

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, 11 No. 20

Last Commentary: September 28, 2000

COMMENTARY

Market Opinions And Topics Of Interest
October 26, 2000

“Economics” versus “Events” in the Bond Market Part 1: Economics

The bottom line: Economic growth looks stronger now than it did three months ago. To be sure, the pace is slowing, but from a red-hot 6% to something closer to 4%. The data hardly make a case that the Federal Reserve's next move will be to cut interest rates, as many areas of Wall Street have begun to expect--or maybe wish for. – BusinessWeek, October 30, 2000

In this series of commentaries, we will look at factors affecting the bond market. In this installment, we will look at the trend of the economy and how we believe it relates to interest rates.

The Expectations Index

To create the Expectations Index, we selected 20 economic series and compared the median estimate from a survey of economists taken the **week before** the release to the actual results. If the actual result of an economic release is above consensus, we add 1 to this index. If it is below consensus, we subtract 1 from this index. If it is exactly equal to consensus, we add 0 to this index. This index starts at 0 on January 31, 1980.

The Expectations Index is the cumulative sum of 20 economic series each month. Fifteen series measure real economic growth and five series measure inflation. A list of the series can be found on Charts 1 and 4.

Chart 1 uses monthly data back to the beginning of 1992 (this is the earliest available date for all 20 series). Chart 4 shows the data back to 1980 (eight series go back this far) adding series as the data became available (the first date of available data is also shown). Both Charts 1 and 4 have the five-year Treasury Note overlaid on “the Expectations Index.” The survey data is from MMS International and is available from the Logical Information Machine service (www.lim.com, 800-LIM-XMIM).

Over long periods of time, this index has an excellent fit with the yield of the five-year Treasury note. (It has diverged in recent months, more on this later.)

What is the Significance of this Index?

The Expectations Index tells us how the economy is performing **relative to** the expectations of economists. We believe this is important because it helps explain the ups and downs of interest rates.

When the Expectations Index is moving lower, like it did from early 1997 to late 1998, it means that economic results are consistently coming in **below** expectations. This heightens the odds that the Federal Reserve will be more accommodative and strengthens the case for a slowdown in the economy. These two factors are bullish, so it should not be surprising that interest rates move lower when this happens.

Likewise, when the Expectations Index is moving higher, like it did from late 1998 to earlier this year, it means that economic results are consistently coming in above expectations. This heightens the odds that the Federal Reserve will be more restrictive and weakens the case for an economic slow down. These factors are bearish, so it should not be surprising that interest rates move higher when this happens.

Given the construction of this index, the absolute level of each individual economic report is not as important as its deviation from expectations. For instance, an economic report that is above expectation will add “1” to the Expectations Index whether it is slightly above expectations or considerably above expectations. Therefore, this index measures the trend of the economy (i.e., better or worse than expected) rather than the absolute level of the economy.

Breaking Down the Expectations Index

The Expectations Index can be broken down into its real growth components (charts 2 and 5) and its inflation components (charts 3 and 6). These charts also show how actual results have deviated from expectations. Charts 2 (back to 1992) and 5 (back to 1980) show that real growth has consistently come in above expectations over the last few years (signified by the rising line). Conversely, Charts 3 (back to 1992) and 6 (back to 1980) show that inflation has consistently come in below expectations for nearly two decades (signified by the declining index line).

The importance of breaking down the Expectations Index into its real growth and inflation components is to show what needs to happen for the overall Expectations Index to decline. Since the inflation component is **already** in a persistent downtrend (meaning that actual results regularly come in below expectations), this trend cannot change enough to move the overall Expectations Index significantly lower. So, any decline in the overall Expectations Index is going to have to come from a downturn in the real growth component since its trend is still in a strong uptrend.

What is happening now?

Tables 1 and 2 show how individual economic releases have affected the Expectations Index and its components. Table 1 shows the September releases and Table 2 shows the October releases to date.

