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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 4: Can the S&P 500 "Save the World?"

"We are far short of anything that could resemble a credit crunch in the United States. To be sure, there are all sorts of difficulties lots of people are having borrowing. But it is by no means evident that this is having as yet a significant impact on the real variables." – Alan Greenspan, 10/7/98

"Growing caution by lenders and unsettled conditions in financial markets more generally are likely to be restraining aggregate demand in the future. Against this backdrop, further easing of the stance of monetary policy was judged to be warranted to sustain economic growth in the context of contained inflation." – Federal Reserve Press Release, 10/15/98

A subtle, yet overlooked, point about last week's easing was that Alan Greenspan acted alone. He has the ability to move rates without a formal vote from the FOMC and he exercised that option for the first time since April 1994. Since Greenspan acted in this fashion, many believe that "Greenspan knows something" and acted to head off a "systemic failure."

This conspiracy theory gained ground less than two hours after Greenspan's ease. The New York Federal Reserve issued a correction at its weekly Thursday press conference saying that "less than half" of the six major New York City banking institutions had borrowed from the discount window a week earlier. The week before the NY Fed said no one had borrowed at the discount window.

Seasoned Fed watchers reasoned that this correction was innocent enough. However, the timing could not have been better for Wall Street's rumor mongers. The NY Fed's correction, on the heels of a surprise "off meeting" ease, had some in the financial community convinced that a major bankruptcy was imminent.

Was Greenspan's Goal A Stock Rally?

Taking Greenspan at his word, *"unsettled conditions in financial markets"* were his main reason for moving. The important point to remember here is

which financial market he was referring to. Unlike 1987, this is **not** about the stock market. Rather it is about the "spread markets" of mortgages, high-yield, emerging markets and investment grade corporates. These spreads were showing no signs of narrowing when the Fed moved last Thursday.

Of all the stories about hedge fund woes and Wall Street losses, very few involve the stock market. So, Greenspan's concern was **not** the stock market.

We believe Greenspan's goal is to find a way to contain the damage in the spread markets. Thus, helping spur a stock market rally is "just what the doctor ordered." If the stock market rebounds sufficiently to get bearish strategists to turn bullish and mutual fund investors to move back into equity funds, this should positively affect the "spread markets." In trying to foster a stock rally, almost nothing is more bullish than the Fed aggressively lowering interest rates.

In a time of crisis, the correlation between all financial markets approaches 100%. This is a concept that we graphically displayed in our October 2nd commentary--"Everything Trades Like The S&P 500, What Side Are You On?" In that commentary we suggested that nearly all financial markets are taking their lead from the S&P 500. These charts are updated and attached following this commentary.

Why the S&P 500? The U.S. stock market (S&P 500) is the largest and most important in the world. So, any move in this market would have a major impact on all other markets.

We also believe that the U.S. stock market is one of the **less** leveraged financial markets today. This is not to imply that this market is devoid of leverage, it is not. Rather, in comparison to other world markets, it is less leveraged than most.

Why do we believe this? Unfortunately, there is no definitive leverage statistic we can cite as none exists. However, several other indicators suggest this is the case.

As the following table shows, the U.S. stock market has been one of the best performing stock markets since Russia's default ("moratorium") on August 17th.

The Best Place To Hide: U.S. Stocks!
(Returns From August 17th To October 16th)

Rank	Country	Index	Return	YTD Return
1	Hong Kong	Hang Seng	32.86%	-10.48%
2	Korea	Composite	23.99%	-0.62%
3	Mexico	Bolsa	8.76%	-26.63%
4	Australia	All Ords	-0.83%	-3.85%
5	India	NSE50	-1.76%	-22.23%
6	U.S.	S&P 500	-2.56%	8.89%
7	Taiwan	Weighted	-5.08%	-15.67%
8	U.K.	FTSE 100	-7.13%	-1.13%
9	New Zealand	Top 40	-7.79%	-22.81%
10	Canada	TSE 300	-8.19%	-12.35%
11	Japan	Nikkei 225	-8.30%	-11.09%
12	South Africa	Johan All-Share	-8.48%	-8.85%
13	Denmark	BMCX	-11.31%	-13.17%
14	Argentina	Merval	-11.69%	-38.10%
15	Ireland	Overall	-13.95%	2.33%
16	France	CAC 40	-14.77%	13.22%
17	Germany	DAX (Xetra)	-17.78%	5.73%
18	Italy	MIB30	-18.58%	15.98%
19	Brazil	BOVESPA	-21.29%	-33.27%
20	Russia	RTS	-48.91%	-85.91%

Source: Bloomberg L.P.

Of the 20 major markets above, sorted best to worst since Russia defaulted on August 17th, the U.S. ranks sixth. It is the only stock market in the top 14 that still has a positive year-to-date return and the third best year-to-date return overall. Taking these two statistics together, if one had to stay invested in a "risk" market like stocks, the U.S. would be the place to be.

The current crisis in spread markets is about forced selling via margin calls. In the current environment, markets that have better returns suggest they have lesser amounts of forced selling than markets that have poor returns. Since the U.S. stock market has

better returns than most, it appears that forced selling is not a large problem for the U.S. stock market.

