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COMMENTARY

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Understanding the Financial Markets in 1999 Part 3 – The Stock/Bond Relationship: Is NOT a De-coupling

"That's why I want to go over this relationship between bonds and stocks again. People are willing to pay more for future stock earnings if interest rates are going down. . . . But the same action occurs in reverse when rates are going up. This relationship is a given. You can't change it with the Net, or with miracle drugs or with money flows and bull market mania. Most large money pools are run using the grounding of this interest rate logic. That's why, if a Martian landed here and tried to make sense of the market, he would probably ask where the rates were heading if he wanted to know the future direction of the stock market. Rates are that important." – James Cramer, www.thestreet.com, February 25, 1999

In Part 1 we detailed how nominal GDP is a better measure in gauging what is the appropriate level of interest rates than inflation or "inflation expectations." In Part 2 we argued our belief that the stock market, via the "wealth effect," is the primary driver of nominal GDP. In this commentary we will show how these two concepts have combined to change the trading relationship between stock prices and interest rates.

Chart 1 shows the relationship between stock prices and interest rates. The top panel shows the stock market (Dow Jones Industrial Average - DJIA). The middle panel shows interest rates (the yield of the Moody's Aaa Bond Index). The bottom panel shows a rolling 52 week (1 year) correlation of the **weekly change** of the stock market and the **weekly change** of interest rates.

For the 30 years ending in the summer of 1997, the correlation between changes in stock prices and the changes in interest rates were almost always negative. This means that stock prices would rise when interest rates were falling and vice versa. One could argue as to which market leads and which follows, but the fact is that stock prices and interest rates had a consistent inverse relationship with each other.

Starting in July of 1997, the correlation between stocks and bonds began its most dramatic change ever. The correlation moved from very negative to positive, suggesting that stocks and interest rates are now moving in the same direction.

How large is this change? Chart 1 traces this relationship back to 1923. Note that the correlation is now the most positive ever! It peaked on 12/15/98 at 40%. Currently it is 29%.

Chart 2 shows this relationship over the last 1 ½ years. The top panel is the DJIA. The middle panel is a "drawdown" chart of the DJIA. A drawdown chart measures how far the DJIA is from its all-time high (a reading of 0% means a new all-time closing high). The bottom panel is the nearest bond futures contract.

This chart has four boxed periods. These are the four largest bond rallies since mid-1997.

Note that no bond rally in the last 1 ½ years has occurred when stock prices were rising. When stocks were making new all-time highs, like they were last week, bonds were either declining or, at best, trending sideways. **To repeat, at no time in the last 1 ½ years have bonds rallied while stocks were making new highs.** We emphasize this because many have suggested that the recent period of stock/bond trading is analogous to some previous period. By our calculation, this period is unprecedented.

The "De-Coupling" Of Stocks and Bonds

While the change between stock prices and interest rates has indeed been dramatic, it should not have been unexpected. We believe this to be a natural happenstance of the tremendous wealth that the stock market has created over the last few years.

As we discussed in Parts 1 and 2, this record wealth creation has turned the stock market into **the most important economic indicator today**. As long as the stock market capitalization to nominal GDP ratio is above 100% (now near 150%), the wealth effect will remain a driver of the economy (nominal GDP).

How does this work? Rising stock prices are a "tailwind" for the economy, a boost to nominal GDP, and a negative for bond prices. Conversely, falling stock prices are a "headwind" for the economy, a depressant to nominal GDP, and a positive for bond prices. We believe the financial market understands this "cause and effect" relationship. Consequently, the trading patterns between stock prices and interest rates have changed accordingly.

This is why we object to the use of words like "decoupling" or "divergence" when describing the trading between stocks and bonds. These words imply that the positive correlation between stock prices and interest rates is temporary or an irrational response by the marketplace. We do not look for the relationship to "re-couple" or the divergence to get "resolved." Rather, we believe that this new trading pattern will exist as long as the wealth effect is the dominant theme. Only when the wealth effect goes away (which is a nice way to say well after the equity bull market ends), will stock prices and interest rates resume a trading pattern similar to the one in existence before 1998.

Conclusion

A basic relationship in financial markets, the interaction between stock prices and interest rates, has undergone a dramatic change. Yet we have seen little analysis about this change.

This is one of the reasons why we continue to pound home these concepts in this series of commentaries. Even though we have outlined these ideas many times before: "they" (the financial community) have not recognized these changes.

- They talk about whether too much real economic growth will lead to inflation. We believe it **does not** have to, as we cannot find any relationship

between real economic growth and inflation since the end of World War 2. Therefore, we believe this argument is irrelevant.

