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COMMENTARY

Market Opinions And Topics Of Interest
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Understanding the Financial Markets in 1999 Part 4 – Is the S&P 500 the “Engine” of World Growth?

“I for one am still puzzled by what happened in the financial markets last August and September. In a short few weeks, a lot of very smart and very well-informed investors abandoned markets that they themselves had created, in what appeared to be a form of mass hysteria. As a result, the risk premiums on everything from interest-rate swaps to long-term equity option rose to new and surprising levels. The movements in many of these markets was the equivalent, statistically speaking, to a drop of several thousand points in the Dow Jones Industrial Average.” – Michael Lewis, Bloomberg, February 2, 1999

In Part 1, we detailed how nominal GDP is a better measure for 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 Part 3, we argued how these two concepts combined to change the trading relationship between stock prices and interest rates. In this commentary we will show how the stock market has changed the perception of risk.

To understand risk, we believe that the question in the quote leading this commentary must be answered. Namely, what caused the near meltdown in **all** financial markets last fall? And, what should we watch to tell us if it is going to happen again?

Before we address what we believed happened, let us address the typical explanations for what happened. To do this, we again turn to Michael Lewis:

1) The panic last fall was perfectly rational. The Russian default raised the specter of many more national defaults. This in turn caused, say, sterling interest-rate swaps to become that much riskier. That is, the markets were simply pricing in a new piece of information: that governments were willing to renege on their debts.

The trouble with this explanation is that the bizarre behavior occurred in the financial markets of large and stable countries. Does anyone really believe that the collapse of Russia increased the possibility that the U.S. or U.K. governments will default on their debt?

2) The panic was a perfectly rational response to the presence of one preposterously large player -- Long-Term Capital Management LP -- that became dangerously weakened. In the latter stages of the panic, this was almost certainly the case, as the belief that Long-Term Capital would be forced to liquidate its trades led others to do it for them.

But this explanation mistakes cause for effect. Long-Term Capital was weakened only after the markets panicked. And in any case, the firm once had a larger share of these markets than it did last August, and no one back then seemed to mind.

3) The panic was, indeed, irrational, in a way that illustrates something more general about financial markets. Far from causing markets to become more efficient, the presence of many seemingly well-informed people channels into a financial market a new, irrational force. People!

It is at least worth considering that markets cannot be thought of simply as less efficient or more efficient. It seems at least possible, in light of recent events, that they can become at once more and less efficient.

What We Think Happened

We believe that the events of last summer/ fall have the elements of all three of Mr. Lewis' explanations. The key is to view what happened in the proper prospective.

How does one do this? By asking the question, “what is the engine of world growth?” To answer this

question, further ask, "How did the U.S. economy grow at nominal rate of 5+% in 1998, (its fastest growth rate since 1984) and over 6.6% in Q4 1998 despite the near melt-down in financial markets and the Asian economic crisis?"

We believe the answer is the "wealth effect." Simply, the economic tailwind created from the booming stock market more than offset the Asian economic crisis of 1998. Further, the 25% equity market rally in Q4 1998 helped to push the economy to 6+% growth in the fourth quarter.

Is the U.S. stock market big enough to be the "engine" of world growth? Consider that equities are:

- Now in excess of \$13 trillion;
- Over 150% of US nominal GDP (which is 1/3 of world GDP);
- Half the value of all world equities in US dollar terms (Japan was also half world stock market value at its 1989 high).

Given these statistics, we do indeed believe that the U.S. stock market is **the "engine" of world growth now**. It hasn't always been and won't be forever, but right now it is the most important.

When The "Engine" Sputtered

The old saw in the financial markets is that at times of "stress," the correlation of all markets goes to 100%. If one is not expecting this to happen, the assumptions that guide investment decisions break down.

Chart 1 shows that this phenomenon occurred last summer/fall. The top two panels show the last nine months of the S&P 500 (through 4/2/98). Below are measures of eight major markets --from emerging markets to stocks to bonds. Listed on each panel is the correlation to the S&P 500 over the **previous three months**.

Chart 2 is a daily plot of the **least** correlated of the eight markets shown in chart 1. Each day we calculate the three month correlation for the eight markets shown in chart 1. Then we plot the market that is **least** correlated (the "minimum" correlation) to the S&P 500.

This chart shows that at least one of these markets (and often more than one) moves independent of the S&P 500. Most of the time at least one of these markets was negatively correlated to the S&P 500. At no other point this decade have all these markets been as close to moving in harmony as they did last October.

We believe the story last summer was not about Russia or LTCM but rather, about the U.S. stock market. Stocks had their worst sell off in eight years, down nearly 20% from their highs earlier in the

summer. This sell off had an effect on nearly every financial market throughout the world.

