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COMMENTARY

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Understanding the Financial Markets in 1999 Part 5 – The “Bad” Bull Market

“LTCM [Long Term Capital Management] specialises in so-called convergence investing, and the new organisation is likely to continue with that style of investing.”

– Financial Times, April 20, 1999

In the last several months we have witnessed one of the most unusual episodes in the history of finance. Yet it seems only a few people have noticed it. What are we talking about? The “bad” bull market in bonds that ended on October 5th and the “good” bear market that subsequently began.

Chart 1 shows the yields for some of the major investment grade sectors of the U.S. bond market. This chart uses the Merrill Treasury Master index, the Merrill Mortgage Master index, and the Merrill Corporate Master index. Last summer/fall, all these yields were plunging. **This is another way of saying that bonds were in a bull market.**

Normally participants in the financial markets, and especially bond traders, welcome a bull market. However, this bull market was very different as bond managers were suffering, dealers were losing a lot of money and Long-Term Capital Management [LTCM] needed to be bailed-out. Can anyone recall another bond **bull market** that caused so much angst among its participants? We cannot. To be clear, we are not talking about the rising interest rates of a bear market. Rather, falling interest rates seemed like a bad thing last fall.

Do Spreads Matter More?

How did we get to the point where a bond bull market became a bad thing? The simple answer is “spread trading”. Prior to 1994, bond trading was primarily about betting on the direction of interest rates. Since 1994, bond trading has evolved into betting on the yield differential between two different securities. We believe this spread trading has become so large that the nominal level of interest rates is now less important than the spread between “risk” assets and “safety” assets. Even though

interest rates were falling last fall, they did so in an adverse way -- spreads were widening.

To appreciate how important this “long risk versus short safety” trade has become, see Chart 2. It shows the positions of the primary dealers broken down by sector. The vertical dotted line is just before the yield low of October 1993 (5.78%). Note that prior to this date, it was not uncommon for the primary dealers to carry a net long position in Treasury securities. Since this date, the primary dealers have been net long Treasuries only once, late 1995/early 1996.

What does this mean? Chart 3 shows the overall net dealer positions of all sectors over the same period. Mid-September 1993 was the all-time peak in dealers positions. We believe this was the all-time peak for the dealers taking **interest rate risk** (a bet on the direction of interest rates).

Since this date, the dealers have not shied away from taking risk with their capital. Indeed last summer they were taking as much risk with their capital as they did in 1993. However, they have shifted to taking more interest rate spread risk (a bet on the yield differential between two securities) and less interest rate risk. This is why net dealer positions for all sectors have not made a new peak. Dealers have been engaged in more aggressive spread trades by shorting safety assets (Treasuries) against a long position in risk assets (Agencies and Mortgages).

Interestingly, the strategy the dealers have been engaged in is the same one described in the quote above about LTCM. That is, the “convergence trade” – betting that the yield of riskier assets will “converge” with the yield of safer assets. The

problem with this strategy is it assumes that yields only **converge**. Saying one specializes in “convergence trading” is like saying one specializes in “buying stocks” or “selling bonds.” What happens when interest rate spreads “diverge?” As we found out last fall, convergence trades “blow up.”

As we detailed in Part 4 (April 9th, Is the S&P 500 the Engine of the World Growth?), a convergence trade is akin to betting on a continued bull market in U.S. equities. This strategy works well as long as stocks are rallying. When stocks peak and decline significantly, these convergence trades will most likely move the other way.

This is what we saw last fall. When U.S. stocks stumbled, convergence trades were big losers. Money rushed into Treasury securities as part of a “flight-to-quality” panic and pushed Treasury yields down faster than the yield of other riskier assets. Since most of this money was from outside the Treasury market, it was unsophisticated to the ways of the bond market. Therefore, it tended to concentrate in the more liquid “on-the-run” securities, (which accounts for the widening spreads between “on-the-run” and “off-the-run” securities). So the dealers, and LTCM, were actually engaged in a trade that is similar to a bet on rising stock prices. The problem is they did not view it that way, and failed to heed the warnings signs that falling stock prices provided.

The Asset Allocation Shift

A large financial institution's asset allocation decision between stocks and bonds is much like a spread trade. They try to “over-weight” the asset category that they believe will outperform and “under-weight” the asset category that will under-perform.