We believe the U.S. stock market has less leverage because the public has added \$1.1 trillion of unleveraged mutual fund money since late 1990. Yes, leverage players exist in the U.S. stock market, but the influx of unleveraged money has served to dilute their effects.

Should stocks hold or even add to their recent gains, we believe the spread markets will begin to take the lead of the stock market and start to tighten meaningfully in the coming days.

Auto Racers As Portfolio Managers

You might agree that spread product markets follow stocks. Furthermore, you might agree that the stock market has fewer forced sellers and therefore was ripe for the recent rally. However, everybody knows that spread product markets have deeper problems than weak stocks. Hedge funds and Wall Street dealers are "stuck" in losing spread product positions and desperately looking for bids--that's why the Fed eased. If stocks rally, why will spread product markets follow since it is known that a seller is waiting in the wings?

For nearly a half generation, we have seen one of the greatest bull markets in history. This bull market has created wealth beyond what many thought possible.

Those that benefit the most during bull markets are those that assume the most aggressive positions. It is not enough to be swept along in the wake of ever higher prices or tighter spreads. Risk takers reap higher rewards than "conservative" managers since they are willing to take greater chances. If we were describing a sport, it would be auto racing. Racers that reach the top in this sport are those that do not fear death as they push their cars to the limits -- only inches away from the wall and their competitors. Likewise, the great managers of the 1990s pushed the limits of prudent management to extremes and won handily until this year.

This explains why a Long-Term Capital Management (LTCM) could happen. To them, risk was not a four letter word. Such managers might even describe a prudent manager as someone who has short-changed his clients.

Many managers might recoil at the metaphor that they are auto racers. They would insist they follow a conservative strategy. This may be true in a narrow sense, but the fact that they operate in risky markets proves our point. Yes, they might not day-trade options on Dell Computer but, conservatively managing a portfolio of high-yield and emerging markets' securities could be as risky, if not riskier.

Furthermore, today's managers became successful by **not** saying no. In the bull market, those that took a risk were rewarded over and over again. So, the natural instinct is to take risk. Why not, it's always worked before.

An old saw on Wall Street is: "the first bounce in a bear market is the best bounce." Why? Because the psychology of the bull market still exists. Those that were rewarded time and again for being aggressive are looking to do it again. When they see that spread product might be tightening, they will find it irresistible to pass up the trade. After all, they did not get to their place of prominence by heeding warnings in the past. We believe that will be the case again.

Conclusion – Why This Period Is Like 1929

The current situation is very analogous to 1929. Saying 1929 evokes images of brokers jumping out of windows and bread lines. However, when we refer to 1929, we mean the de-leveraging of the stock market that took place in 1929, **not** the depression that followed. Within this context, the similarities are striking.

- In 1929 the leveraging was done by "pool operators" and was primarily concentrated in the stock market. In 1998 the leveraging was done by "hedge funds" in the spread product markets.
- In 1929 the stock market crashed. In 1998 many of the spread product markets crashed.
- In 1929 the fear was the stock market would take down the economy. In 1998 the fear is that the woes in the spread product markets will take down the stock market.
- In 1929 a counter-trend rally in stocks was fostered by the Fed lowering the discount rate (they did in February and April of 1930). In 1998 a rally in spread products is being fostered by a cut in the discount rate.
- In 1929 stocks were unable to make a new high. They did, however, have a significant rally until April 1930. We believe the stock market could not make new highs because it lost a major buyer. The damage done to the pool operators was too much for their lenders to extend them "bull market credit." Consequently, the next down-turn hurt the economy. In 1998 we believe that spread products will be unable to get back

to the tight spreads seen earlier this year. The market should, however, have a significant rally. The reason spread product will not get back to its recent tight levels is that the hedge funds suffered too much damage for their lenders to extend them "bull market credit." Consequently, the next downturn will hurt the stock market.

World-wide markets are still suffering from a de-leveraging much like the stock market did in 1929. In 1929 the de-leveraging of the stock market affected the economy. In 1998 the de-leveraging of the spread product markets is affecting the stock market.

Without healthy spread product markets, stocks will be unable to make new highs. Unhealthy spread product markets will raise borrowing costs, deny credit to some borrowers (credit crunch) and lower earnings. It also means that U.S stocks can have a bear market rally where "the first bounce is the best bounce."

While this is happening, the "flight-to-safety" bid for Treasuries will deflate. This will push yields higher, thus continuing the recent relationship between stock and bond prices moving inversely.

What goal did the Fed have for easing?. We believe it was to foster an S&P 500 rally to "save the world." Will it work? It depends on your objectives.

If one is looking for a way to create any kind of bid for spread product, enabling those that are "stuck" to transfer their paper to others, it should work. The auto racing mentality of bull market managers will make it too irresistible to pass up a chance to buy at these levels. This means that hedge funds and dealers are hurting, but still in business.

If one thinks the Fed is going to recreate the bull market days of the 1990s, that will only happen if lenders extend "bull market credit" to hedge funds and dealers. That does not look as though it will happen. Without the hedge funds, another buyer of their size needs to be found. Right now, we do not see that buyer.

If one is looking for levels, the Dow Jones could reach 9,000 (S&P 1,125) and the yield on the long-bond could test 5.25%. So long as these targets are not exceeded, the bear market in stocks and bull market in Treasuries will remain in force.

All Markets Now Look Like the S&P 500

