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Commentary

Market Opinions and Topics of Interest

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Stock-Treasury Relationship: Revisiting Long-Term Analogs

The recent selloff in global equities in general and Japanese stocks in particular – the Nikkei 225 recently completed a 12-session losing streak – raises the question of whether the ongoing credit crunch is turning into something more severe.

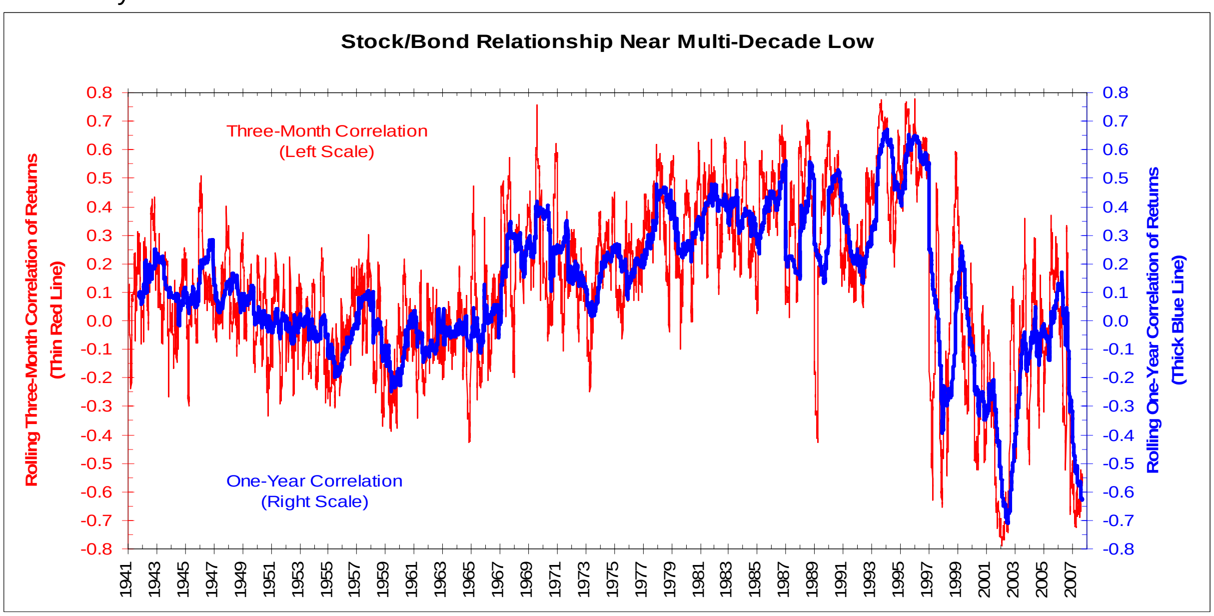
By "severe" we mean a decline in financing activity and a concomitant increase in the demand to hold cash balances. Taken in combination with declining asset prices and reduced consumer purchasing power, this is a ***deflationary*** environment, one similar to that seen globally in the 1930s and in Japan after 1990. Deflation, ironically, must be fought with the very same negative real interest rates seen as the cause of commodity prices inflation in recent months.

Let's update a January Commentary looking at long-term stock and bond relationships and the interest rate analogy between the U.S. and Japan. We still see an exceedingly negative correlation of returns for rolling three-month and one-year periods (thin red and thick blue lines, respectively) between U.S. stocks and ten-year Treasuries.

We wrote in January (original boldface):

> *The adoption of a risk-management approach by Alan Greenspan in late 1997 altered a longstanding trend toward ever-greater correlation of returns between U.S. equities and Treasuries. Efforts to offset the Asian crisis then unfolding precluded the Federal Reserve from tightening credit. The trade deficit as the U.S. became the world's customer of last resort.* ***A second consequence was an implicit "put option" for the world's speculators and a concomitant altering of perceived risk amongst asset classes. We live with that today.***

That paragraph was written on January 10th, before the January and March panics. **The situation is no better now than it was then; indeed, given the numerous rate cuts and other emergency actions undertaken thereafter, we can argue the situation today is worse as we have fewer policy "bullets" remaining.**