An interesting pattern is emerging from these tables. In Table 1, the first 9 releases (through September 14) show that 8 of these reports were below expectations. We can see this by all the "-1's" in the column titled "contributions to Expectations Index." This suggests that the economy was weaker than

expected. The next 5 releases (through September 25) show two above expectations ("1"), two below ("-1") and one equal to expectations ("0"). The next 21 releases (the bottom of table 1 and all of table 2 through October 18) show 15 above expectations ("1"), 5 below expectations ("-1") and 1 equal to expectations ("0").

These tables show that the economy has moved from consistently under-performing expectations (through September 14) to performing in-line with expectations (through September 25) to consistently out-performing expectations (through October 18).

Conclusion

If the economy has been beating expectations for nearly a month, why have yields continued to fall in recent weeks? We believe this has happened because bonds are currently responding to "events" rather than "economics."

However, the point of this commentary is to show that the trend of the economy is currently **not** the friend of the bond market. Table 2 shows that the economy is again consistently beating expectations. When this has happened in the past, strong economic growth has soon followed. This suggests that economic activity may have bottomed earlier this year. (Evidence of this slowdown can be seen on Chart 1 in the dip in the Expectations Index earlier this year.)

In part 2, we will discuss an important "event" helping bond prices move higher -- weak stock prices and the potential for a "reverse" wealth effect. After tomorrow's release of Q3 GDP, we will also update a related theme to this commentary -- Nominal GDP as the fair value of interest rates. Stay with us.