This makes sense when one says the same thing differently -- last summer the "engine" of world growth, the U.S. stock market, stumbled. When it did, all risk assets were priced lower because of the threat stumbling stocks posed to world growth. This is why the S&P 500 and most major markets became highly correlated. These markets were acting rationally to the potential threat of slower world-wide economic growth. We agree with Michael Lewis' quote suggesting that the markets were acting rationally. However, we believe the response was to the stock market, not Russia or LTCM.

Only Two Bets Available

Chart 3 shows the "product" weightings of a Technical Data survey of fixed-income managers' portfolios plotted against a commonly used benchmark index. For the entire decade of the 1990's, fixed-income portfolios were long "risk" by over-weighting corporate bonds and short "safety" by under-weighting government bonds. This chart is current through April 1, 1999 and shows that this trade is still on.

Conceptually, LTCM was doing this trade. Whether it was Danish Mortgages or Russian Bonds, the concept was the same -- nearly all of their trades were long risk and short safety.

LTCM was making a bet on rising stock prices. When stocks stumbled (the engine of world growth stumbled), all of these trades started losing money. Even though the total value of their portfolio only lost about 1%, this was enough to nearly erase out all their equity, given the huge leverage they employed.

The assumption behind the long "risk" and short "safety" trade is that world economic growth will continue to "chug along," rewarding those managers that assume a riskier stance. As long as this assumption is correct, the trade makes sense.

When world economic growth sputters, this trade is in trouble. How many Nobel laureates at LTCM or portfolio managers now engaged in this trade believe that the "engine" of world growth is the U.S. stock market?

We are arguing that all financial markets are linked to the largest risk asset market in the world-- the U.S. stock market. As long as U.S. stocks continue to perform well, "risk" assets will do better than "safety" assets. When (if?) the stock market stumbles again, all "risk" assets will again under-perform "safety" assets.

Said another way, one has to determine whether to be long U.S. stocks or short U.S. stocks. In spite of all the various investment choices, these are the only

two bets available. When stocks stumble, they are a “headwind” not only for U.S. nominal GDP, but for world GDP as well. Should stock prices fall, look for all financial markets to again trade with a high degree of correlation to the S&P 500.

If one accepts our view that the stock market is the “engine” of world growth, then last summer’s panic

makes more sense. It also means one can devise an exit strategy for the long “risk” short “safety” trade – tumbling U.S. stocks. Like it or not, we are all betting on the U.S. stock market.

In Part 5 (the last part), we will discuss the real risks associated with trading derivatives.

