

BIANCO RESEARCH, L.L.C.

AN ARBOR RESEARCH & TRADING, INC. AFFILIATE
1000 HART ROAD • SUITE 250 • BARRINGTON, ILLINOIS 60010
E-MAIL: jbianco@biancoresearch.com • WEB SITE: www.BiancoResearch.com
TOLL FREE 800-876-1825 • PHONE 847-304-1511 • FAX 847-304-1749

James A. Bianco, CMT

Volume, 10 No. 12

Last Commentary: May 3, 1999

COMMENTARY

Market Opinions And Topics Of Interest
May 25, 1999

Updating Our Bond Outlook: Watching the Most Important Relationship in the Bond Market

"[A]ll else equal, a flattening of stock prices would likely slow the growth of spending, and a decline in equity values, especially a severe one, could lead to a considerable weakening of consumer demand. -- Alan Greenspan on the state of the economy before the committee on ways and means, U.S. House of Representatives January 20th, 1999"

In our writings over the last few months we have made the case for higher yields. Our forecast is based on three concepts.

First, we believe the best valuation measure for determining the appropriate level of interest rates is nominal GDP (real GDP plus inflation). See chart 1. In recent months nominal GDP growth has been above the current level of interest rates. This is the first time since the late 1970s that nominal GDP has been above the current level of interest rates on a sustained basis. For the first time in 20 years, one could argue that the current level of interest rates is too low relative to the nominal growth rate of the economy. This is a big change that has been largely ignored.

Second, we have stated that nominal GDP will stay stronger than expected and sustain an upward trend in interest rates. For the last 11 consecutive quarters (since Q2 1996) real GDP growth has beaten the median estimate of economists as surveyed by MMS International. We believe these upside surprises are due to the economic "tailwind" created by the "wealth effect." Simply stated, soaring stock prices are pushing the economy. Since many (but not all) economists reject the idea of a wealth effect, it is not a big enough factor in the median estimate. Until it is, or the stock market declines significantly (20% on a sustained basis), we believe the nominal growth rate of the economy will continue to surprise to the upside.

Third, the trend of interest rates will continue to be up until they rise high enough to "break the back" of the stock market. Since the stock / bond trading relationship has violated all of its historical parameters, the interest rate that will break stocks

will be more of a "psychological" level than a "mechanical" level. The first level to watch is 5.78% on the five-year note (6.10% long-bond). This would be the highest level since 1997 and combined with record highs in stock market valuations, it might be a cause for concern. Should this level not end the stock rally, the wealth effect will continue to push nominal GDP growth faster, and we would look for even higher interest rates.

In essence we are looking for a peak in interest rates to be much like those shown on chart 2. This chart has been a staple of ISI Research (Ed Hyman) for years. We are looking for the latest rise in interest rates to end when the label "stock market peak" can be applied to the peak of the current rise in interest rates. The precedence for this happening is similar to the 1987 and 1990 peaks.

Where Is Nominal GDP Now?

As we outlined above, we believe the key relationship for the bond market today is **nominal GDP growth relative to the current level of interest rates**. Since nominal GDP has now sustained itself above the current level of interest rates for the first time in 20 years, we believe it is pushing interest rates higher.

Wait a minute! The annual growth rate of nominal GDP shown on chart 1 is 5.05% (through Q1 1999). While the interest rate shown on chart 1 was 5.14% as of March 31st, the current level of the five-year yield is 5.45%. So, doesn't this mean that the growth rate of nominal GDP is now back below the current level of interest rates? If so, doesn't this alleviate the pressure on interest rates?

Yes, the official statistics for nominal GDP, through Q1 1999, show its growth rate well below the current level of interest rates. However, the growth rates of nominal GDP should be much higher when the annual growth rate through Q2 1999 is finally calculated and released. We believe this for three reasons.

First, nominal GDP expanded at a 6.3% annualized pace for the last two quarters (Q4 1998/Q1 1999). So, the annualized growth rate of nominal GDP since last fall has been running much faster than the 5.05% pace shown on chart 1.

Second, real GDP expanded at a 1.8% pace in Q2 1998. The median estimate for Q2 1999 is now 2.85% (remember the median forecast has been too low for 11 consecutive quarters). So, when Q2 1998 is dropped for Q2 1999 in the annual calculation, this alone should move the annual growth rate of nominal GDP to over 6%.

Finally, the already documented jump in inflation should further expand nominal GDP. Remember that nominal GDP is made up of real GDP growth **plus** inflation. So, an increase in inflation is a point for point increase to nominal GDP. This is how inflation matters – it has a direct affect on nominal GDP.

