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COMMENTARY

Market Opinions And Topics Of Interest
November 7, 2000

"Economics" versus "Events" in the Bond Market Part 2: Events – When Does The "Reverse Wealth Effect" Kick In?

*Cancel the Boxster. My Portfolio's Been Pummeled
With the market shaky, watch out for the "reverse wealth" effect
-- BusinessWeek, October 30, 2000*

In part 1 of this commentary (October 26), we argued that the economy was bottoming, or possibly turning up, because the "Expectations Index" was moving higher. The next day (October 27), we published our quarterly "Market Cap to GDP update" for Q3 2000 and it revealed that the annual growth of nominal GDP was 7.73% and the five-year Treasury Note was 5.93%. Taken together, these two commentaries argued that interest rates are too low relative to the pace of economic growth, and with the Expectations Index" turning higher, **further** slowing of the economy looks suspect.

When we queried bond market participants about this, surprisingly many agreed with our assessment that the economy was running ahead of interest rates. The economic data over the last month did indeed call into question further slowing. However, they were all quick to point out that none of this matters. As one participant relayed to us: "the bond market is not trading on economics, but rather events." The big event, in the bond market's opinion, is a plunging stock market and the potential for a "reverse wealth effect." This line of reasoning suggests that whatever strength the economic data is now suggesting could be wiped out by a declining stock market.

The Wealth Effect Is Very Much Alive and Well

Charts 1, 2 and 3 show three measures of the economy that many agree are related to the wealth effect. Chart 1 shows the year-over-year change in "real" retail sales and the S&P 500, Chart 2 shows the University of Michigan's consumer confidence survey and the S&P 500 and Chart 3 shows the personal savings rate and the S&P 500. Notice that all of these economic series have shown a high

degree of correlation to the stock market over the last several years.

The idea that a plunging stock market would affect these economic series makes perfect sense. However, the question is: "at what point will declining stock prices throw the economy into reverse?"

The wealth effect impact on the U.S. economy is unprecedented (as expressed by the incredibly high market capitalization to GDP ratio). This means that we are in uncharted territory when it comes to understanding the stock market's effect on the economy.

While one could argue that "real" retail sales are showing some effects of weaker stock prices (Chart 1), one would be hard pressed to make the case that weaker stock prices have impacted consumer confidence (Chart 2) and the personal savings rate (Chart 3). **We would go one step further and argue that the "reverse wealth effect" is, so far, non-existent.**

The Public is Still Bullish!

Chart 4 shows the results of the Gallup organization's survey of 1,000 people who own stocks. This monthly survey shows that the public has held steadfastly to their bullish beliefs despite the recent ups and down of the stock market.

Why should the public not be bullish? As Chart 5 shows, the public has retained a great deal of their unrealized profits (bottom panel of Chart 5) despite a rough year in the stock market. Simply put, the public has not experienced that much financial pain this year.

How the “Reverse Wealth Effect” works

We would argue that the wealth effect is a “binary decision” for investors. By this, we mean that the public either believes that the stock market will augment their income or they do not. If they believe in the wealth effect, investors should largely act the same at NASDAQ 3,100 as they do at NASDAQ 5,100. This appears to be the case. If they were to stop believing in the wealth effect, they would view the stock market as too risky to rely on as an income supplement. In this environment they would reduce their spending and increase their personal savings rate (Charts 1 and 3).

We agree with *Wall Street's* concept that lower stock prices can and will slow the economy. However, we disagree with the idea that investors, **as a group**, are so sensitive to weekly movements in the stock market, that they cancel purchases because of the latest level of the DJIA or NASDAQ. Yet, the pattern of trading by the bond market and the stock market suggests every little movement in stock prices affects the economy. As long as the public believes in the wealth effect, stock market gyrations will have little effect on their spending decisions and thus the overall economy.

So, when does the “reverse wealth effect” kick in? Or, to put the question another way, “when will the financial pain level become so great that the public abandons its belief that the stock market will continue to serve as an augment to their income?”

The bottom panel of Chart 5 can best help in answering this question. We hypothesize that when **at least half** of these unrealized profits have disappeared, the public will start to abandon the wealth effect (or the “reverse wealth effect” will kick in). We emphasize *hypothesize* because, in this unprecedented environment, no one knows for sure.

Stock prices have to decline another 20% **from current levels** to reach the point where half of the unrealized profits have disappeared. Until this happens, **the public will behave as if the bull market is alive and well.** Investors have sizable

profits and remain overwhelmingly bullish, so why should they act differently?

