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# COMMENTARY

Market Opinions And Topics Of Interest
October 2, 1998


## A New Era in the Relationship Between Stocks and Bonds? Part 3: Everything Trades Like The S&P 500, What Side Are You On?

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 that makes it nearly unprecedented in the over 75 years of data we studied.

In Part 2 (September 25th), we discussed what was behind this change. While it is impossible to quantify the extent of this situation, we argued that hedge funds and leveraged traders were large enough to cause this dramatic change.

**Only Two Bets Available?**

The old saw in the financial markets is that at times of “stress,” the correlation of all markets goes to +100%. This can cause any number of problems when assumptions that guide investment decisions break down (LTCM?).

Chart 2 shows that this phenomenon is occurring right now. The top two panels show the last three months of the S&P 500 (through 10/1/98). Below are measures of eight major markets --from emerging markets to stocks to bonds. Currently all these markets are at least 80% correlated to the S&P 500 over the period shown. Thus, everything trades like the S&P 500.

How unusual is this? Chart 1 shows that this is unprecedented during this decade (maybe even longer but many of these markets do not have daily data prior to 1990). This chart is a daily plot of the least correlated of the eight markets shown in chart 2. It 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 market even been close to moving in harmony as they are now.

Why do we use the S&P 500? We could have placed any market on the top and all the others would have been highly correlated. We believe the S&P 500 is the most important market because it is the largest market in the world and the one that has created the most wealth. It is also the most visible and is perceived to be the most important. Therefore, trading in other markets takes its lead from the S&P 500 as opposed to the other way around.

**These charts depict the incredible stress that the financial system is under.** To have trading in all markets so highly correlated to each other suggests that one story must be in play. That story is “de-leveraging.” It does not seem that the more traditional economic and fundamental concerns are at play currently.

**Conclusion**

It does not matter whether you are trafficking in mortgages, Brazilian stocks or the long-bond. All these markets trade like the S&P 500. Effectively, there are only two bets in the financial markets – long U.S. stocks or short U.S. stocks.

This may help to explain the problems that LTCM encountered and the fear about many other hedge funds. They did not expect a myriad of markets would turn into the S&P 500 all at once. The hope was that diversification would prove to be a viable strategy when the next bear market in stocks and credit began. Now that it has started, diversification is not working, and all markets are moving together.

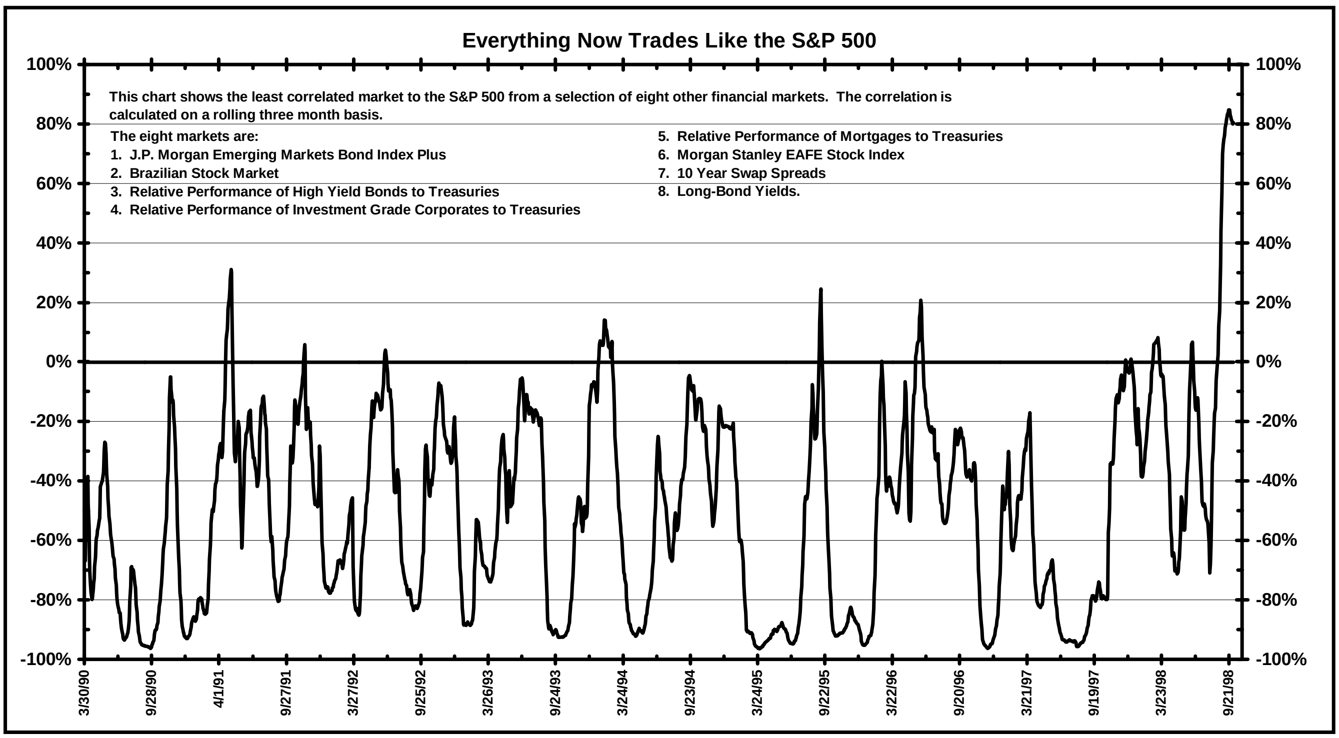
One might argue that U.S. Treasury bonds are the safe haven. That is true. However, with only $425 billion of Treasuries greater than 10 years, this market is barely large enough for LTCM, let alone the thousands of others stuck in riskier assets.

