THE GREENSPANNING OF THE MARKET

By Patrick Niland

If only the financial markets were as cool and collected as Alan Greenspan appears to be when testifying before congressional committees. Unfortunately, many "nervous Nellie" bond traders fear that inflation must be lurking out there somewhere. Why else would the Fed have raised rates so many times? Even Greenspan himself must be at least a little confused by the conflicting signs.

For example, continuing corporate cutbacks, growing unemployment, falling housing starts, poor Christmas retail sales, rising inventories, and a low 2.6% core inflation rate for 1994 all seem to indicate that our economy is just limping along. Therefore, you would think that the Fed has done more than enough to ward off inflation.

On the other hand, increasing producer prices, healthy GDP growth, robust capacity utilization, rising industrial production, firming commodity prices, and a confident consumer outlook all argue that further Fed tightening might be needed to keep this soaring economy from overheating. Confused yet?

Now, mix in a little Mexican credit crisis, a falling Canadian dollar, a disastrous earthquake in Kobe (Japan), instability in Russia, the prospect of trade sanctions against China, and booming credit demand from emerging Far Eastern economies. These trends make it easier to understand why the market has a bad case of the jitters. But, not to worry; Greenspan is aiming to be the first Fed chairman to pilot our economy to a "soft landing" and a rosy, albeit more reasonably-paced, future. I've heard this before, and it worries me. "Soft landing" always reminds me of the joke in which two Japanese children argue over who has the softer futon. As anyone who has slept(?) on one knows, there is no such thing as a "soft" futon.

However, now there are hints that the "up" indicators may be softening as well. Both consumer debt (currently at an all-time high) and home mortgage debt (much of which is subject to adjustable rates) are starting to feel the burden of the Fed's increases. With more of their income going to pay off credit cards and home loans, consumers will have much less to spend at the store. This will, in turn, reduce industrial production, ease wage pressures, and (hopefully) calm Greenspan's inflationary nightmares.

Most disturbing, though, are those who say that the Fed has gone too far and that the seeds of recession already have been sown. These folks contend that it takes about six to nine months for a Fed rate increase to work its way through the system and then show up in lower economic figures. Therefore, they argue, the most recent batch of slow-growth numbers are really the result of the Fed's <u>first</u> rate increase back in February 1994. For those who've lost count, there have been <u>six</u> increases since then, lifting the discount rate (what the Fed charges banks for overnight loans) by 2.25% and the federal funds rate (what banks charge each other for overnight loans) by 3.00%. We all should hope that these doomsayers are wrong. If not, Greenspan's "soft landing" will be on a futon.

So, what does *my* crystal ball say? Sadly, I see one final Fed increase of 0.25% to 0.50% toward the middle of the second quarter. That should put the last nail in inflation's coffin for this business cycle. By the middle of the year, long bond rates will retreat to the 7.00% to 7.50% range, while the short end will fall by 1.50% to 2.00%. This will restore more "curve" to the yield curve. The economy (and rates) then will waddle sideways until the elections in late 1996.

As for commercial mortgage rates, loan-hungry lenders will continue to narrow spreads and lengthen amortization schedules. They also will accept higher LTVs and thinner coverage than they would have during the last three years. Other terms, like prepayment provisions and environmental issues, also may be watered down. So, despite the higher rates, now actually may be a good time to refinance your commercial loans – the "total package" might be better today than ever before.