Chart 1

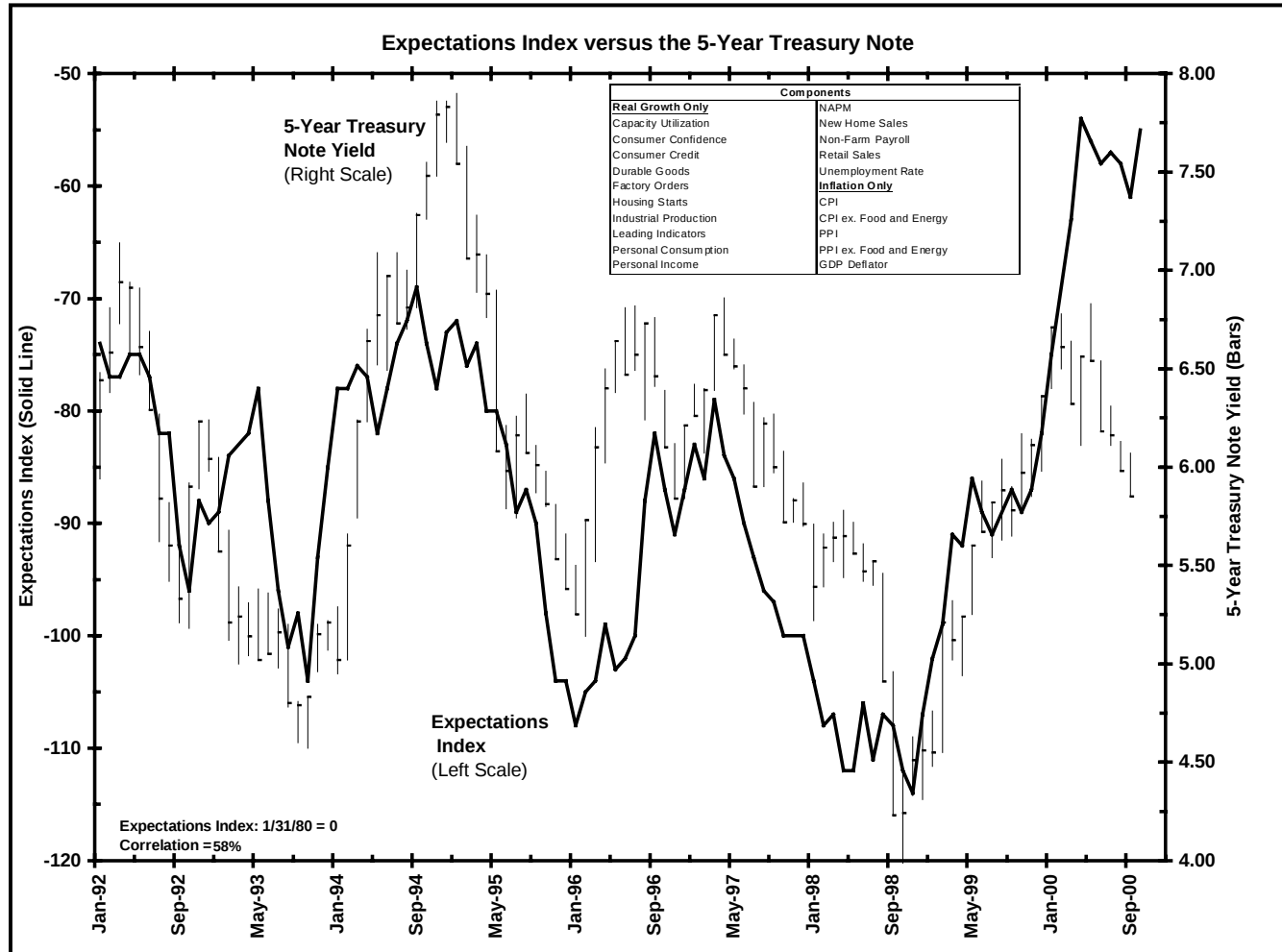


Chart 2

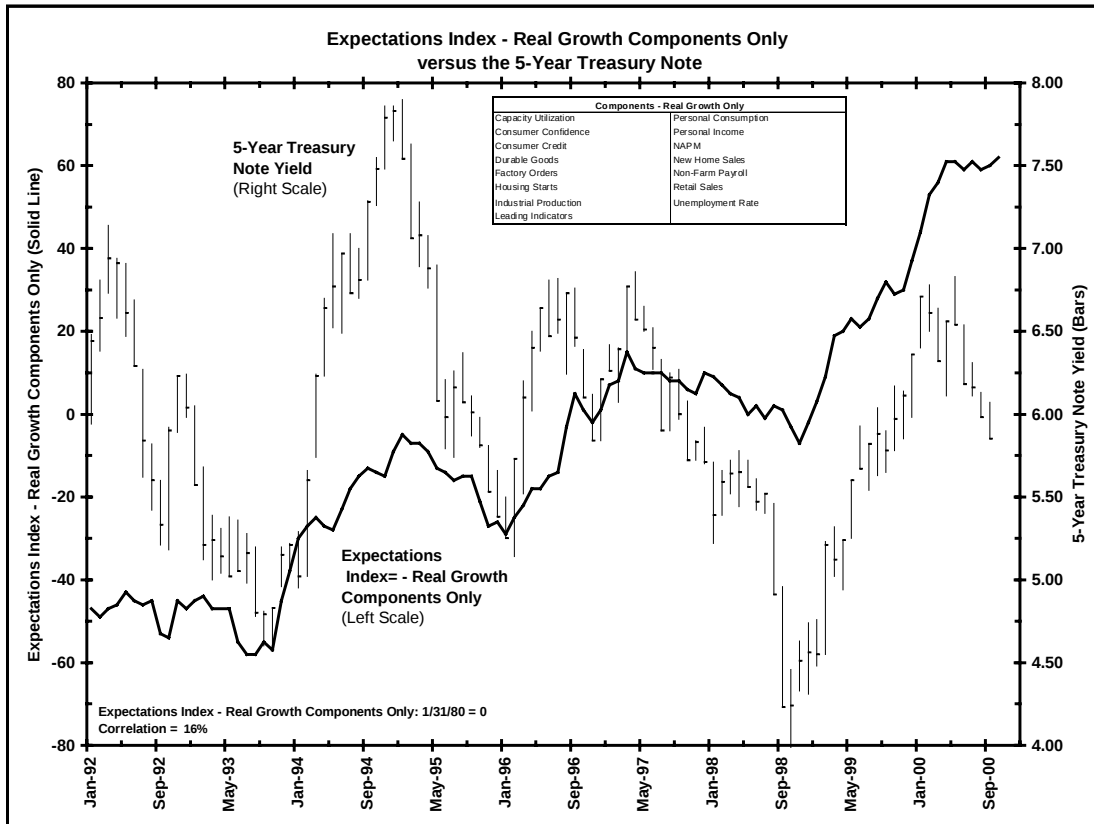


Chart 3

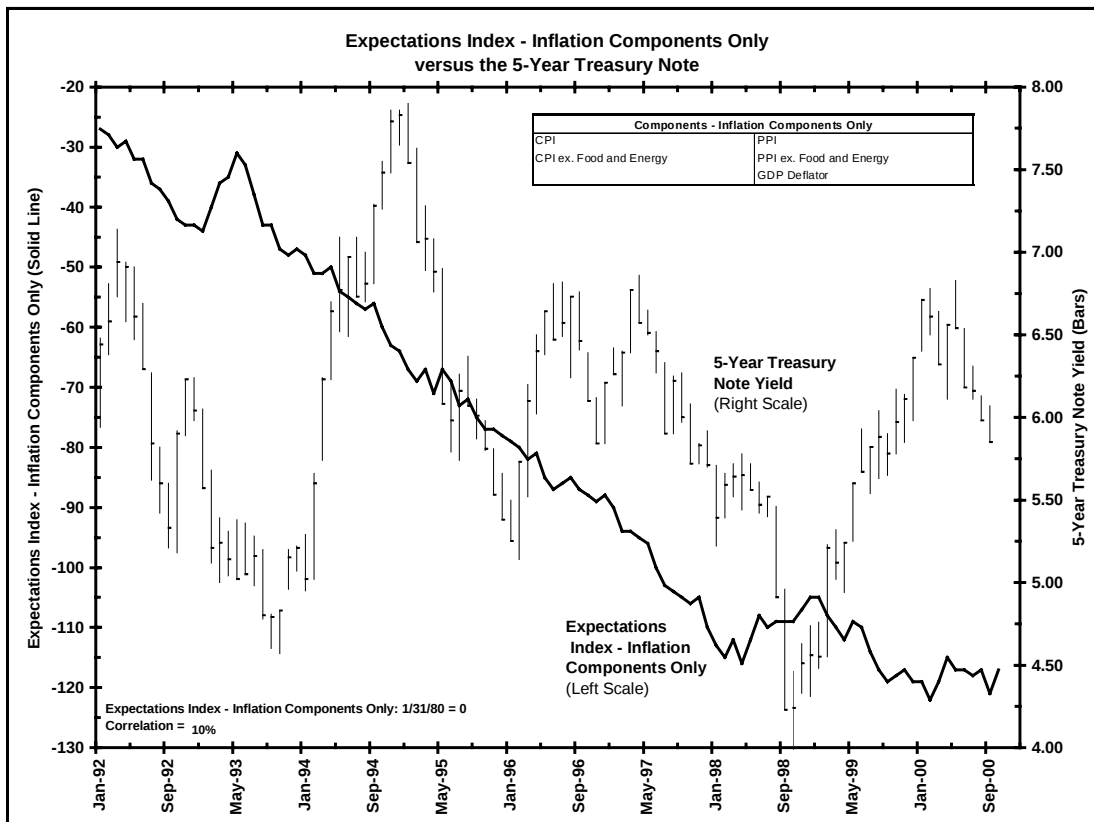


Table 1

Tracking The Expectation Index
September 2000

Release		Date of Release This Month	Median Estimate (from MMS)	Actual (First Release)	Contribution to Expectations Index	Contribution to Real Growth Only Index	Contribution to Inflation Only Index
Previous Month's Index Level	August				-58	59	-117
Leading Economic Indicators	July	08/30/2000	0.00	-0.10	-1	-1	n.a.
Factory Orders	July	08/31/2000	-7.00	-7.50	-1	-1	n.a.
NAPM Composite Index	August	09/01/2000	52.20	49.50	-1	-1	n.a.
NonFarm Payrolls (000s)	August	09/01/2000	-35	-105	-1	-1	n.a.
Unemployment Rate	August	09/01/2000	4.00	4.10	1	1	n.a.
Consumer Credit	July	09/08/2000	9.50	9.40	-1	-1	n.a.
Retail Sales	August	09/14/2000	0.30	0.20	-1	-1	n.a.
PPI ex. Food & Energy	August	09/14/2000	0.20	0.10	-1	n.a.	-1
Producer Prices	August	09/14/2000	0.20	-0.20	-1	n.a.	-1
Industrial Production	August	09/15/2000	-0.10	0.30	1	1	n.a.
Capacity Utilization	August	09/15/2000	82.00	82.30	1	1	n.a.