How long will the financial markets continue to trade as a single market? As long as the de-leveraging continues, and the fear of more to come exists. Until then, everybody is betting on the stock market and therefore, it will provide the leadership for everything else.

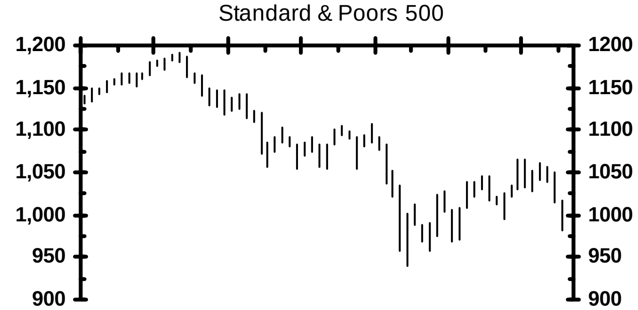
In part 4 we will outline our outlook for U.S. stocks.

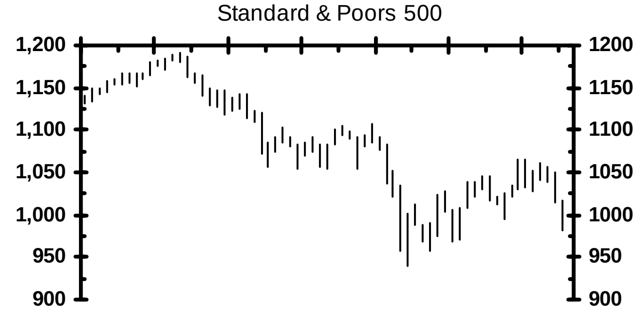
(**Hint**: in our September 11th commentary, when the DJIA was near 7600, we suggested a rally was coming. Stocks did rally 500 points and have now round tripped. Currently, we would bet on them holding as opposed to breaking below the old lows. We will take this up next time.)

