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COMMENTARY

Market Opinions And Topics Of Interest
March 16, 1999

Understanding the Financial Markets in 1999

Part 1 – Why Economic Growth Matters to Bonds – Regardless of Inflation

"[T]he bond market remains concerned that if the economy continues to expand briskly, inflation could reignite." – The Wall Street Journal, Credit Markets Column, March 9, 1999

The bond market has never liked growth. It assumes that growth will lead to higher inflation. Is this true? Many believe so.

"New paradigmers" would argue that it doesn't have to happen this time. They would argue that the "new economy" can handle faster growth without igniting inflation.

We agree that growth does not have to lead to inflation. Our argument is not that we have a new economy, but rather **that a characteristic of the "old economy" was that growth did not lead to inflation.**

Chart 1 shows annual real GDP growth and inflation (the implicit price deflator). Note that there was a strong correlation between economic growth and inflation between 1930 and 1945. Since 1945, however, there has been no correlation between growth and inflation. If strong growth leads to inflation, it has not been evident in the last 50+ years.

Then Why Worry About Growth?

Despite the lack of evidence that growth **directly** leads to inflation, *Wall Street* suggests it does. In fact, reading most economic commentary would lead one to believe that the **only** thing that moves interest rates is inflation (or the more elusive "inflation expectation"). See the quote leading this commentary.

Interest rates are more complicated than being just a derivative of inflation. Many things move interest rates. Inflation is an important reason, but not the only reason. Growth itself can be an issue for the bond market.

Chart 2 shows what we believe is a better way of relating total economic activity to interest rates. It shows nominal GDP and the five year Treasury note. (Nominal GDP is both "real" GDP and inflation) **We believe this is the best valuation yardstick for the bond market.** The bars show the year-over-year change of nominal GDP. The line shows the yield of the 5-year Treasury note. (We chose the 5-year Treasury note because it is the middle of the yield curve. Any other point on the yield curve, or even corporate bond yields, could have been used and would show similar results.)

Think of this measure as an asset valuation model with the asset being the entire economy. If the asset, as measured by nominal GDP, returns a rate higher than the prevailing interest rate, the 5-year Treasury note, then it makes sense to borrow and expand. One can make money in such an environment because the asset has a higher return than the cost of borrowing. This will cause an increase in the demand for money thus putting upward pressure on the price of money, interest rates. This will last as long as yields are below the year-over-year change in nominal GDP (or at least the perception that interest rates are below nominal GDP).

On the flip-side, if interest rates (5-year Treasury note) are higher than the return provided by the economy (nominal GDP) then borrowing to "buy" is a money losing proposition. In this case the demand for money will fall because the profit incentive is not present. This will drive the price of money (interest rates) down so long as yields are above the growth rate, or perceived growth rate, of nominal GDP.

Are Interest Rates Too Low?

An important event occurred in the fourth quarter of 1998 -- nominal GDP growth surpassed the yield of the 5-year Treasury note. The last time this happened was 1984. More importantly, it was not just the mechanical act of nominal GDP surpassing the prevailing level of interest rates that was important, but the fact that the perception of growth changed as well. In January most economists "threw in the towel" on the prospects of an economic slowdown (something they have predicting for almost two years) and raised their forecasts for 1999 growth. Since interest rates were already below nominal GDP, this change in the perceived growth rate of the economy also hurt the bond market. **Simply put, the level of interest rates is now too low relative to the level of overall economic activity.**

This is what makes economic forecasts so critical right now. Since the level of the 5-year note is now significantly below nominal GDP growth, an actual slowdown or perception of slowing in nominal GDP growth must take place for the bond bull market to continue. However, exactly the opposite has been happening. Nominal GDP grew at a 6.6% annualized rate in the fourth quarter, and the first quarter is expected to be strong as well. This is why growth alone is bad for the bond market.

Why Growth Matters Now

For nearly a generation economists correctly looked to inflation as the key to interest rates. Viewed through the lens of nominal GDP as the key to interest rates, this makes sense. The inflation component of nominal GDP had a dramatic impact on the growth rate of nominal GDP and interest rates. This was certainly the case as inflation rose to its peak in 1980 and fell into the mid-1990s.

Inflation is now approaching zero, and its prospects of dramatically changing up or down are perceived to be small. In the absence of major changes in inflation, the "real" component of nominal GDP is becoming the driving force in setting its growth rate. It is even more important since interest rates are below the level of nominal GDP growth. The economic community has been slow to pick up on this. This is why they continue to believe that inflation alone matters in determining interest rates. Inflation would matter if it was changing dramatically, but this is no longer the case.

Chart 3 and 4 present more evidence that nominal GDP is a better measure than inflation alone when determining the proper level of interest rates relative to economic growth.

Chart 3 shows nominal GDP growth back to 1889 (the history of good statistics) and 3-month interest rates. We smoothed nominal GDP by using a 10-year annualized rate and we smoothed interest rates using a 3-year average. We used a shorter average on interest rates because it better reflects how they respond to changes in economic activity. Note: the only other series we have going back this far is long-term interest rates. We could have substituted these rates for short-term rates. However, in some periods over the last 100 years, the movements of long-term interest rates were restricted and thus were artificially held down (i.e., FRB Regulation Q). Short-term interest rates were less susceptible to these influences and provide a better measure relative to economic activity.

