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COMMENTARY

Market Opinions And Topics Of Interest
November 20, 1998

A "Bad" Bull Market

"Although conditions in financial markets have settled down materially since mid-October, unusual strains remain. With the 75 basis point decline in the federal funds rate since September, financial conditions can reasonably be expected to be consistent with fostering sustained economic expansion while keeping inflationary pressures subdued." – FOMC Press Release, November 17, 1998

In the last few months we have witnessed one of the most unusual episodes in the history of finance. Yet only a few people have noticed it. What are we talking about? The "bad" bull market in bonds that that peaked on October 5th.

Chart 1 shows the yields for some of the major sectors of the bond market. This chart uses the Merrill Treasury Master, the Merrill Mortgage Master and, the Merrill Corporate Master. Despite all the (legitimate) worry about systemic risk and the potential of failure of a major financial firm, all these yields were going down during this crisis. This is another way to say that bonds were in a bull market.

Can anyone recall another bull market that was perceived to be bad? We cannot. To be clear, we are not talking about the subsequent bear market. Rather, the act of rising prices was considered a bad thing.

Follow The Money: Unleveraged Players

How did we get to the point where a bond bull market became a bad thing? The simple answer is leverage. The bond market became so leveraged that the nominal level of interest rates seemed unimportant. What became important was the spread between "risk" assets and "safety" assets. So even though interest rates were falling, or prices rising, it did so in an adverse way – spreads widened. As we have found out in recent months, **spreads matter more than the direction of interest rates.**

How much leverage is there in the bond market? This question is hard to answer since there is no definitive statistic which one can point too. What we

can do is point out the trends that lead us to this conclusion.

One trend has been for unleveraged players to move from bonds towards stocks. We are all familiar with the fact that mutual fund investors place the vast majority of their money in equity funds. Year to date through September 1998, mutual fund investors have poured \$141 billion into equity funds and \$57 billion into bond and municipal funds. Even though this is a major improvement from last year (\$174 billion versus \$12 billion), it is a far cry from the late 1980s/early 1990s. From 1985 to 1993, mutual fund investors put over 60% of all new cash flow into bond funds. Since 1994, barely 15% of all new cash flow has gone into bond funds – and most of that went into high yield funds which are a surrogate for equity prices.

Chart 2 shows the asset allocation between stocks and bonds held by major financial institutions. Between 1974 and 1994, these institutions held their weightings in stocks fairly constant. Over that same period, bonds saw some erosion in the weightings, but were still by far the largest asset category.

Since the beginning of 1995, a major shift in asset allocation has occurred at these institutions. Now stocks are the largest asset category for the first time ever. Bonds are now at their lowest weightings ever.

When one combines mutual fund flows and the asset allocation of financial institutions, it becomes apparent that the world's largest pool of unleveraged money has been aggressively moving away from bonds. Currently, this pool totals over \$14 trillion in

assets -- \$11 trillion at financial institutions and \$3 trillion in long-term mutual funds. So, its movements are significant.

Follow The Money: Leveraged Players

Normally the loss of the largest unleveraged money pool would be bad news for a market. However, it need not be if that loss can be replaced. The bond market has been able to offset these losses through the use of leverage.

Chart 3 shows the size of the Treasury repurchase (repo) market relative to the size of the all Treasury debt outstanding. This chart shows the extraordinary amount of leveraging that has taken place in recent years.

This ratio first peaked in October 1993, along with bond prices, at 29% of all Treasury debt outstanding (repo = \$845 billion, Treasury debt = \$2.88 trillion). When the Fed started to raise rates in February 1994, the "carry trade" (borrowing at a 3% funds rates to buy bonds on margin) began to unwind. The unwinding process ended when this ratio bottomed in January 1995 at 23.5% (repo = \$743 billion, Treasury debt = \$3.16 trillion).

Even though the de-leveraging process of 1994 was very painful, especially for Kidder Peabody and Orange County, it did not deter another large build-up of leverage in the bond market. From the lows in January 1995, repo as a percentage of all Treasury debt outstanding has doubled to 46.4% (repo = \$1.52 trillion, Treasury debt = \$3.28 trillion).

So, who replaced the unleveraged institutions and mutual funds in the bond market? In large part it was the leveraged players re-leveraging the bond market.

Another way to look at the potential leverage in the marketplace is to look at the size of the derivatives markets. Table 1 is from the Bank for International Settlements (BIS) 1997 annual report. It details the notional value of all derivatives from 1991 to 1997.

Two things are worth noting about this table. First, the vast majority of derivatives are tied to interest rates -- over 93% in 1997! Second, not only are interest rate derivatives the largest sector of the derivatives market, they are also the fastest growing. From 1991 to 1997, the compounded growth rate of interest rate derivatives was 28%, currency derivatives grew at 9.4% and stock market derivatives expanded 25%. (Note: notional value should not be equated with risk. It is **not** a measure of risk. It is best used to measure growth rates and relative size only).

The message from this table is that when we say "derivatives" we really are saying "interest rates" as they are the dominant underlying market for these

instruments. Since derivatives are by their nature a leverage instrument, it also shows that the leveraging of the bond market continued at a frenetic pace.

Did The Fed Make A Mistake Last Tuesday?

So far we have defined the problem in the financial markets as an over-leveraged bond market and, by implication, an over-invested stock market. How does one "fix" an over-leveraged bond market?

One way is to deny credit and leveraging opportunities. This would help to force the leveraged players to the sidelines. This is what the credit markets were doing though early October, and the market did not like the consequences.

Another way to de-leverage the bond market is to encourage unleveraged money to flow its way. To do this, investors must perceive that bonds offer a competitive return potential relative to stocks. At the time of the first and second eases (September 29th and October 15th), we believe one could have argued this to be the case. However, by this past Tuesday, we do not believe this was the case any longer. Stocks were soaring, and bond returns again languished far behind stocks.

