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COMMENTARY

Market Opinions And Topics Of Interest
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A New Era in the Relationship Between Stocks and Bonds? Part 2: Who Is Behind The Change?

In part 1 (September 17th) we showed that the relationship between stocks and bonds has undergone its most dramatic change this century. That is, the trading pattern of stock prices and bond prices are now moving inversely to each other to an extent and degree that makes it nearly unprecedented in the over 75 years of data we studied. The bond market no longer trades on, or seems to care about the "traditional" fundamentals. This even applies to the very short-term. Consider:

- On Friday, September 4th, the employment report was released. The range of the nearby T-bond contract from the open (10 minutes before the report was released) until the open of the stock market at 9:30 ET was 9/32. The range of the T-bond contract from the time the stock market opened until the close was 25/32. The bond market had nearly three times the movement during stock trading hours than it did in responding to the release of the employment report. Incidentally, the 9/32 range was the same as August 1998 and is the smallest range in the first 1 ½ hours of trading on the day the employment report is released since October 1988!
- That same night, September 4th, Greenspan spoke in California. The big news from this speech was that the Fed moved from a tightening bias to a neutral bias. The next trading day the nearby T-bond contract fell 22/32. The Dow Jones Industrial Average was up 380 points – its largest point gain ever. So, it appears the bond market thought the huge gain in the stock market was more negative than the positive of a change in Fed policy! When was the last time the bond market reacted negatively to a surprisingly positive change in Fed policy?

- On September 11th, the PPI was released and surprised everybody by **falling** a greater than expected 0.4% (the consensus was looking for no change). The T-bond contract fell 27/32. Could it be that bonds were reacting to stocks gaining 180 points that day?
- On September 16th, Greenspan spoke before the House banking committee. The big news came during the Q&A period when Greenspan said: "there are no plans for a coordinated rate cut." Normally this would be considered bad news for bonds, yet bonds were up over a point from the time that comment was made until the next day's close. Amazingly bonds rallied on the disappointing news about no rate cut. Could the real reason for the rally be that stocks were down in excess of 200 points over the same period?

In part 1 our contention was that bonds now view the potential for a "reverse wealth effect" from plunging stock prices **as the most important economic story today**. Everything else, including Fed policy, takes a back seat to the movements of stocks. (Maybe a better way to explain this is to say that Fed policy affects stocks which in turn affects bonds. So Fed policy now affects the bond market through the proxy of the stock market).

Who Is Doing This Trade?

While the dramatic change in the relationship between stocks and bonds is not that surprising given the explanation of a "reverse wealth effect," the speed at which it occurred is still stunning. In less than one year, the relationship between stocks and bonds has nearly done a 180 degree shift. Is there a group of market participants that have shifted their trading pattern?

A review of the data covering the “usual suspects” like mutual funds and institutional investors suggests little change in the asset allocation between stocks and bonds. However, large futures speculators, whose activity mirrors that of hedge funds, have made big changes in their trading patterns over the last several months.

Chart 1 shows the net positions of large futures speculators in T-Bonds and the S&P 500. Note that two weeks ago (latest data) the T-Bond speculators were at an extreme long position while the S&P 500 futures speculators were at an extreme short position. This is very unusual. Since the start of the data in 1983, this has occurred only once before and that was following the October 1989 “mini-crash.” What is more common is that these traders will carry extreme positions in both contracts and **in the same direction** at the same time.

Can Speculators Affect Stocks/Bonds Alone?

The large futures speculators (hedge funds) are the only market player to have changed their trading patterns in stocks and bonds. At the same time, the price action between stocks and bonds has nearly done a 180 degree shift. So, are the large speculators the cause of this change? Are they big enough to cause this to happen by themselves?

The data that can give us insight into this question is shown on chart 2. The top panel shows the total capitalization (open interest x contract size x closing price) of the S&P 500 futures contract and the three long-term interest rate futures contracts – T-Bonds, 10 Yr. T-Notes and 5 Yr. T-Notes. The bottom panel shows the total purchases plus total sales (turnover) of stocks and bonds from the tax haven countries. This is the “home” of many hedge funds.