**Chart 1**



## Chart 2


Standard & Poors 500
1,200
1,150
1,100
1,050
1,000
950
900


Standard & Poors 500
1,200
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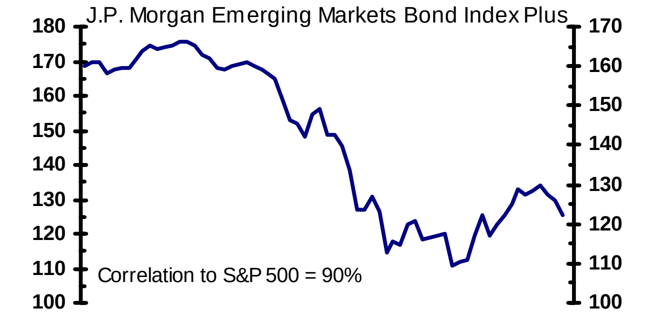
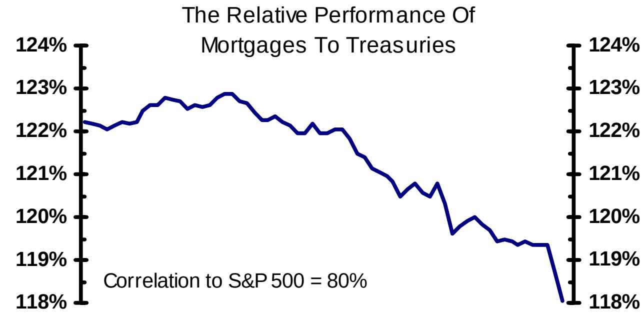
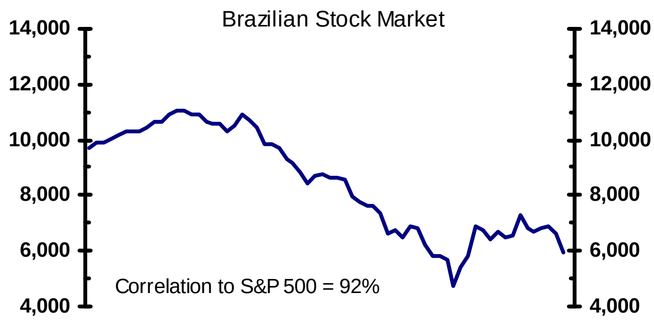
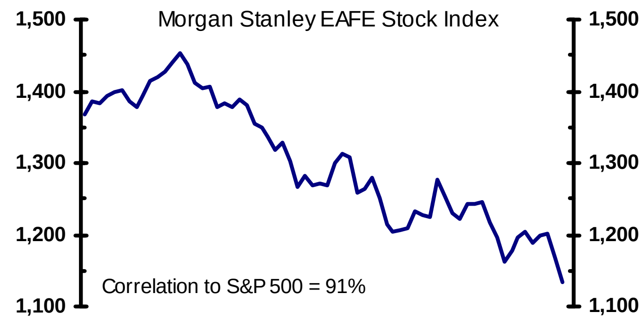
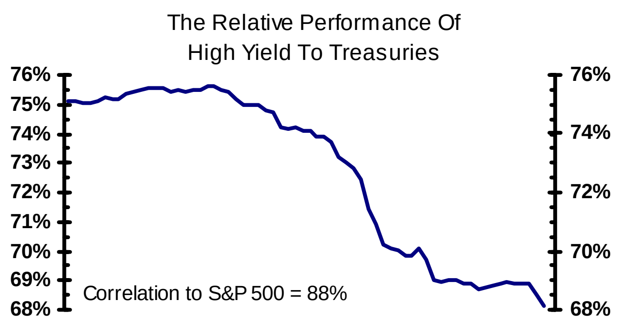
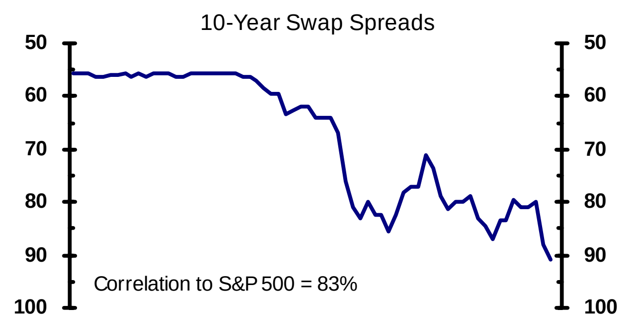

J.P. Morgan Emerging Markets Bond Index Plus
Correlation to S&P 500 = 90%

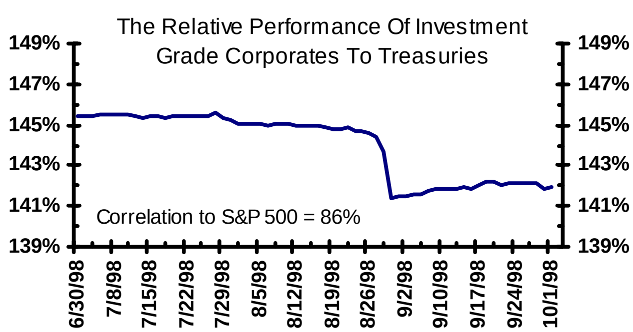

The Relative Performance Of
Mortgages To Treasuries
Correlation to S&P 500 = 80%

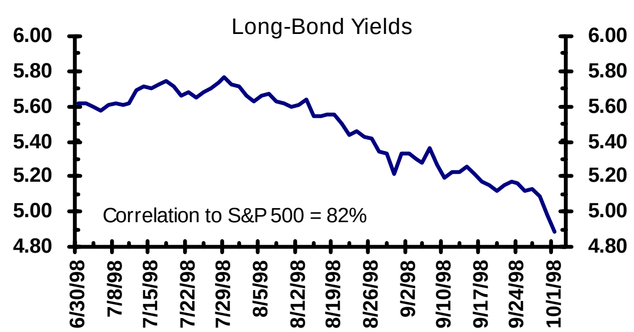

Brazilian Stock Market
Correlation to S&P 500 = 92%


Morgan Stanley EAFE Stock Index
Correlation to S&P 500 = 91%


The Relative Performance Of
High Yield To Treasuries
Correlation to S&P 500 = 88%


10-Year Swap Spreads
Correlation to S&P 500 = 83%


The Relative Performance Of Investment
Grade Corporates To Treasuries
Correlation to S&P 500 = 86%
6/30/98
7/8/98
7/15/98
7/22/98
7/29/98
8/5/98
8/12/98
8/19/98
8/26/98
9/2/98
9/10/98
9/17/98
9/24/98
10/1/98


Long-Bond Yields
Correlation to S&P 500 = 82%
6/30/98
7/8/98
7/15/98
7/22/98
7/29/98
8/5/98
8/12/98
8/19/98
8/26/98
9/2/98
9/10/98
9/17/98
9/24/98
10/1/98