Chart 4 shows the asset allocation between stocks and bonds held by major financial institutions. Between 1974 and 1994, these institutions held their weightings in stocks fairly constant. Over that same period, bonds saw some erosion in the weightings, but were still by far the largest asset category.

Since the beginning of 1995, a major shift in asset allocation has occurred at these institutions. Stocks are now the largest asset category for the first time ever while bonds are near their lowest weightings ever. This means that financial institutions have also been engaged in their own version of the “long risk, short safety” trade.

The Latest Leverage Wave

Chart 5 shows the size of the Treasury repurchase (repo) market relative to the size of the all Treasury debt outstanding. This chart shows the extraordinary amount of leveraging that has taken place in recent years.

This ratio first peaked in October 1993, along with the dealers zenith in interest rate risk. At that point 29% of all Treasury debt outstanding (repo = \$845 billion, Treasury debt = \$2.88 trillion) was involved in a leveraged transaction. When the Fed started to raise rates in February 1994, the “carry trade” (borrowing at a 3% funds rates to buy bonds on margin) began to unwind. This unwinding process ended when this ratio bottomed in January 1995 at 23.5% (repo = \$743 billion, Treasury debt = \$3.16 trillion).

This de-leveraging process was very painful for those that were making big bets on the direction of interest rates (i.e., Kidder Peabody and Orange County). Following this experience, one would have thought another even larger leveraging wave was unlikely. However, as Chart 5 shows, one did happen. This time, however, the leveraging was not built on the assumption of declining interest rates, but rather on convergence between risk assets and safety assets.

From the low in January 1995, repo as a percentage of all Treasury debt outstanding has doubled to 46.4% at the July 1998 high (repo = \$1.52 trillion, Treasury debt = \$3.28 trillion) before pulling back in recent months.

Another way to look at the potential leverage in the marketplace is to look at the size of the derivatives markets. Table 1 is from the Bank for International Settlements (BIS) 1997 annual report (these are the most current numbers). It details the notional value of all derivatives from 1991 to 1997.

This table tells two things. First, the vast majority of derivatives are tied to interest rates -- over 93% in 1997! Second, interest rate derivatives are not only the largest sector of the derivatives market, but they are also the fastest growing. From 1991 to 1997, the compounded growth rate of interest rate derivatives was 28%, currency derivatives grew at 9.4% and stock market derivatives expanded 25%.

The message from this table is that when we say “derivatives” we really are saying “interest rates.” They are the dominant underlying market for these instruments. We believe the primary focus of these instruments has shifted to spread trading and away from betting on the direction of interest rates.

Conclusion: The Real Risk of a Bad Bull Market

We believe the problems in the financial markets last fall were the culmination of a fundamental shift that began in late 1993. Prior to the October 1993 yield low, the primary bet by bond market participants was on the direction of interest rates. Since then, the bet has shifted to the yield differential between two securities. Specifically, this bet has been for yields

to converge with each other. These “convergence trades” have become so big that when interest rate spreads widened last fall, a lot of pain was inflicted on *Wall Street*. This pain was so great that declining interest rates did not offset it. This caused so much concern at the Federal Reserve that they lowered the federal funds rate three times.

It worked! Renewed confidence in riskier assets caused stocks to soar (the NASDAQ returned over 29% in Q4 1998 for its best quarter in history). This rally encouraged the flight-to-quality money hiding in the Treasury market to move back toward “risk” markets.

So, what does this history lesson have to do with the markets now? Our fear is that the reasons for the convergence trade “blowing up” are not fully understood. This makes the markets vulnerable to the same problems again since it seems that financial institutions are still betting on the yield of risk assets converging with safety assets.

We believe the profitability of the convergence trade is tied to the performance of the stock market. Since the stock market is the largest risk asset market in the world, all other risk asset markets take their lead from it. When stocks stumbled last fall, interest rate spreads widened. When stock rallied this winter/spring interest rate spreads converged.

But more importantly, *Wall Street* appears to prefer higher interest rates. When interest rates were declining last fall, *Wall Street* lost money. When interest rates started rising last October, *Wall Street* started to make money.