- They talk the bull case in bonds because inflation and "inflation expectations" are low. We believe that nominal GDP is a better measure of the appropriate level of interest rates. Currently, the prevailing level of interest rates is below the level of nominal GDP for the first time in 15 years. This is bearish.
- They believe the primary driver of real GDP growth is the "new paradigm" economy. We believe it is the wealth effect because the stock market is 150% the size of nominal GDP.
- They have underestimated real GDP growth (that is, the median estimate of economists) for the last 10 consecutive quarters. We have long believed, and continue to believe, that economic statistics will routinely surprise to the upside so long as the wealth effect is ignored by a great number of economists.

We believe our view best explains: 1) why the stock/bond relationship has dramatically changed; 2) why interest rates have been rising for over six months (and may continue to do so) despite low and steady inflation; and 3) why the economic community continually underestimates the strength of the economy.

Given our view, DJIA 10,000 could be a big stumbling block for the bond market. In a 5% to 6% real GDP growth environment (6% to 7% nominal growth) and the five year note near 5.10%, the bond market's problem is that interest rates are too low relative to economic growth (nominal GDP). It is not the more publicized concerns such as too much corporate bond supply.

In part 4 we will discuss the importance of the S&P 500 to the rest of the world. Is it the "engine" of world growth?

Chart 1

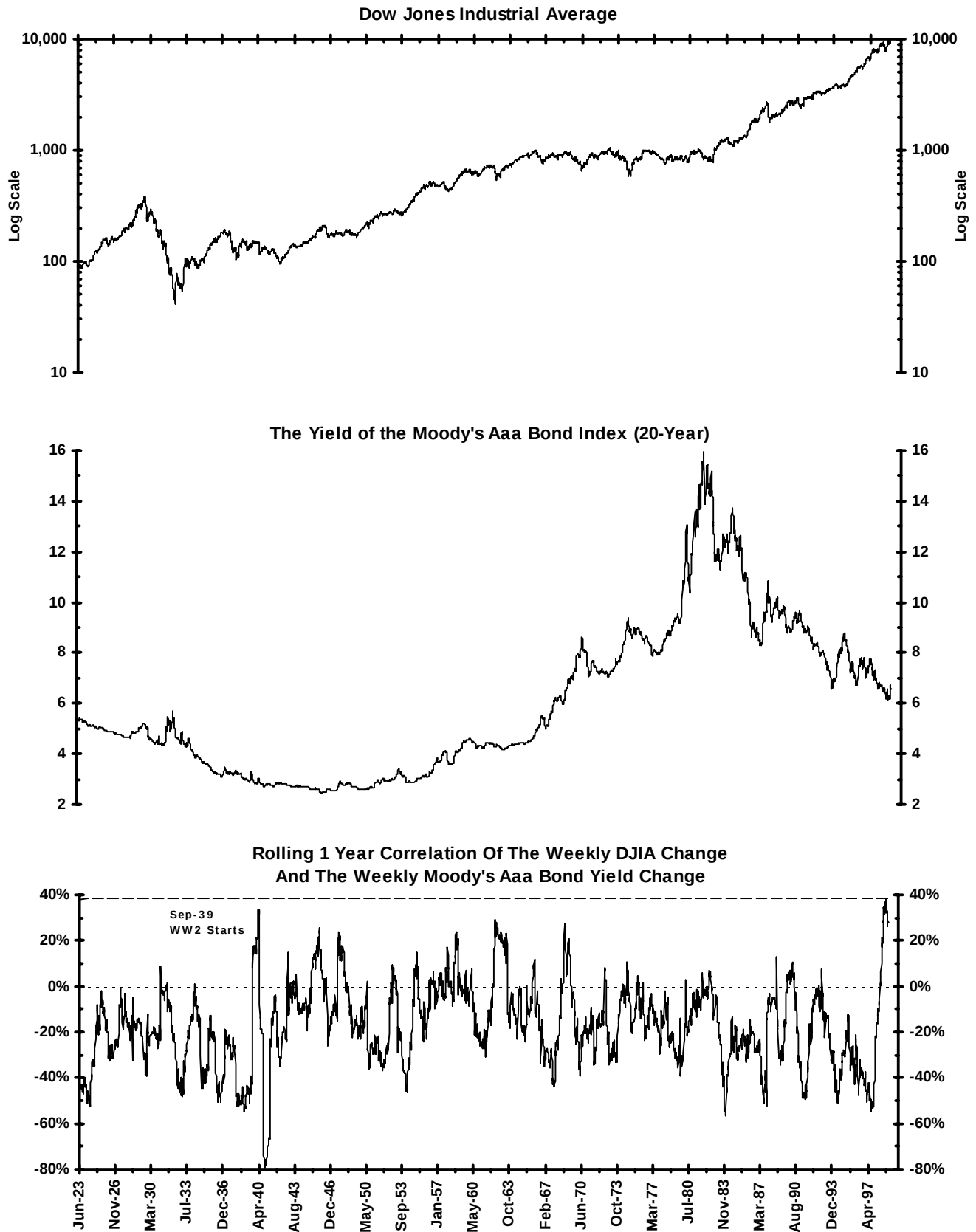


Chart 2

