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Risk, What Risk?

In 1998, we wondered, “What happens when the potential high-impact consequences of risky behavior lose their power to limit such behavior . . . when confidence reaches such a peak that individuals begin to believe that the consequences of risky behavior have all but been eliminated?” (see **IF 1910**, 4/6/98). In the 18-24 months that followed, we saw the answer to our question play out in the financial markets. Today we see signals that it is time to ask that question again, but this time, the time frame may be shorter.

Volatility, as a proxy for risk, is at or near historic lows in numerous markets. The CBOE Volatility Index hit an all time low Thanksgiving week, while The German Dax 30 and the South Korean Kospì, among others, are experiencing the lowest volatility ever. The European Central Bank’s “global hazard indicator” which measures the implied volatility of currency trading also fell to an all-time low.

Meanwhile, credit derivative spreads are tightening. The Dow US CDX indices, measuring the spread investors pay for investment grade debt in the credit derivatives market, have dropped to historic lows, and the European “Crossover Index,” a basket of credit default swaps on risky European corporate bonds, tightened to its lowest level ever.

Another indicator of low levels of perceived risk can be found in debt markets, which are also producing some historically interesting numbers. The spread for emerging market debt, corporate junk bonds, and small company stock have all reached near historic lows in the past year. U.S. private equity firms have loaded their acquisitions with more than \$25 billion in debt – just to fund dividends for themselves. At European private equity firms, senior (core) debt leverage now runs 4.5 times EBITDA, compared with 3.8 times earlier this year.

Based on past observations, perceptions of risk hitting unexplained lows in one financial arena usually signals the possibility that real risk is about to rise. However, right now such events are widespread across many geographical regions and various financial markets. Historically, such a convergence has indicated the bottom of real risk and the beginning of rising risk.

At the end of 2005, the yield curve inverted for the first time in 5 years, and that inversion has deepened through November. In the U.S., a recession has followed all but one yield-curve inversion since 1950. Moreover, the yield-curve inversion has spread to Europe. During the first week of November, yields on 10-year European bonds dipped below yields on 2-year bonds, the

first time that has happened in 6 years. Despite these historic warning shots, perceptions of risk in various financial markets remain low, and such perceptions are widespread.

Anecdotally, we've noticed that some investors are now aggressively playing the "pump and dump" game. As worldwide spam levels have doubled in the past year, many of those unwanted e-mails have targeted those in the investment community, peddling various stocks as due for a "sure rise" in the coming days. Two recent university studies revealed that, on average, those who participate in the first day of these pump and dump e-mail spams are rewarded with 5-7 percent two-day increases in stock value. That some investors are playing this game suggests to us that behaviors are getting extreme, and that perceptions of risk are out of line with reality.

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