Why are higher interest rates preferred? Because they are typically accompanied by interest rate spreads converging. Since last October, interest rate spreads have converged as a function of the yield of safety assets rising faster than the yield of risk assets (See Chart 1). This has occurred

because flight capital has continued to exit safety assets for risk assets.

We believe this trend will continue as long as the largest risk asset market in the world, the U.S. stock market, continues to rally. This will reduce the function of the Treasury market to the “short wing” of a convergence trade or an under-weighted asset in a portfolio.

For years we have heard and read dire stories about a big derivatives melt-down. The stories usually revolve around some kind of error in the assumption used in the models to value these instruments. It was feared that one day this error would bankrupt some or many financial institutions.

Our fear is exactly the opposite. Derivative traders are not going to lose enough money to go bankrupt, but rather, they might **make all the money!** If stock prices keep going up, the yield of risk assets will continue to converge with the yield of safety assets. This convergence will come about as investors abandon safe assets for risk assets.

How long does this last? Until the U.S. equity market changes the current equation by slumping. What could cause that slump? Higher interest rates might be the trigger!

Since the end of 1997, every bond market rally (decline in yields) has been fueled by “flight-to-quality” money rushing into the safety assets – U.S. Treasuries. While this has lowered interest rates, it has also caused the yield spread between risk assets and safety assets to widen. Since the fortunes of many bond market participants were tied to converging yields rather than falling interest rates, we termed last year’s bond rally a “bad bull market.” It seemed to hurt more participants than it helped. Understanding this concept is key to understanding the bond market in 1999.

