fury. Listen carefully and you can hear the growls from financial markets too. Can the fur and fury be far off?

The growls come in many forms. The first and most obvious is the rising price of oil. The US benchmark, light, sweet crude—it sounds a bit like the stuff you have with a burger, doesn’t it?—rose this week to over $55, a new record, at least in nominal terms. Oil for future delivery has also been rising, suggesting that not only do consumers think it very unlikely the price of oil will fall sharply but that it may indeed rise further. The price of petrol and other oil derivatives is also going up, in part because the price of crude is rising, but also because there isn’t enough refining capacity. That these increases will have a bad effect on the world economy is not in doubt; the questions are what sort of bad effect and how big.

The bad effects come in two varieties: inflation and slower growth. Having worried briefly about the first of these earlier in the year, financial markets are becoming more vexed about the second, especially since central banks, and the Federal Reserve in particular, have been removing some of the extreme looseness of monetary policy in recent months by hiking interest rates, albeit by tiny amounts. Thus have inflation expectations dropped. The combination of lower expected inflation and slower growth has caused the yield on ten-year Treasuries to fall by almost a percentage point since reaching a high earlier this year. Not that this is solely an American concern. An index of rich-country government bonds compiled by Citigroup has gone up by an extraordinary 10% since May.

Concerns about the effects of slower growth and higher oil prices on corporate profits have started to spook stockmarkets. The Eurotop 300 index of European shares is now down by some 4.5% from its high this year; America’s S&P 500 is down around 5.5%; and Japan’s Topix has fallen by almost 12%. Given how expensive these markets are by any reasonable metric, however, these falls can be seen as slight.
Growls aplenty there are elsewhere, too. The cost of insuring against bad outcomes in equity markets, at least as measured by the Chicago Board Options Exchange’s VIX index of volatility, has been rising in recent days. It is, however, still extraordinarily low—a third of its level in October 2002—given the myriad uncertainties in the world.

So, too, are the interest rates demanded by holders of corporate bonds over those on Treasuries, even though these spreads have climbed a bit over the past couple of weeks. In America, spreads of bonds rated BBB are about 1.2 percentage points, four points less than they yielded in October 2002. Most of the doubts about creditworthiness have centred on car companies and, of late (thank you, Mr Spitzer), on insurers. For how long will concerns be so narrow, and rewards so meagre, if growth really falters?

Spreads on junk bonds have actually fallen lately. They now yield about four percentage points or so over Treasuries. In October 2002 the spread was over ten points, not that the numbers meant much, given the panic in the markets at that time. Perhaps all the issuers of such bonds are indeed much healthier now than they were then. Perhaps, on the other hand, they are simply the beneficiaries of ultra-loose monetary policy and a huge appetite for risk among investors. After a panic in May, emerging-market debt recouped most of its losses. In recent days this market, too, has wobbled but it still looks horribly expensive by historical standards.

The dollar has also been falling out of favour in recent days. This week, it reached its lowest level in eight months on a trade-weighted basis, according to the Fed, and is within a whisker of an all-time low against the euro. Foreign-exchange traders seem to have discovered what everyone else already knew: that America’s huge and growing current-account deficit is unsustainable, and that two things are required to correct it. First, Americans must save more (which will slow growth, perhaps sharply); and second, the dollar needs to fall more than it has done already—perhaps a lot more.

Alan Greenspan, the Fed’s chairman, and a man with a somewhat Panglossian view of the world, thinks that all these fears are overdone. His message is: don’t fret about America’s current-account deficit, consumers’ huge debts or the surging oil price; none of them matters, or at least not much. But your columnist does worry about such things, not least because the financial markets seem to be frighteningly sanguine about them: fears in the markets look about as overdone as a steak haché.

The dollar looks in danger of plunging, the price of oil continues to surge, gold is going up and world growth is slowing. Oh, and America is about to hold an election that could create as much uncertainty as it removes. Small wonder that there are a few growls from financial markets. Buttonwood has a nasty feeling that something worse is in store.

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