All told, these three events lead us to believe that the actual growth rate of nominal GDP right now is much higher than the annual growth rate of 5.05% through Q1 1999. We believe it might be as high as 6% to 6.5%. If so, a 5.45% five-year note is still too low relative to the growth rate of the economy.

Can Interest Rates Decline?

What about the case for falling yields? We feel it would take a dramatic slowing in the growth rate of nominal GDP to lower interest rates. However, given our belief that the wealth effect is a driving influence on the economy, a slowdown in growth would take a significant decline in the stock market. Since stocks are only 12 days and 4% off their all-time highs (as measured by the S&P 500), it is too early to start looking for a negative wealth effect slowdown in the economy.

We believe that many are missing the larger point that **a bullish stance in the bond market is equivalent to a bearish stance in the stock market**. Chart 3 shows that in the last two years bonds have not rallied while stocks are making new highs. To illustrate this point, we have “boxed” the four largest bond rallies since mid-1997. During these periods, stocks prices at best stopped making new highs, and at worst, were declining significantly.

In earlier commentaries we have argued that it was mid-1997 when the wealth effect's dominant role in

the economy took hold. We believe this “new” trading relationship between stocks and bonds will continue until the wealth effect is no longer an issue for the economy. To be bullish on bonds now, one would have to either argue that stocks are about to decline significantly, or that the “new” stock/bond relationship shown in chart 3 is about to end. Either could be the case, but we do not hear these discussions taking place.

Conclusion

In our last few dispatches we have made some bullish noises. We have noted that the Commitment of Traders (CoT) data shows the large speculators are carrying an extreme short position in T-bond futures (CoT Update: May 7th, May 21st). We have also noted the seasonals for the bond market will turn bullish in June (“Key Chart Update”, May 24th). What gives?

Over the next few weeks, we believe a combination of extreme pessimism and positive seasonals could serve to lower interest rates. This rally might take 30-year bonds yields as low as 5.55%. However, while a rally will make many bond bulls feel better, it does not solve the basic problem that interest rates are too low relative to the economy (nominal GDP). To change the relationship between the economy and interest rates, a significant economic slowdown is needed. We do not see a slowdown coming with the stock market barely off its all-time highs. Furthermore, we do not see stocks correcting significantly if interest rates continue to fall over the near term. High bond yields are the main reason given for the stock weakness of the last few days. Yields falling far enough might clear the way for higher stock prices.

The story of chart 3 should not be ignored. The wealth effect has dramatically changed the trading relationship between stocks and bonds. Higher stock prices are a “tailwind” for the economy (nominal GDP) which pushes interest rates higher. Lower stock prices are a “headwind” for the economy, which pulls interest rates lower. Thus, movements in interest rates are really a function of stock prices.

Should the weakness in the stock market of the last several days continue, proving our sanguine stock outlook wrong, then bond yields can decline significantly. Otherwise, a bottoming of stock prices, inspired in part by lower interest rates, should end the bond rally. Unfortunately, this means that bond managers who make duration bets are forced into being stock market forecasters. It is a position we believe few bond managers want to assume, but it is a reality of the bond market in the late 1990's.