Chart 1

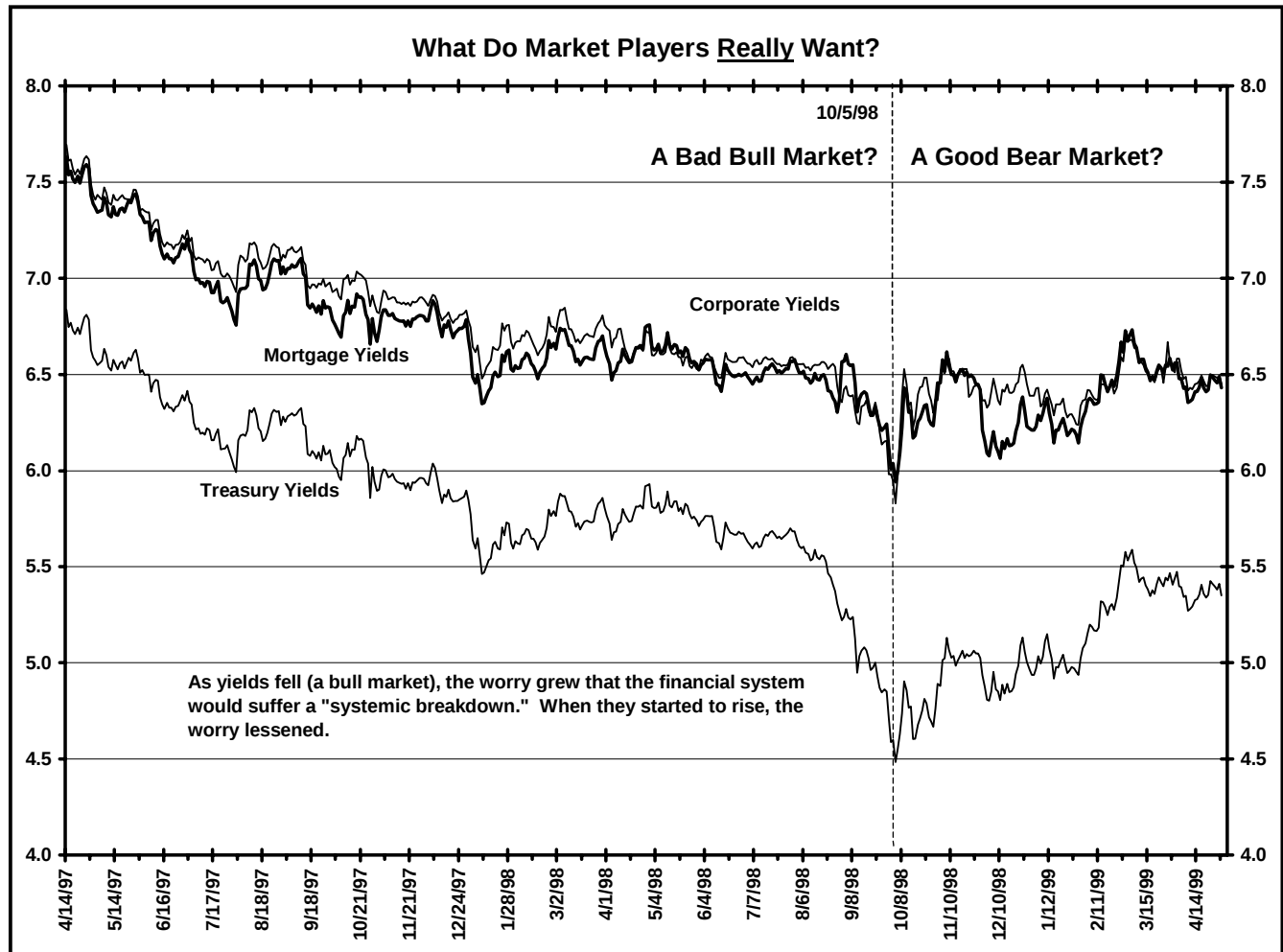


Chart 2

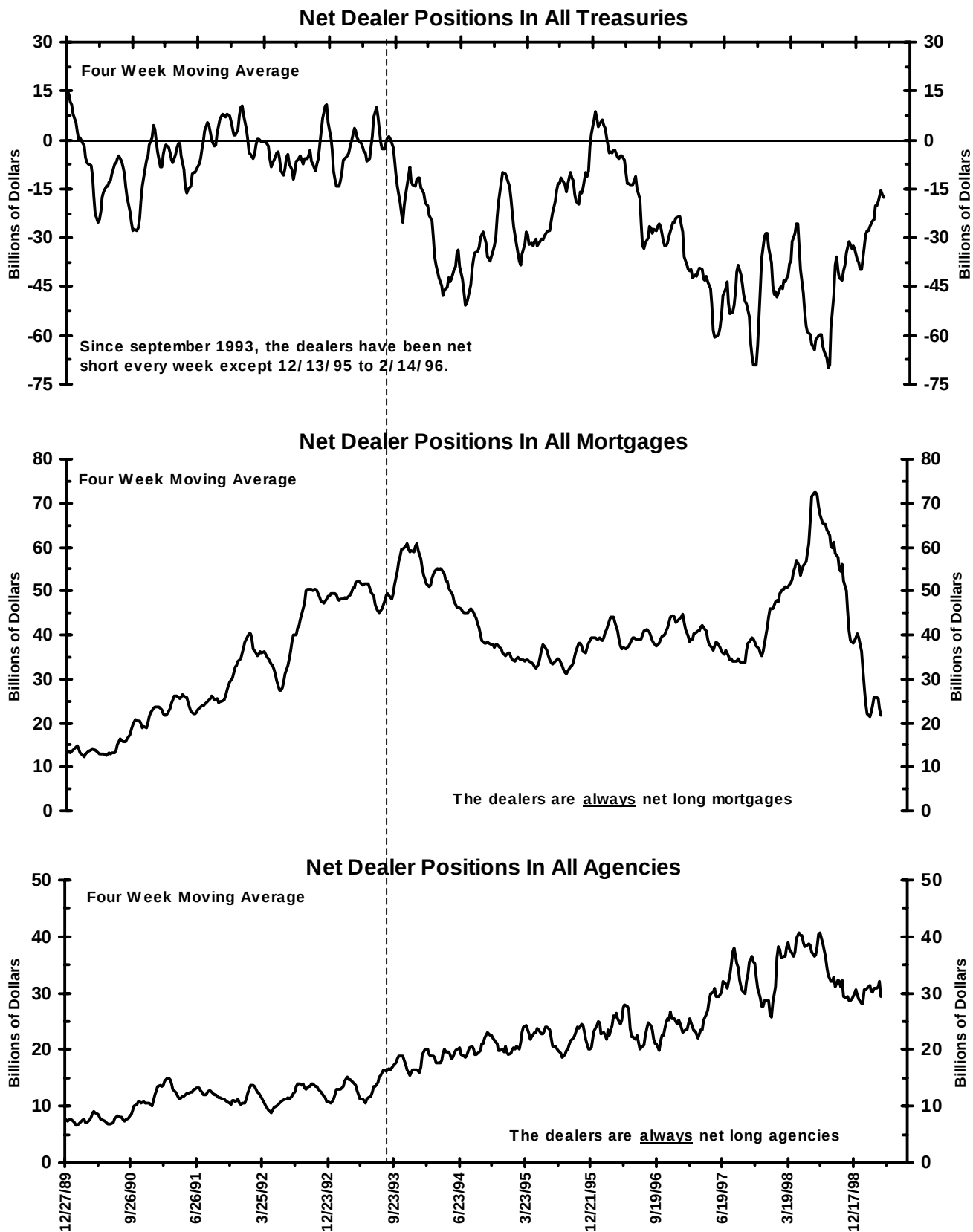


Chart 3

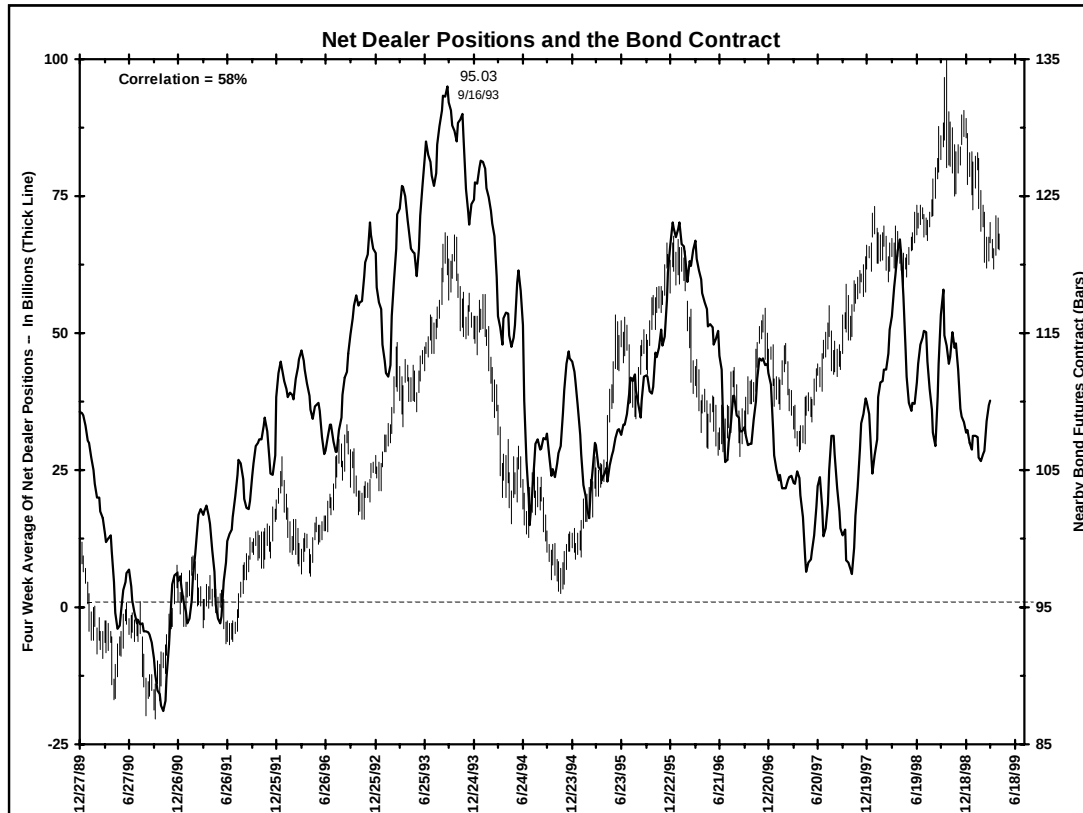


Chart 4

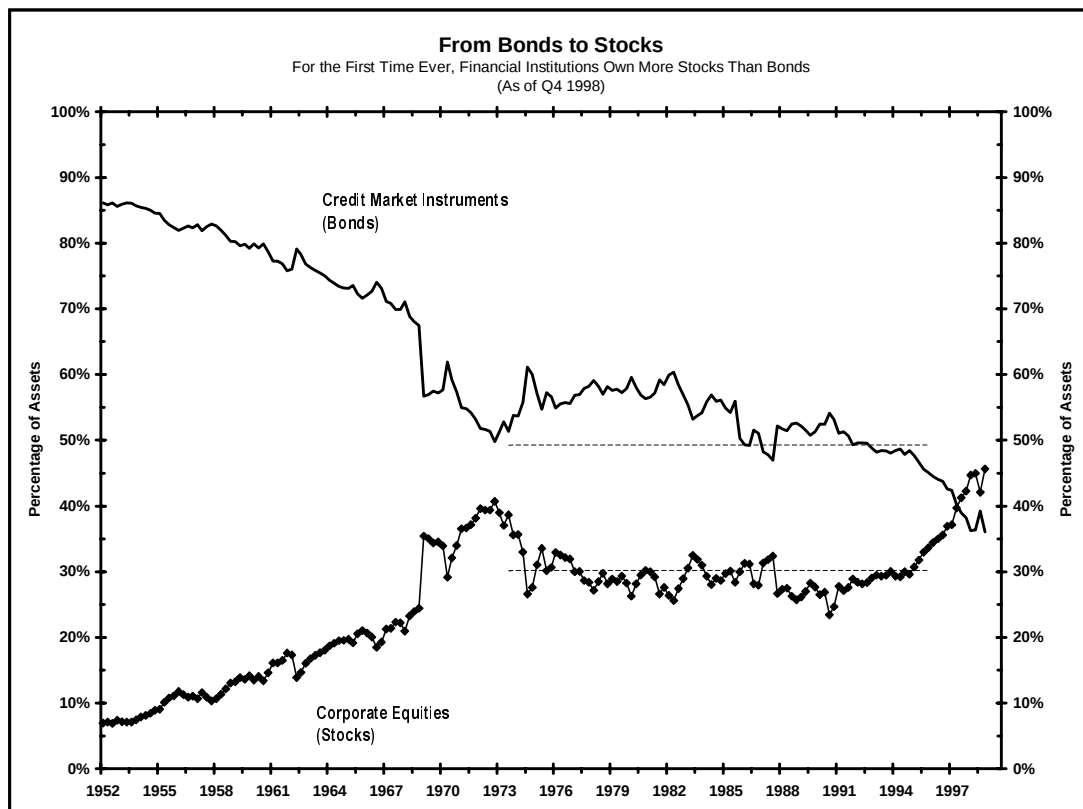


Chart 5

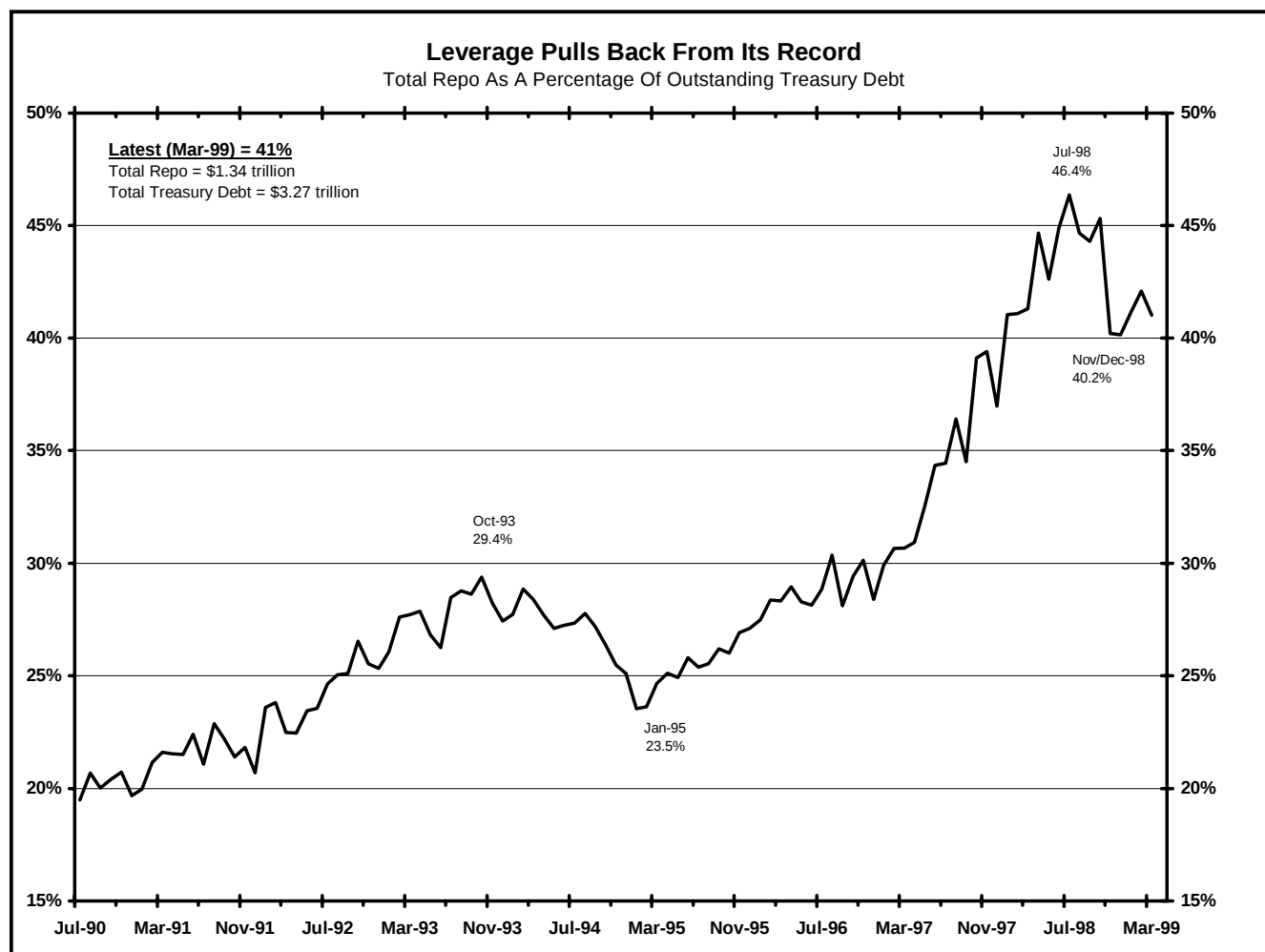


Table 1

The Size Of Selected Derivative Instruments							
	Notional amount outstanding at year-end (trillions)						