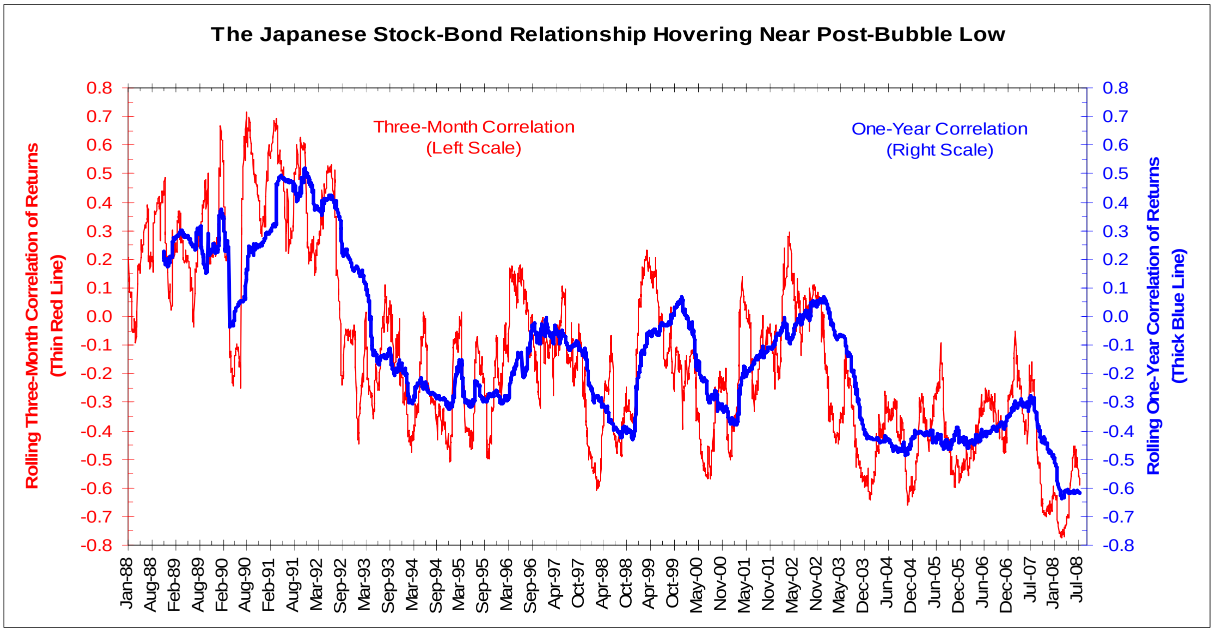


The Japanese Analog

If we construct an identical set of correlation of returns over rolling three-month and ten-year periods (thin red and thick blue lines, respectively, following page) between ten-year Japanese government bonds and the Nikkei 225 index as we did for the U.S., we see a similar trend. The one-year rolling correlation of returns is hovering near its lowest level since the December 1989 peak in the Japanese twin real estate and stock market bubbles, and the three-month correlation of returns is once again turning lower.

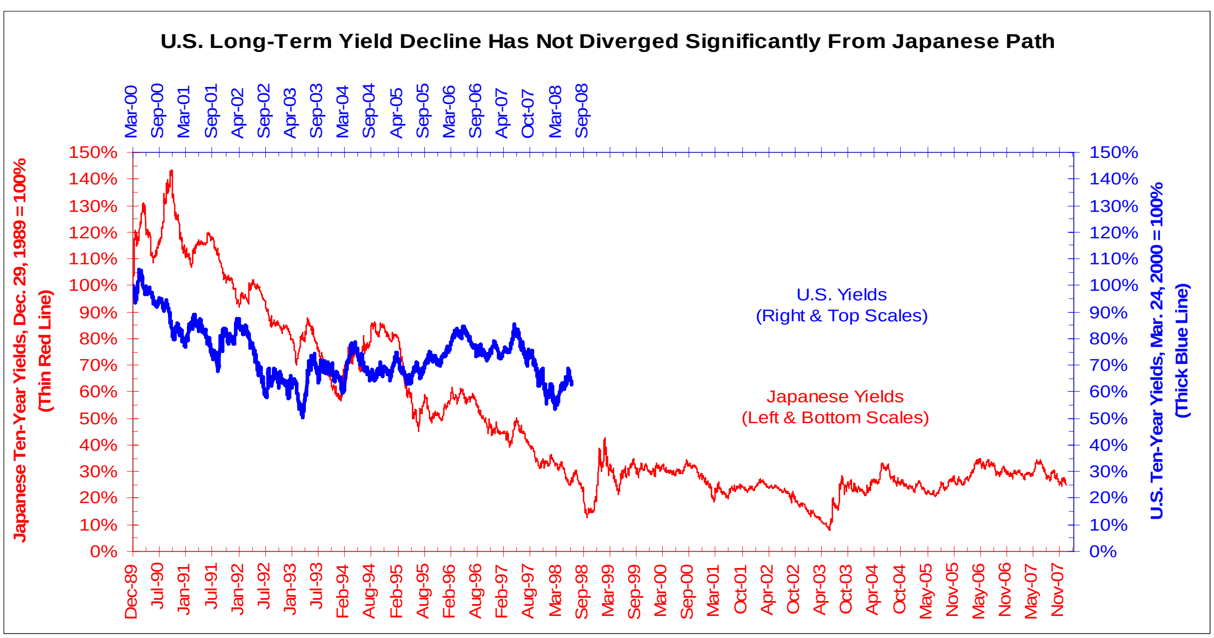
We repeat from January (original boldface):

> ***The Japanese experience indicates a negative correlation of returns between stocks and bonds can persist and deepen over a very long period of time.***



Let's revisit a comparison between U.S. and Japanese long-term interest rates first introduced in a February 2005 Market Facts. U.S. long-term rates have yet to decline as much on a percentage basis from the March 2000 peak in U.S. equities as have Japanese long-term rates from their December 1989 peak (thick blue and thin red lines, respectively), but the divergence is not significant.

If credit contraction and risk aversion deepen, how unthinkable is it the U.S. will slide down a Japanese path toward years of still-lower long-term rates?



Conclusion

The Federal Reserve and its sister central banks – and by extension, all of us – are in a highly precarious position. A reasonable observer can look at what has happened in food and energy prices, the exchange value of the dollar and in the massive U.S. incentive to repudiate its debts, both foreign and domestic, via inflation and conclude our greatest threat is hyperinflation.

A second reasonable observer can look at equity indices near decade-ago levels, collapsing housing prices, contracting credit and commercial lending markets and squeezed consumers and conclude economic activity is at risk of imploding. The Federal Reserve and then-Secretary of the Treasury Andrew Mellon looked at all of the cash resulting from the liquidation of assets in 1930 and made what we now know to be the fatal mistake of letting the money supply contract. Deflations often look like bad inflation when they begin.

We only can hope Benjamin Bernanke, who for all of the criticism aimed at him here and elsewhere is nothing if not a foremost student of the Great Depression, can avoid both perils. History does tell us inflations *if they are not engineered into hyperinflations* are easier to manage than deflationary recessions.

This raises the very distinct policy the current monetary policy might be the correct one.

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