Consumer Prices	Sept.	09/15/2000	0.20	-0.10	-1	n.a.	-1
CPI ex. Food & Energy	October	09/15/2000	0.20	0.20	0	n.a.	0
Housing Starts (000s)	August	09/19/2000	1,540	1,530	-1	-1	n.a.
New Home Sales (000s)	August	09/25/2000	840	944	1	1	n.a.
Consumer Confidence	Sept.	09/26/2000	141.00	141.90	1	1	n.a.
Durable Goods	August	09/27/2000	2.40	2.90	1	1	n.a.
GDP Deflator	Q2 F	09/28/2000	2.60	2.40	-1	n.a.	-1
Personal Spending	August	09/29/2000	0.50	0.60	1	1	n.a.
Personal Income	August	09/29/2000	0.30	0.40	1	1	n.a.
Sum of Current Month's Contributions					-3	1	-4
Current Month's Index Level	September				-61	60	-121

Source: Logical Information Machines, Austin Texas (1-800-LIM-XMIM, www.lim.com)

Table 2

Tracking The Expectation Index
October 2000

Release		Date of Release This Month	Median Estimate (from MMS)	Actual (First Release)	Contribution to Expectations Index	Contribution to Real Growth Only Index	Contribution to Inflation Only Index
Previous Month's Index Level	September				-61	60	-121
NAPM Composite Index	Sept.	10/02/2000	50.10	49.90	-1	-1	n.a.
