

BUSINESS CYCLES AND FINANCIAL MARKETS

Market driven short-term interest rates bottomed in January at 4.70% and have been rising steadily since then. They finished at 5.90% in the past few days, a jump of 120 basis points (1.2 percentage points). This is a big increase. What makes it even more astounding is that the press and most Wall Street observers are still debating whether the Fed will raise the fed funds rate by 25 basis points (a quarter of a percentage point).

It's important to keep things in perspective. Previous cyclical rises in short-term interest rates have been 200-300 basis points. The only exception was the business cycle of the late 1970s when the rate on Treasury bills more than tripled from 4% to 15%.

To understand why short-term interest rates have been rising, and why they will continue to rise for several more months, we must place the issue in a business cycle context. Since the late 1950s there have been seven business cycles. We are living through the eighth one.

Short-term interest rates do not rise because of decisions made by the Fed. I wrote extensively about this in the August issue of *The Peter Dag Portfolio Strategy and Management*. They rise because of what has happened in the economy in previous years. Rate increases are the outcome of a long series of events that eventually place upward pressure on money market rates.

Each of the previous seven business cycles began with a strong acceleration in monetary aggregates. In other words, they started because business and consumers found it attractive to borrow, in order to buy goods and to invest. Without exception, this credit expansion has been the spark that ignited all previous economic expansions. It's also what the various measures of money supply try to capture.

Eventually, as the economy keeps growing, all resources become increasingly utilized and prices begin to rise. The price of labor, raw materials and money is not immune from the pressures created by strong demand.

As soon as the price of money begins to rise, credit expansion begins to slow down. Marginal borrowers become discouraged by the increase in interest rates. As interest rates continue to rise, an increasing number of borrowers scale down their appetite for money. The money supply then slows down even more rapidly.

Eventually the slower growth in business activity reflects the slowdown in credit. Finally, following a protracted slowdown in the economy, the price of labor, raw materials and money peaks and then declines. This is the signal for business and consumers to start borrowing again. A new business cycle begins.

This is a very natural process with a long chain of related causes and effects. Instead, we are led to believe that what is happening is somehow a command performance by the

Fed. I really doubt it. If this were true, how did we get in the current situation in the first place?

Where do we stand in this cycle? We are somewhere in the middle of the eighth business cycle, with the growth of the money supply slowing down (which I correctly predicted) because of the increase of interest rates. If previous cycles are any guide, and I believe they are, the money supply will have to slow down to the 0-3% range from the current 10% pace to have an impact on cooling down an overheated economy. Only then will short-term interest rates peak.

Meanwhile the price of money will continue to rise, driven by strong business conditions. It would not be unusual for short-term interest rates to reach at least 7%. Given the time it will take for the money supply to slow down to 0-3%, interest rates should not peak before May 2000.

I see no reason why this eighth business cycle should be different from previous ones. The Fed has little to do with what will happen next. One could say the Fed should have prevented monetary aggregates from accelerating so rapidly from 1997 to 1999. But in 1997 the Fed was more concerned (correctly) with the global impact of the Asian crisis, than with the US business cycle.

There is no question that even if I am mildly right about the above scenario, it is going to be very difficult to make money in the stock market.

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