Note the spectacular growth in the time series on both of these charts. Back in 1993/1994, we argued that the boom in speculation from the “carry trade” (borrowing at the then 3% funds rate to buy higher yielding Treasury securities) was a driving force behind 1994 turning into one of the worst years ever for the bond market. This occurred in the wake of the Fed raising rates in February 1994 and setting off a giant “margin call” on these leveraged positions. The leveraged trade was large enough back then to have a huge impact on the bond market even though

many of the “traditional” fundamentals did not forecast such a move. Currently, the size of exchange traded derivatives and the turnover from the tax haven countries is many times larger. So, if the 1993/1994 levels of activity could cause havoc in the bond market, it is reasonable to suspect that this activity can now have a similar effect in the **stock and bond** markets. Add to this the worry about “systemic risk” from Long-Term Capital (are we saying that one hedge fund can bring down the entire financial system?) and it seems more than likely that speculators/hedge funds have the muscle to change the trading relationship of stocks and bonds.

Conclusion

What does all this mean? Most important is that the stock market may continue to influence the bond market more than “traditional” economic indicators. This will probably last until the “wealth effect” is no longer perceived as the dominant force in the economy. It will also persist as long as the failure of one hedge fund can single handedly threaten the entire financial system.

Additionally, the gyrations within the hedge fund community will continue to play an important role in setting prices on virtually all securities. It can be reasonably argued that volatility has picked up in all financial markets because most dealers and hedge funds have taken such a beating over the last few months and are unwilling or unable to “play” as aggressively as they did a few short months ago. Thus liquidity has been reduced. Volatility will remain high as long as dealers and hedge funds continue to report losses on an almost daily basis.

Finally, it is impossible to quantify the extent of this situation. That it has turned the trading relationship between stocks and bonds upside down suggests it is huge! (See the “Up and Down Wall Street” column in the September 21st Barron’s for a good attempt at quantifying). Inasmuch as financial markets have a situation that can twist a basic relationship like the trading pattern between stocks and bonds, we indeed may have entered a “new era.” Maybe the market’s view on “what moves prices” needs to be adjusted accordingly.