Leading Economic Indicators	August	10/03/2000	-0.10	-0.10	0	0	n.a.
New Home Sales (000s)	August	10/03/2000	898	893	-1	-1	n.a.
Factory Orders	August	10/04/2000	1.80	2.00	1	1	n.a.
NonFarm Payrolls (000s)	Sept.	10/06/2000	228	252	1	1	n.a.
Unemployment Rate	Sept.	10/06/2000	4.10	3.90	-1	-1	n.a.
Consumer Credit	August	10/06/2000	9.20	10.90	1	1	n.a.
Retail Sales	Sept.	10/13/2000	0.60	0.90	1	1	n.a.
PPI ex. Food & Energy	Sept.	10/13/2000	0.10	0.30	1	n.a.	1
Producer Prices	Sept.	10/13/2000	0.50	0.90	1	n.a.	1
Industrial Production	Sept.	10/17/2000	0.10	0.20	1	1	n.a.
Capacity Utilization	Sept.	10/17/2000	82.10	82.20	1	1	n.a.
Consumer Prices	Sept.	10/18/2000	0.40	0.50	1	n.a.	1
CPI ex. Food & Energy	Sept.	10/18/2000	0.20	0.30	1	n.a.	1
Housing Starts (000s)	Sept.	10/18/2000	1,540	1,530	-1	-1	n.a.
Durable Goods	Sept.	10/27/2000	0.80				n.a.
GDP Deflator	Q3 A	10/27/2000	2.30			n.a.	
Personal Spending	Sept.	10/30/2000	0.60				n.a.
Personal Income	Sept.	10/30/2000	0.40				n.a.
Consumer Confidence	October	10/31/2000	140.00				n.a.
Sum of Current Month's Contributions					6	2	4
Current Month's Index Level	October				-55	62	-117