	1991	1992	1993	1994	1995	1996	1997
Interest Rates							
Interest Rate Swaps	3.07	3.85	6.18	8.82	12.81	19.17	22.12
Interest Rate Futures	2.16	2.91	4.96	5.78	5.86	5.93	7.49
OTC Interest Rate Options	0.58	0.63	1.40	1.57	3.70	4.72	5.03
Exchange Traded IR Options	<u>1.07</u>	<u>1.39</u>	<u>2.36</u>	<u>2.62</u>	<u>2.74</u>	<u>3.28</u>	<u>3.64</u>
Total Interest Rates	6.87	8.78	14.90	18.79	25.12	33.10	38.28
Currency							
Currency Swaps	0.81	0.86	0.90	0.91	1.20	1.56	1.58
Currency Futures	0.02	0.03	0.03	0.04	0.04	0.05	0.05
Currency Options	<u>0.06</u>	<u>0.07</u>	<u>0.08</u>	<u>0.06</u>	<u>0.04</u>	<u>0.05</u>	<u>0.03</u>
Total Currency	0.89	0.96	1.01	1.01	1.28	1.66	1.67
Stock Market							
Stock Market Index Futures	0.08	0.08	0.11	0.13	0.17	0.20	0.22
Stock Market Index Options	<u>0.13</u>	<u>0.16</u>	<u>0.23</u>	<u>0.24</u>	<u>0.33</u>	<u>0.38</u>	<u>0.78</u>
Total Stock Market	0.21	0.24	0.34	0.37	0.50	0.57	0.99
Grand Total	7.97	9.98	16.25	20.17	26.90	35.33	40.94

Source: Bank For International Settlements Annual Report

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