CREDIT SPREADS,

OVERINVESTMENT, AND FINANCIAL MARKETS

Credit spreads (yield differentials between BAA bonds and 10-year Treasuries) are enormous. They have reached new highs since 1955 (see chart below). Such high spreads are creating serious problems for business and the financial markets.

Companies find it increasingly more difficult to justify paying such high interest charges. New investments are being delayed until these spreads decline to more reasonable levels.

The outcome is that the money supply, which reflects demand for credit, will continue to slow down with its **negative implications for the stock market, the dollar, and the economy**.

The growth of the money supply will continue to slow down until credit spreads decline close to historical norms.

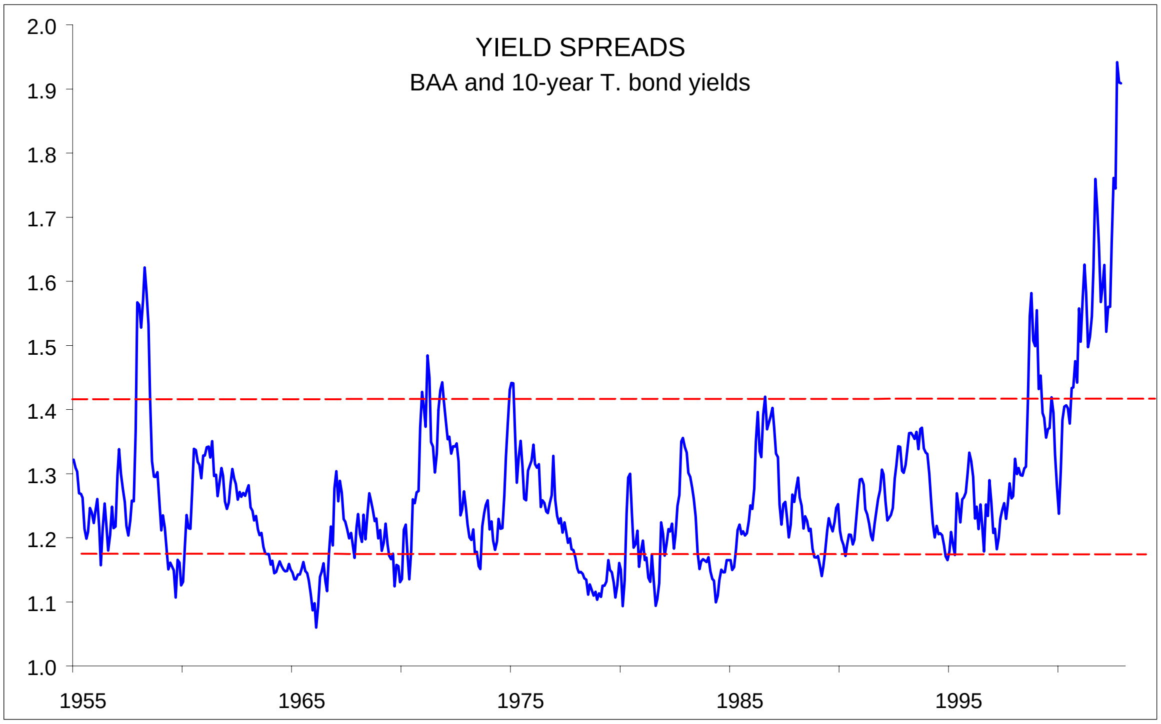
The Fed can pump as much money as possible in the banking system, but if companies do not want to borrow, the growth of the money supply will continue to decline. Slower growth in monetary aggregates will have a negative impact on the **stock market**.

Even **the dollar** will suffer. The dollar and the growth of the money supply have exactly the same turning points. For this reason we use them as realiable leading indicators of the economy.

Continued weakness in the dollar and monetary aggregates will have, in due course, a dampening effect on **business activity**.

Credit spreads will have to decline. There is no doubt about it – the market will make sure that it will happen.

As credit spreads decline, they will create **investment opportunities in high yield bonds**.



Credit spreads are at historically high levels. They are the outcome of excessive business investment speculation in the late 1990s. Companies were borrowing to expand capacity and money was easy to find thanks to the generous injection of liquidity by the Fed.

Eventually, corporations reached the limit of their financial viability, as investments were not producing the expected results. Earnings growth was not enough to repay the debt accumulated during the go-go years of the late 1990s.

Lenders recognized what was happening, and in 2000 they started to increase lending rates relative to Treasuries. And spreads began to soar. The current high spread reflects the credit risk caused by unwarranted capital investments in the late 1990s.

The market will gradually, but steadily, rectify this unusual and abnormal situation. The financial integrity of these businesses will become "normal" again when the yield spreads decline close to their historical ranges.

It will take some time for this to happen. In the meantime the financial markets will have to deal with strong headwinds as this adjustment process takes place.

George Dagnino, PhD
Editor, *The Peter Dag Portfolio Strategy and Management*
Since 1977

www.peterdag.com

11/15/02