Chart 1

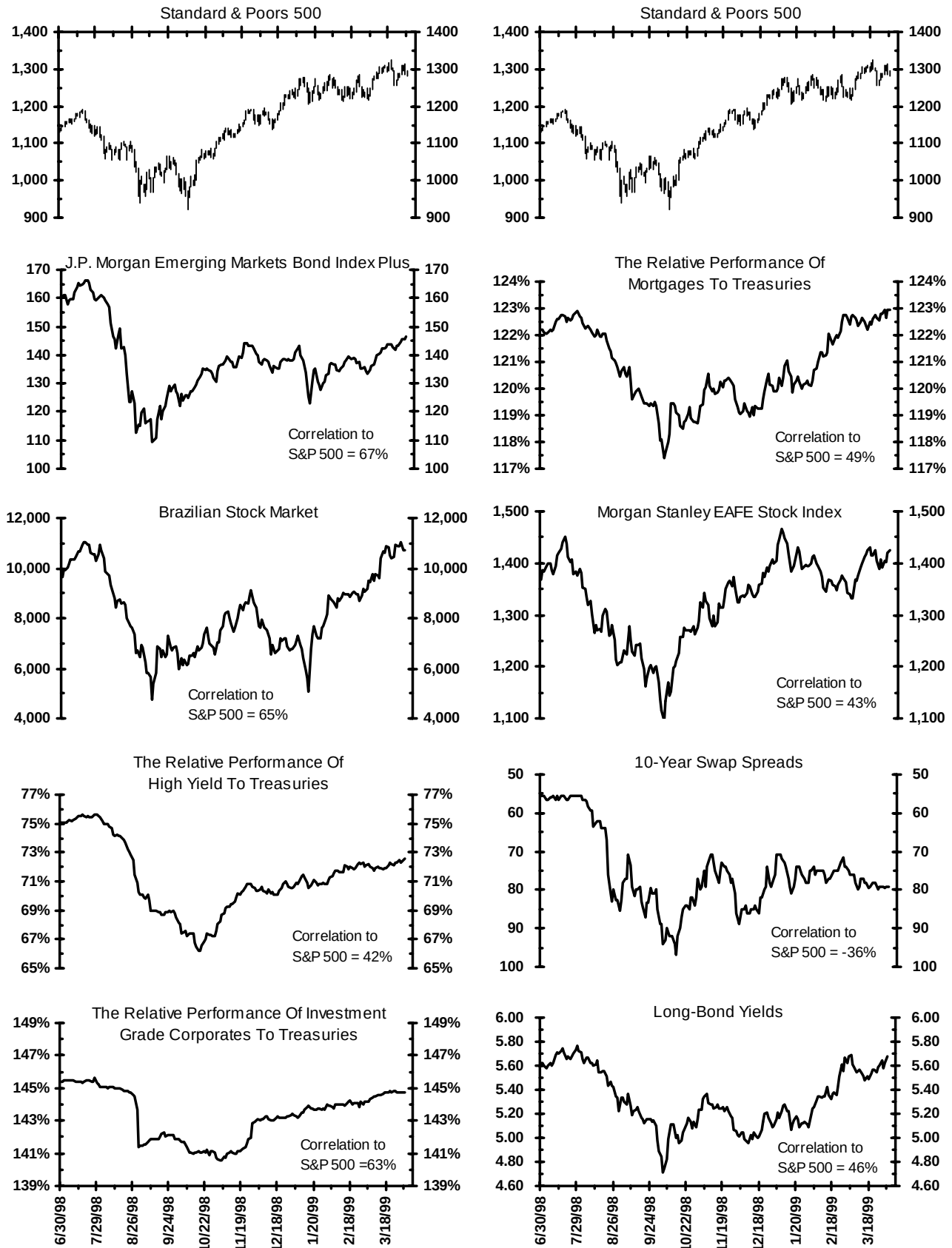


Chart 2

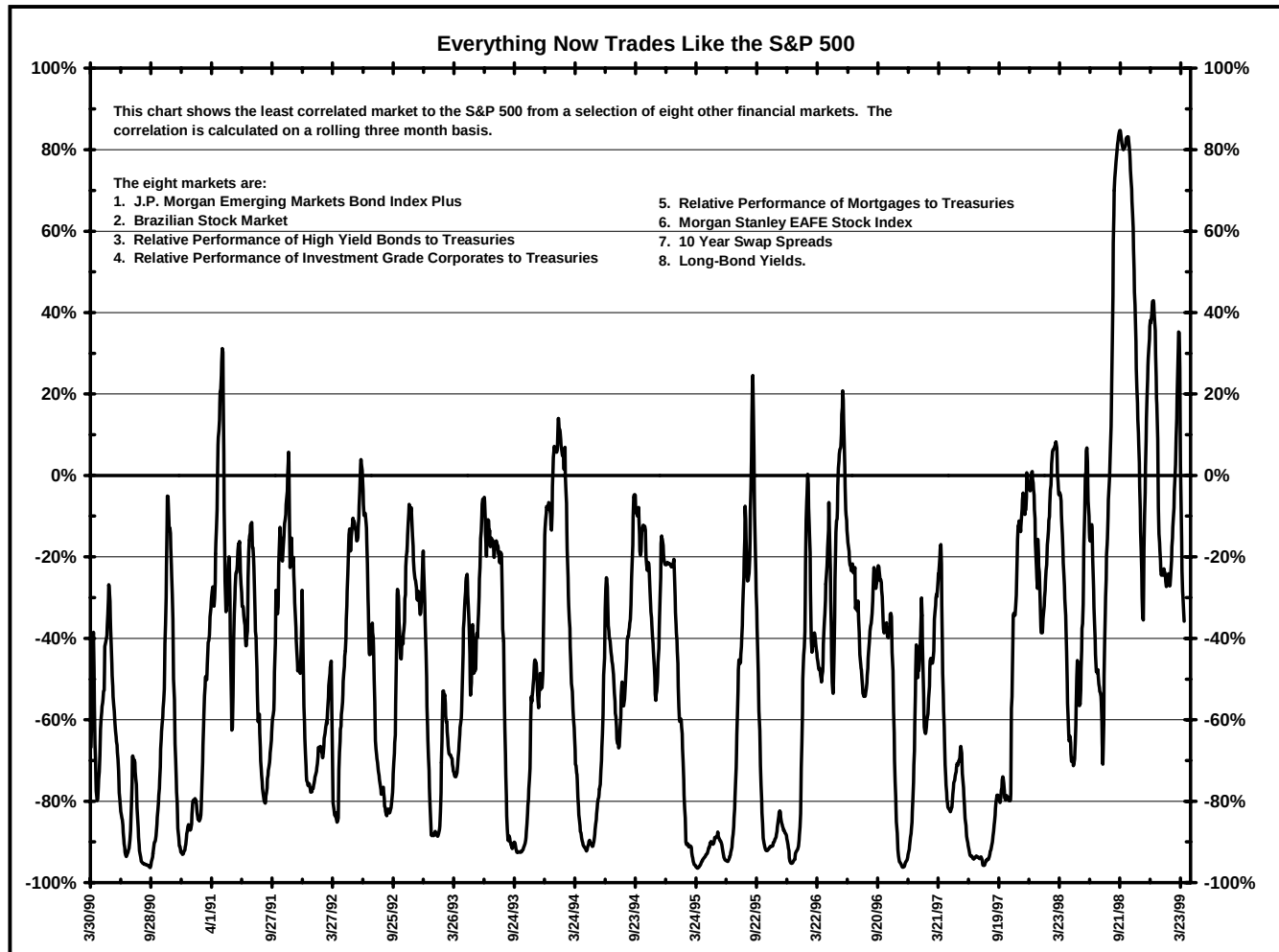
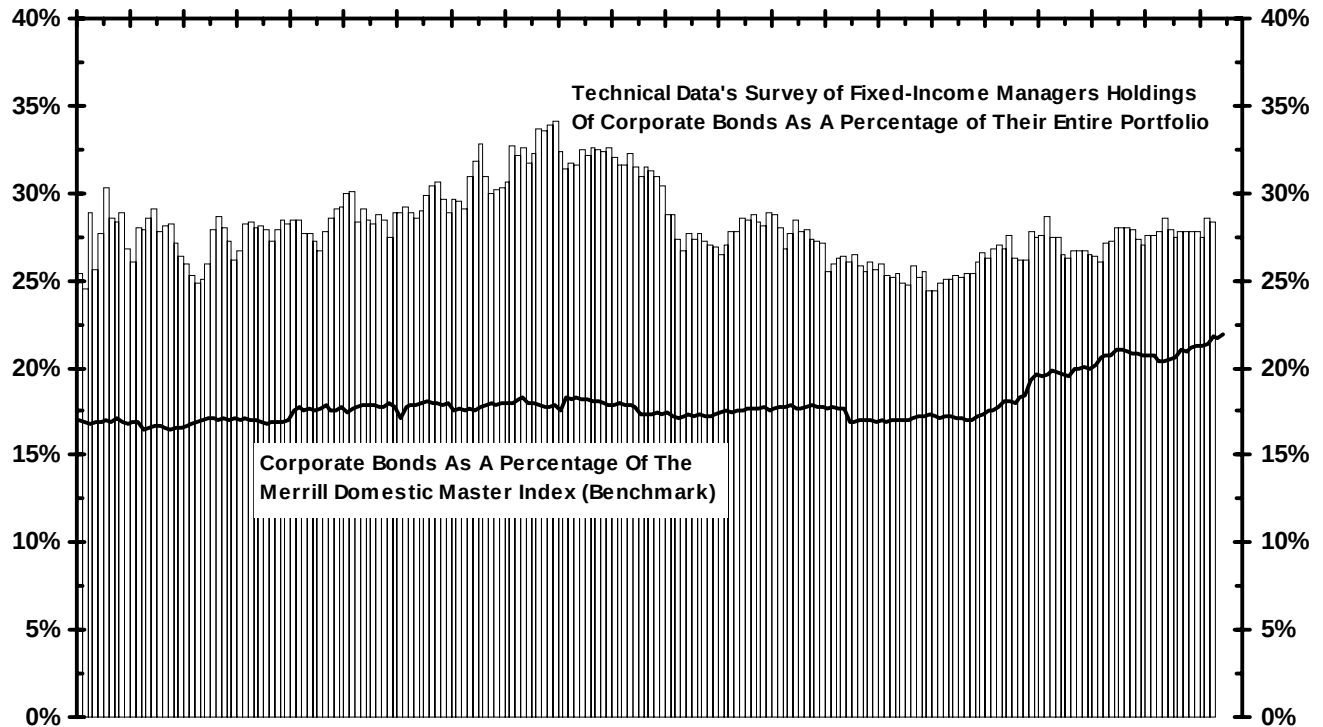


Chart 3

Bond Managers Are Long "Risk" ...

(They are over-weighted corporates relative their benchmark)

**... And Short "Safety"**

(They are under-weighted governments relative their benchmark)