Chart 1

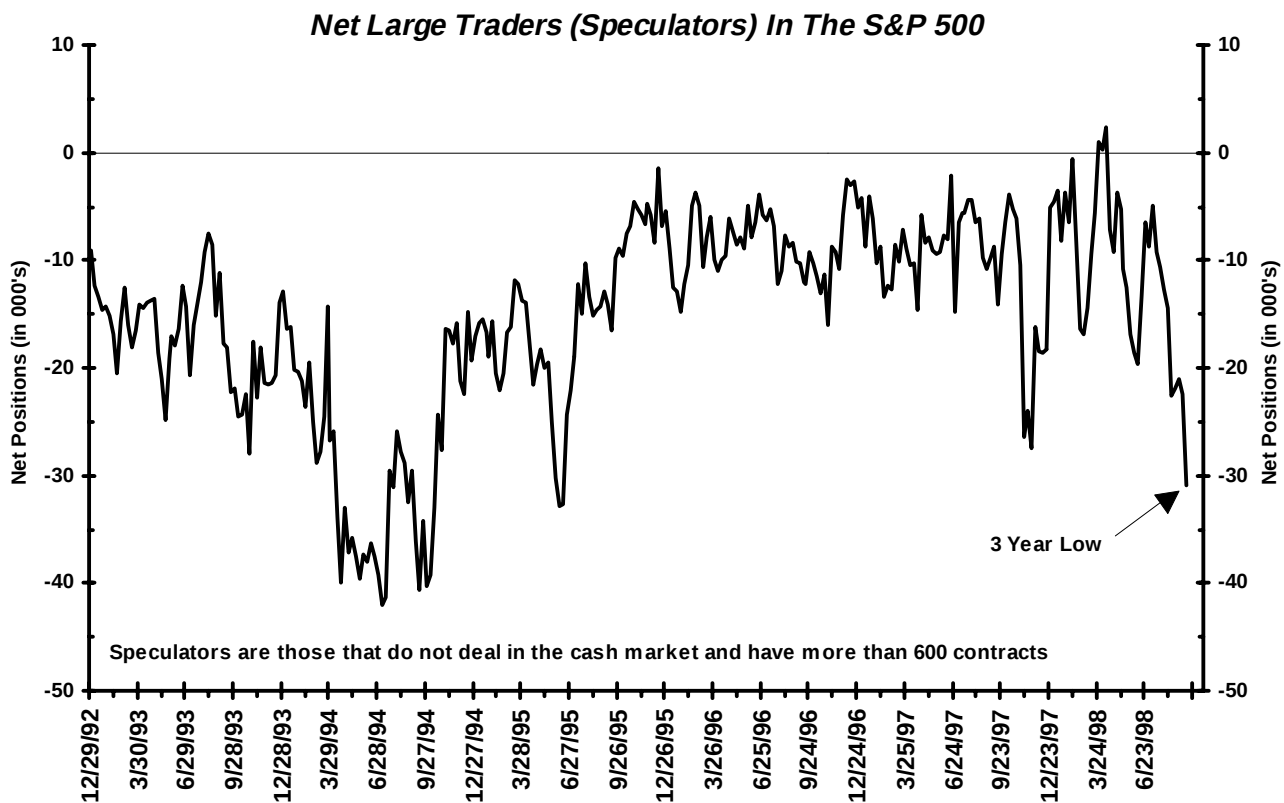
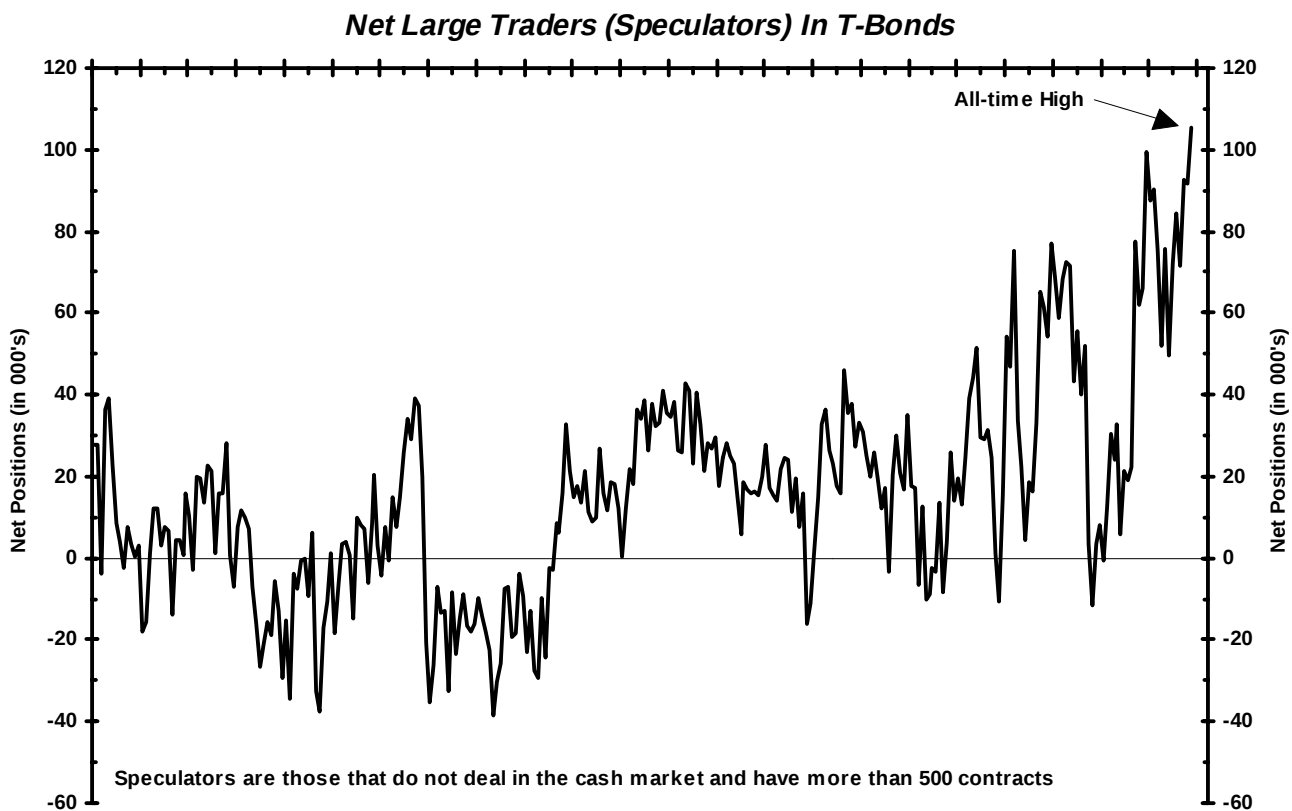
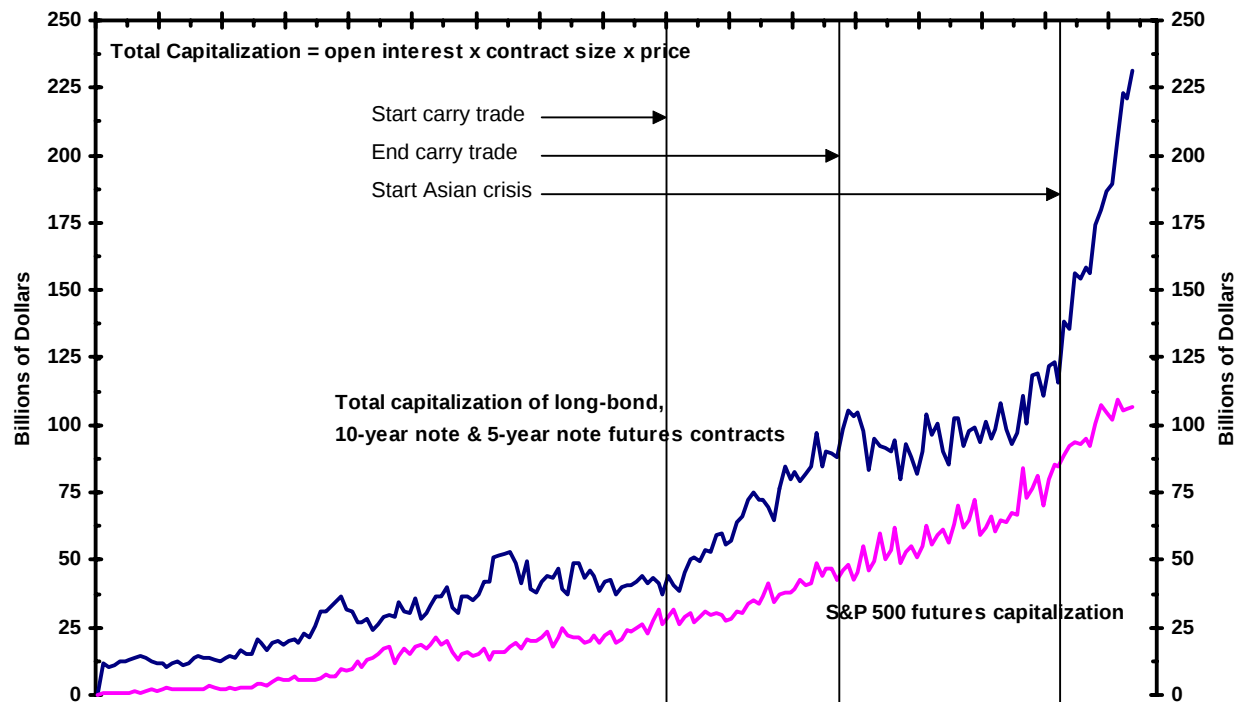


Chart 2

Growth of Financial Futures

Total Purchases plus Total Sales
of all Stock and Bond Activity from Tax Haven Countries