Source: Logical Information Machines, Austin Texas (1-800-LIM-XMIM, www.lim.com)

Chart 4

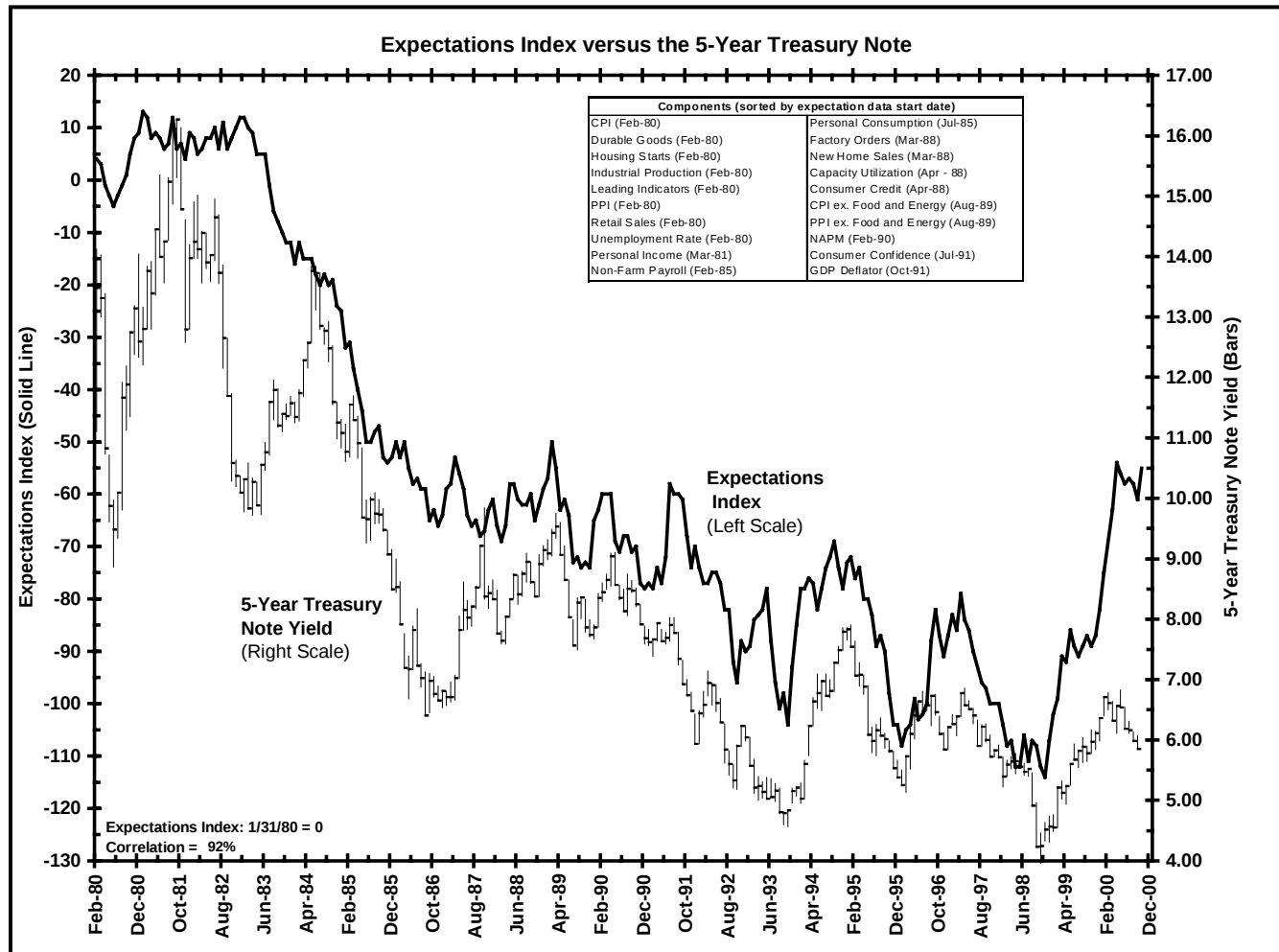


Chart 5

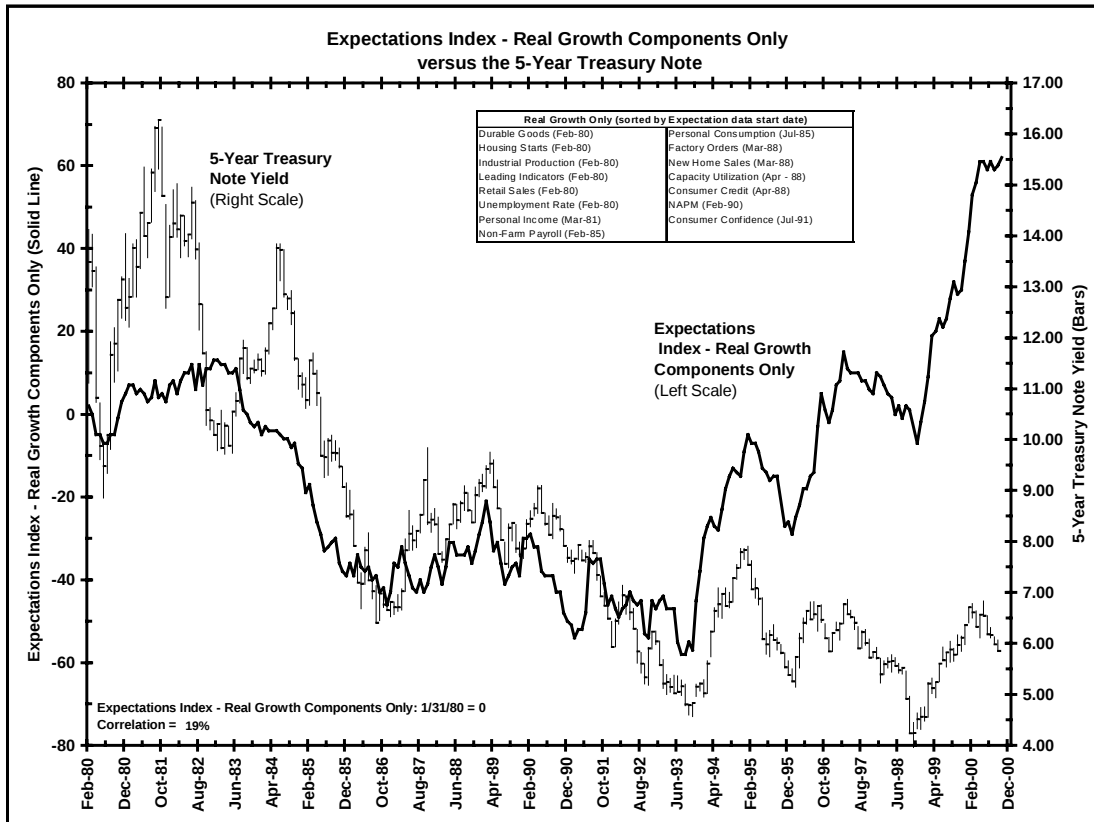


Chart 6