Chart 4 shows the same holds true in Japan. We only went back to the mid-1970s because the Japanese had heavy regulation on the level of interest rates prior to this period. Once, these regulation were lifted and interest rates were set by the marketplace, nominal GDP growth has provided a good measure for their direction and level.

Conclusion

Survey after survey continues to show that most economists believe that the only thing that determines interest rates is inflation or "inflation expectations." We believe that nominal GDP is a better measure in gauging what is the appropriate level of interest rates. So, what drives nominal GDP? Until 1995, it was primarily the level and change in inflation -- both up (prior to 1980) and down (from 1980 to 1995). Now with inflation muted, the driving force behind nominal GDP is "real growth." With interest rates now trading below nominal GDP for the first time in over a decade, growth alone has become a major issue for the bond market.

For interest rates to continue falling, the bond market needs a slowing of real economic activity (nominal GDP). It doesn't matter if growth will spur inflation, the current level of nominal GDP is too high relative to prevailing interest rates.

In part 2 we will look at what is driving nominal GDP growth and thus moving the bond market.

Chart 1

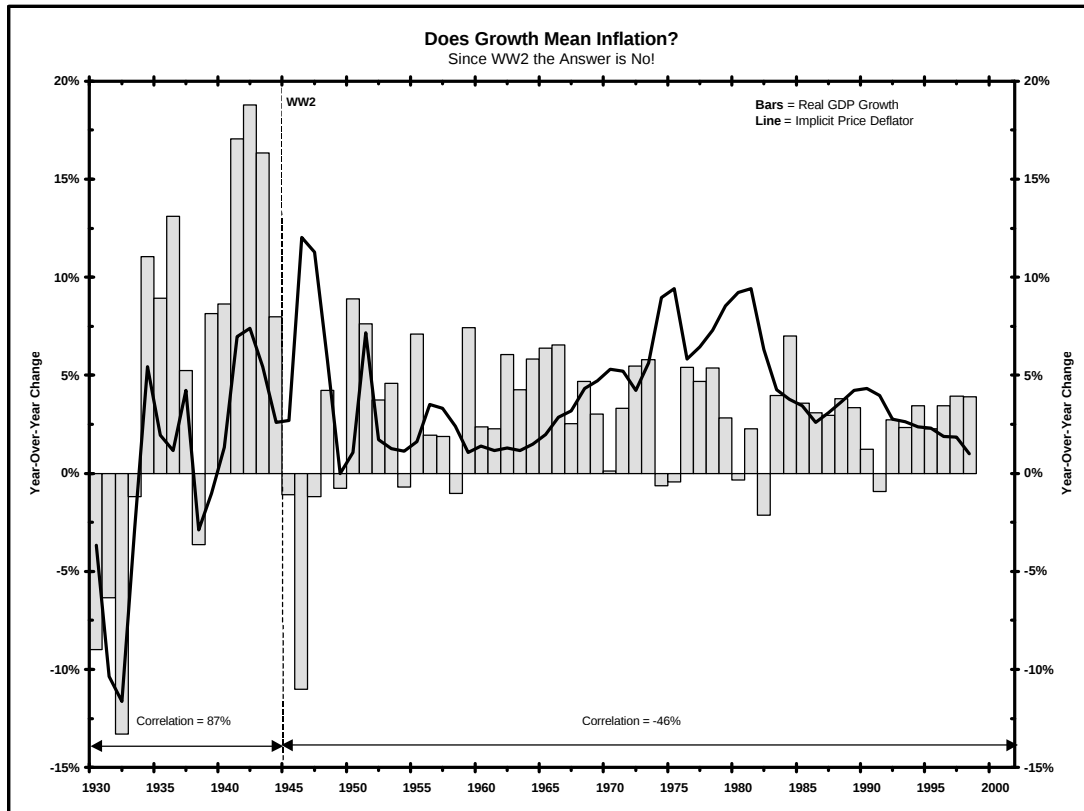


Chart 2

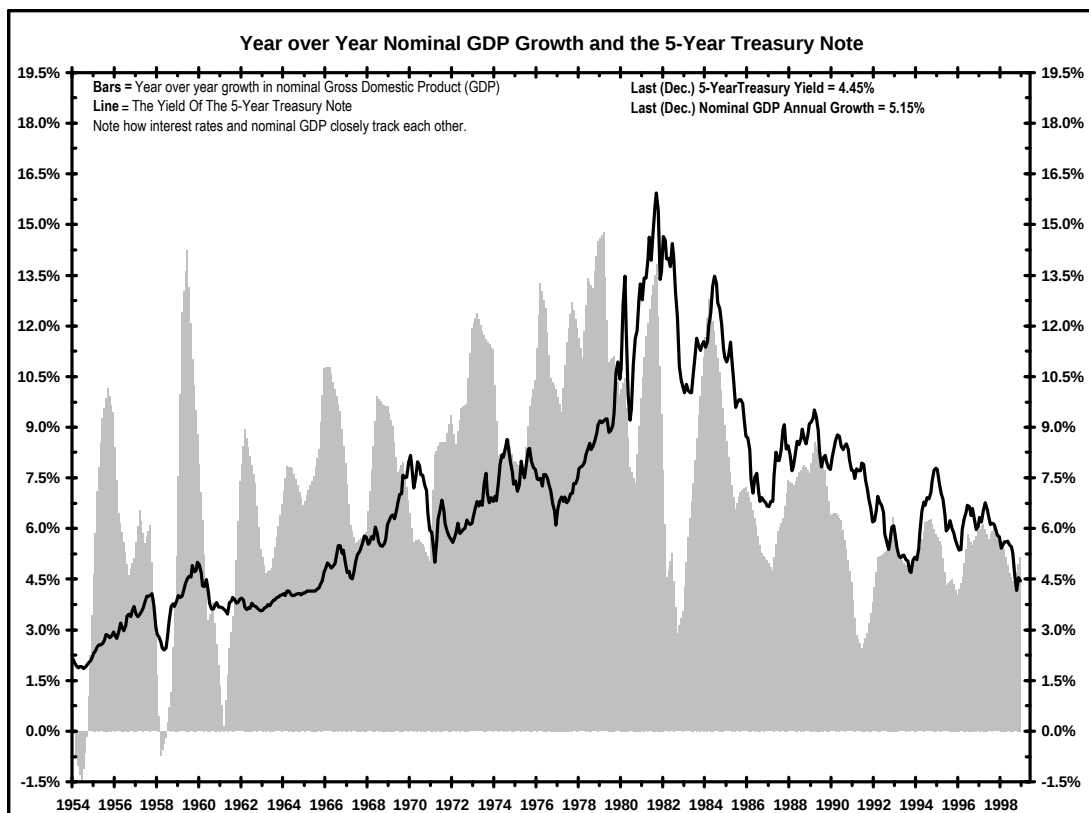


Chart 3

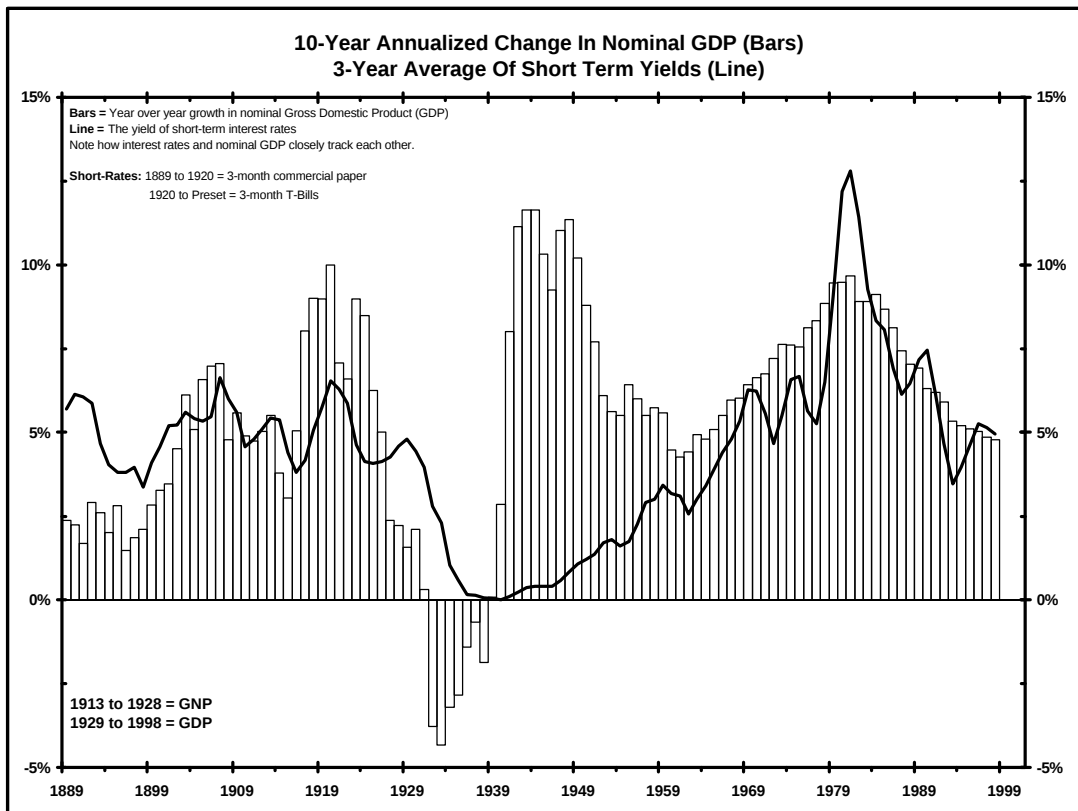


Chart 4