Chart 1

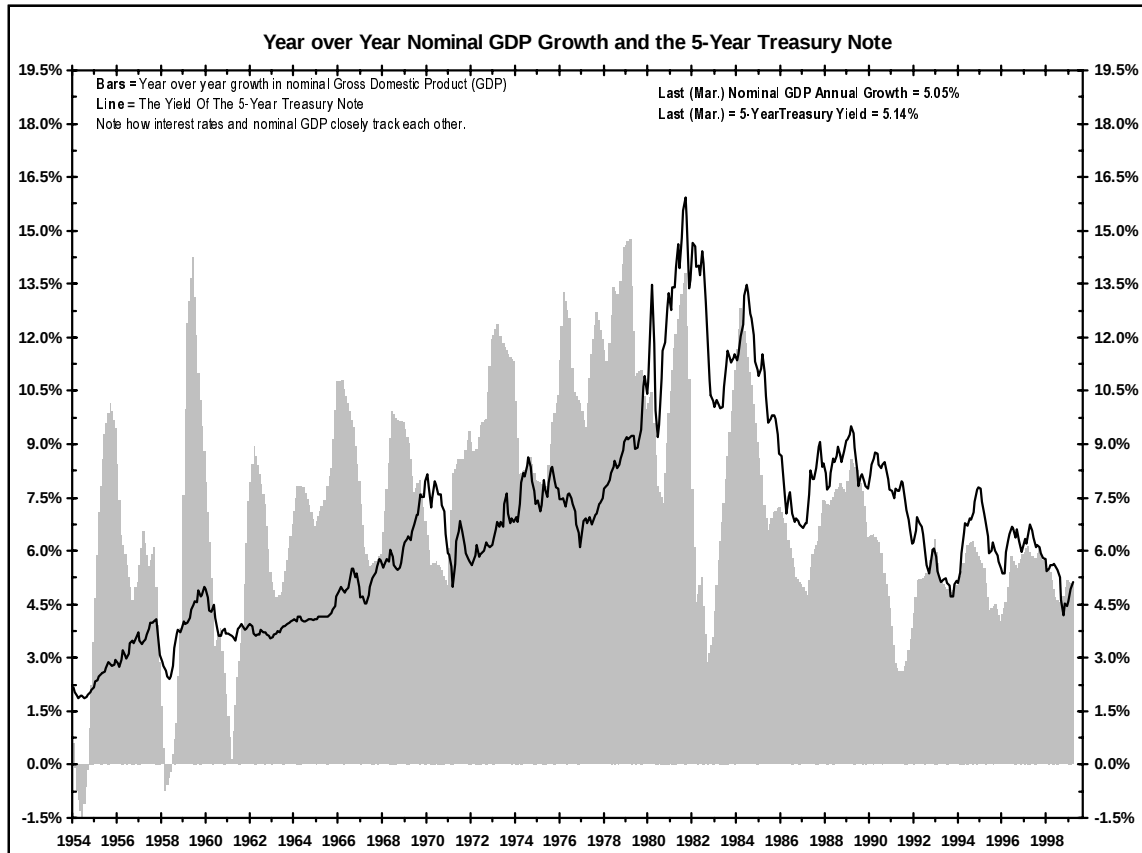


Chart 2

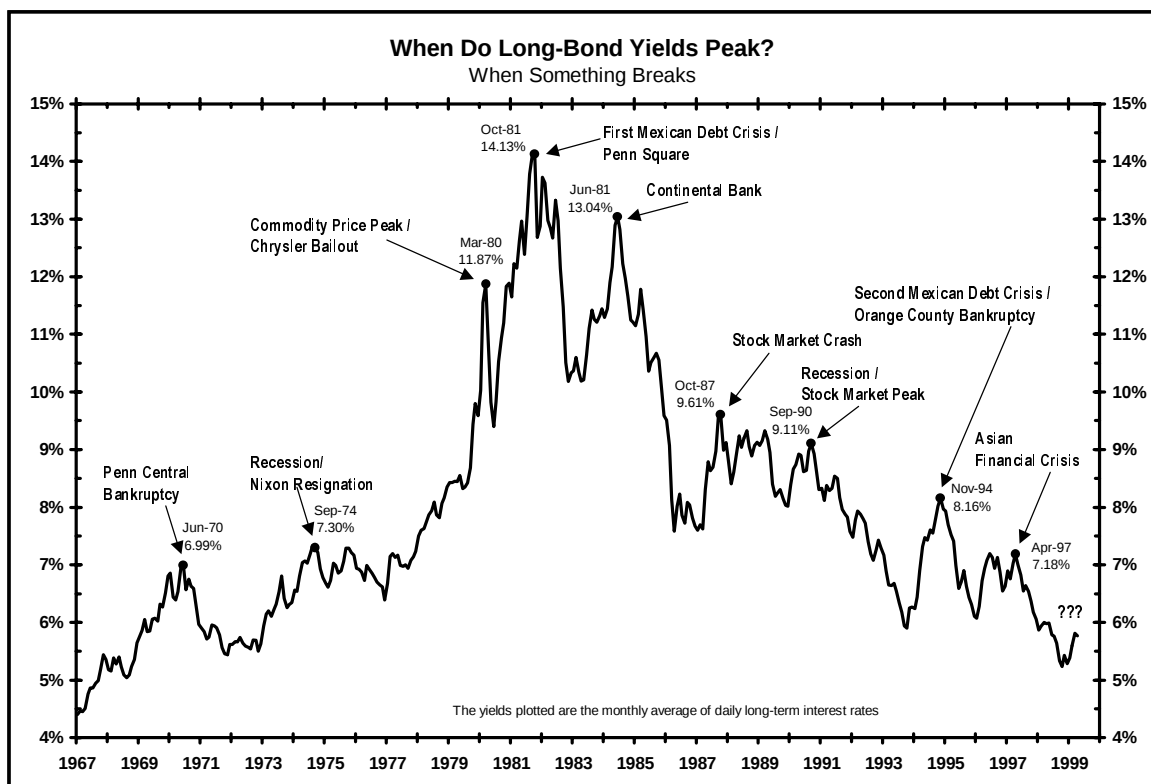
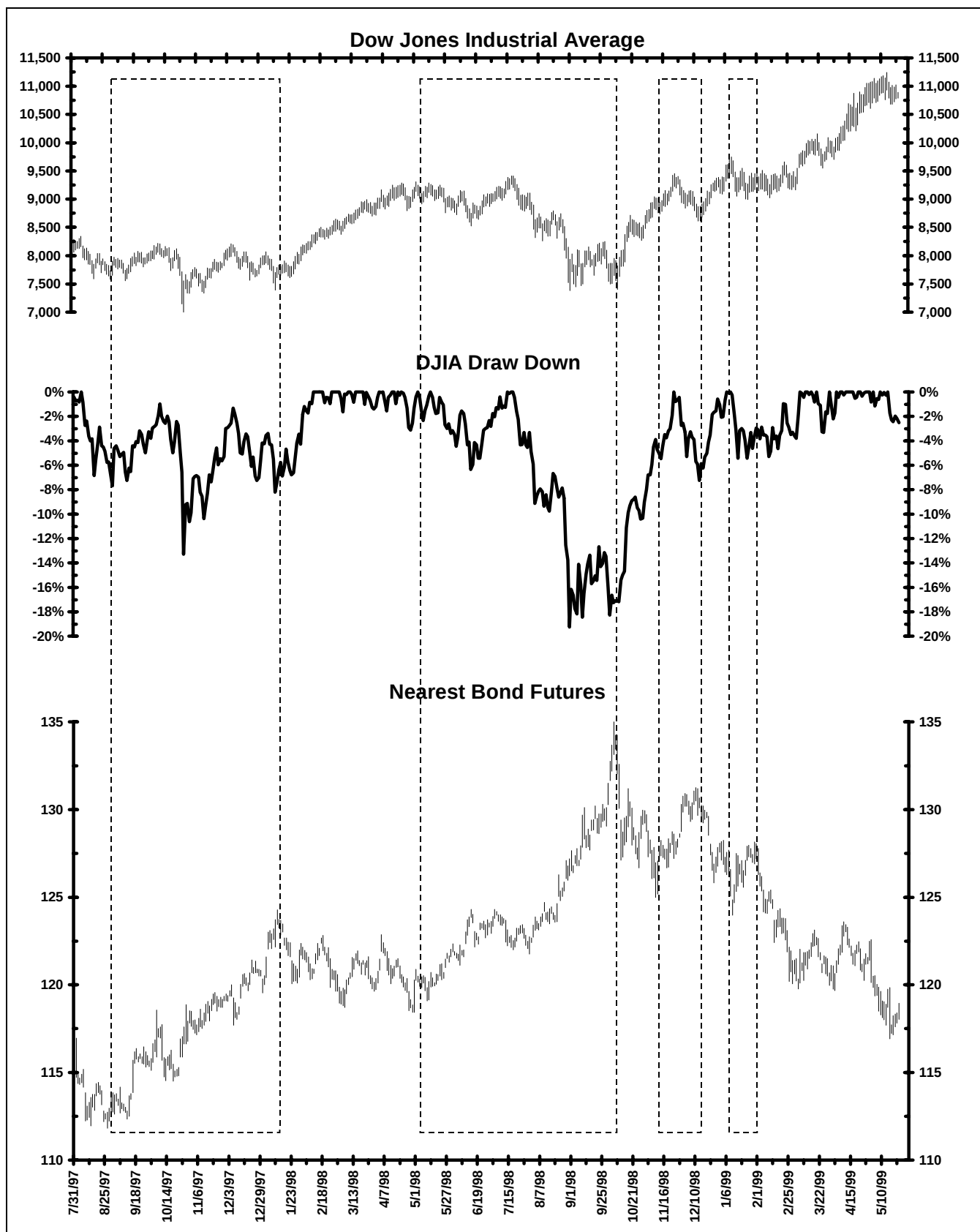


Chart 3



Information contained herein is from sources we believe to be reliable but we cannot guarantee its accuracy or completeness. Due to volatile market action, the opinions may change at any time without notice. This is not a solicitation to buy or sell. We, or anyone associated with us may from time to time purchase or sell any of the above mentioned or related securities.

© 1990 - 1999 Bianco Research, L.L.C. All rights reserved.