Conclusion

The bond market is not trading on “economics,” but rather on “events.” The bond market was banking on the stock market's decline in September/ October to create a “reverse wealth effect.” This meant that the growth rate of nominal GDP would be heading much lower. The resulting “reverse wealth effect” would justify bond yields to now trade significantly below the growth rate of nominal GDP.

This story appeared to be working in early to mid-October. However, two things have changed in recent weeks.

First, the stock market has rebounded smartly from its October lows. For now, the bear market appears to be “on hold.”

Second and more importantly, the latest releases of economic numbers taken in total show more upside surprises than downside surprises. Since October 1, nearly 75% of all economic releases have been above consensus. This calls into question the idea that a “reverse wealth effect” has been depressing the economy. If this were the case, we would see more downside surprises than upside surprises.

We do not believe that the economy is currently experiencing, or is about to experience, a “reverse wealth effect.” As Chart 4 shows, the public is still overwhelmingly bullish, and has stayed this way despite the gyrations in the stock market this year. As Chart 5 shows, the public still has the vast majority of their unrealized profits. They have felt little financial pain this year.

Until the public feels more financial pain, brought on by further stock market declines, the public will act as if the wealth effect is alive and well. As this realization becomes apparent to the bond market, we believe interest rates will head higher.

Chart 1

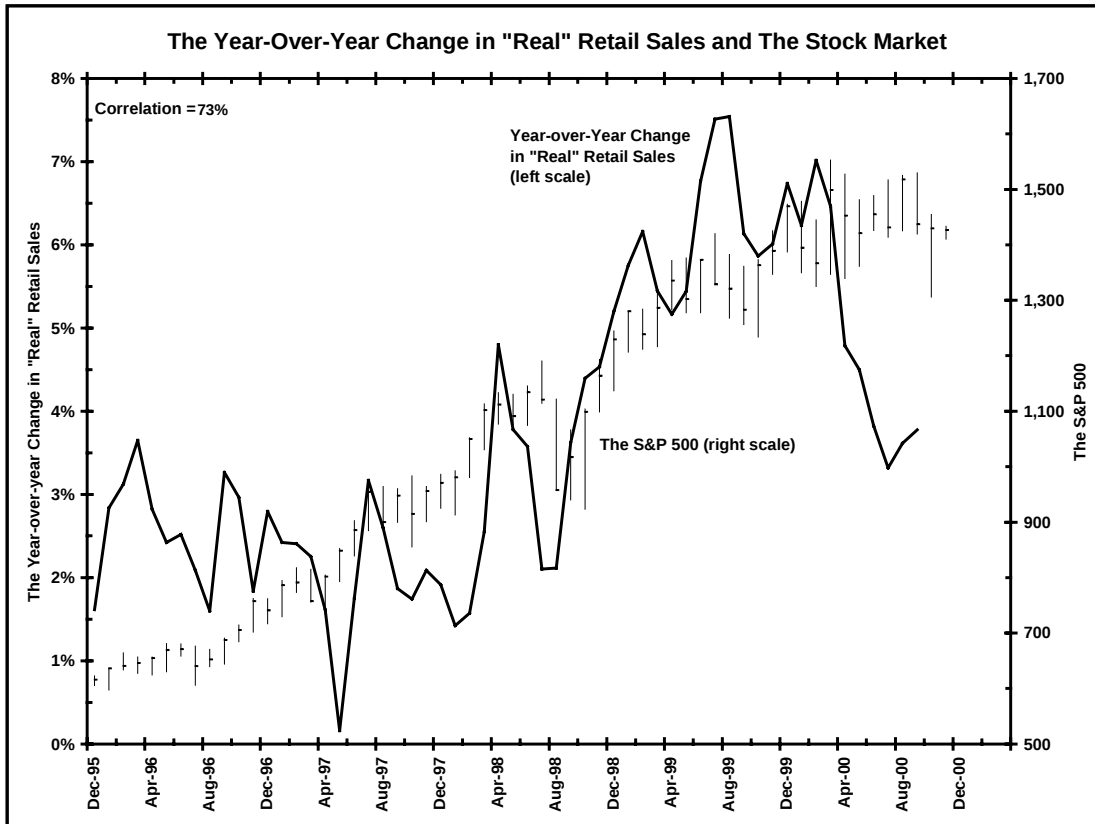


Chart 2

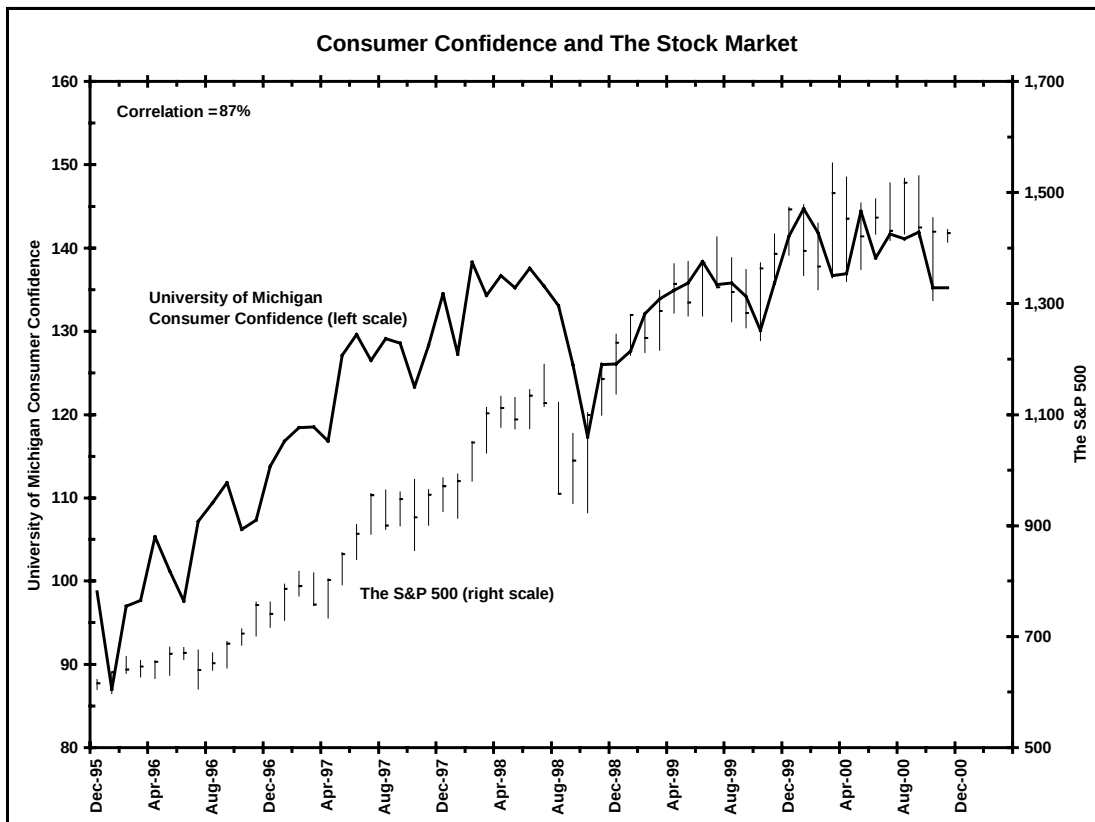


Chart 3

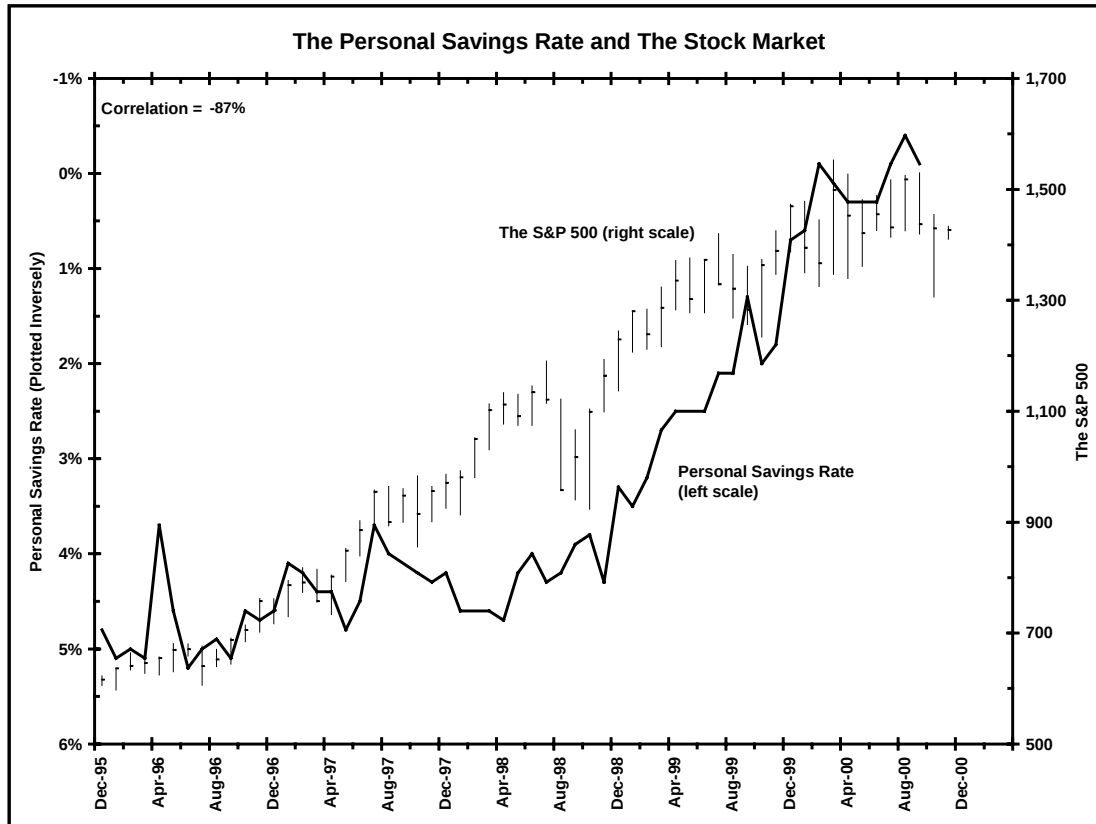
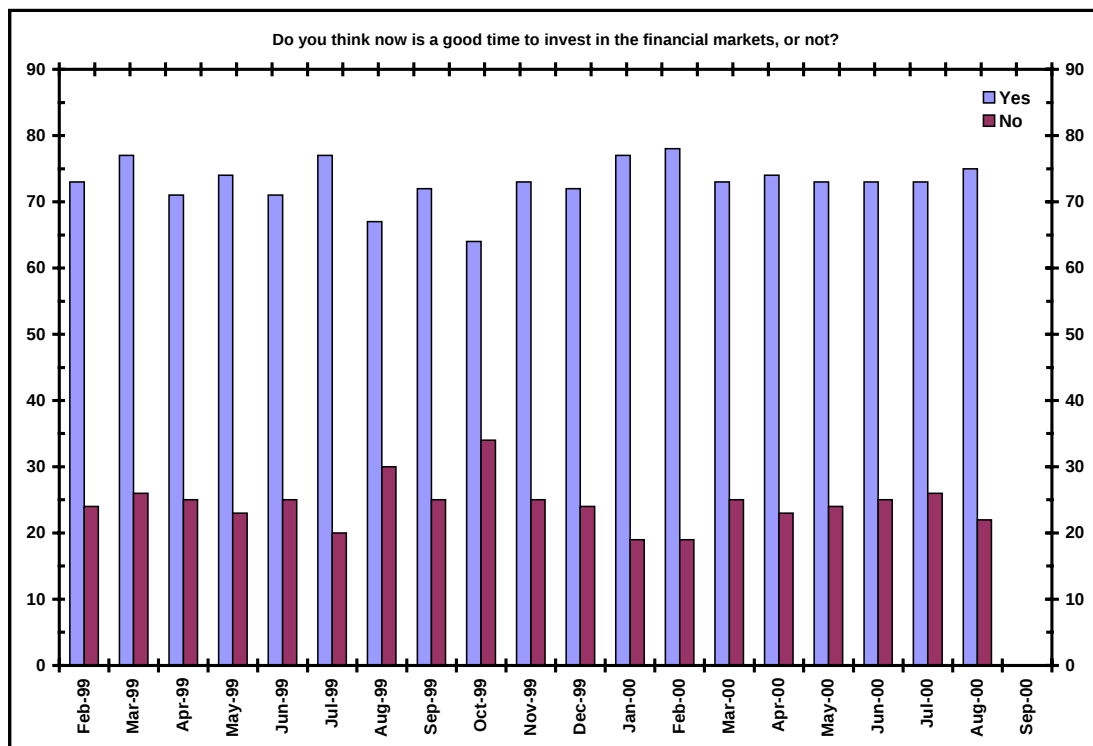


Chart 4



Source: Gallup.com investor sentiment survey

Chart 5