Our fear is that the third Fed ease will encourage stocks to continue to move higher since everybody knows: "you don't fight the Fed." Conversely, bonds will, at best, trade sideways. While the argument is that unleveraged money seeks "value," unleveraged money actually chases "momentum." So, if rates were indeed to move lower in the face of higher stock prices, it would probably come as part of a re-leveraging rather than a shift of unleveraged money toward fixed-income assets. Bonds don't have the return momentum that stock do.

The problem with a re-leveraging of the bond market is, what happens if (when) stocks stumble? Assuming that stock and bond prices continue to move in the opposite direction (they are showing no signs of reversing this trend), another "flight-to-quality" bid for Treasuries could develop. If this happens, wider spreads would be the outcome as Treasury rates fall faster than other rates. This sounds similar to the crisis situation we just saw.

Conclusion

In our November 10th Commentary, we suggested that investors begin to swap from risk assets, like stocks, to safer assets, like Treasuries. We also said:

"[I]f stocks were to blast through to new highs, such a move could also pose problems for the credit markets."

*For several years we have argued that the bond market has been "crowded out" by the stock market. There simply is not enough capital to support a stock market that is 130% of GDP **and** a credit market of similar size. So, stocks get the investment flows and bonds get the leveraged players.*

What bonds need are investment flows. There have been signs of investment flows returning this year. However, if stocks produce their fourth straight year of 20+% gains, these meager flows into bonds are at risk of reversing (who wants bonds when stocks return 20% every year?). So, higher stock prices, from here forward, do not help the bond market.

Notice that stocks and bond prices are still moving in opposite directions. Should stocks indeed race to new highs, rates could jump even higher. For this reason we do not believe that the Fed will lower rates and give stocks another reason to rally."

Apparently the Fed did not see things the same way we did. They eased anyway and assumed the risk

of the "moral hazard" of higher stock prices. If equity returns continue to outpace bond returns, de-leveraging the bond market will be that much harder.

So, does the Fed ease change our view that stocks are near a peak and, therefore, bonds near a bottom? For now, we say no. Yes, the Fed ease makes this call much harder, but the basic tenets for our call are still valid. The health of the credit market is still shaky and the roaring stock market does not help. The sign that the credit markets are returning to health, despite a roaring stock market, would be for spreads to narrow as Treasury rates fall. So far this is not happening.

If the Dow Jones and S&P 500 were to make new highs, above 9,338 and 1,187 respectively, we would **reassess** this view. In the meantime, we will swallow hard, and look for a peak in stocks and a low in bonds very soon.

Chart 1

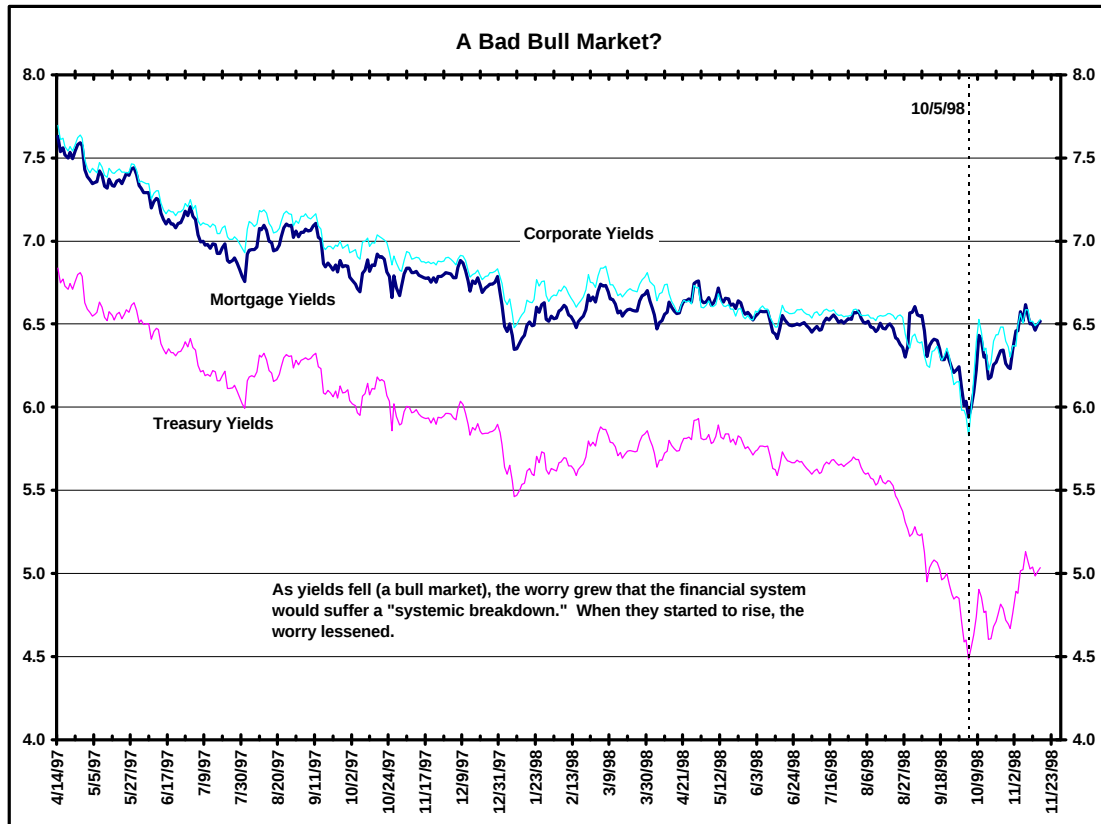


Chart 2

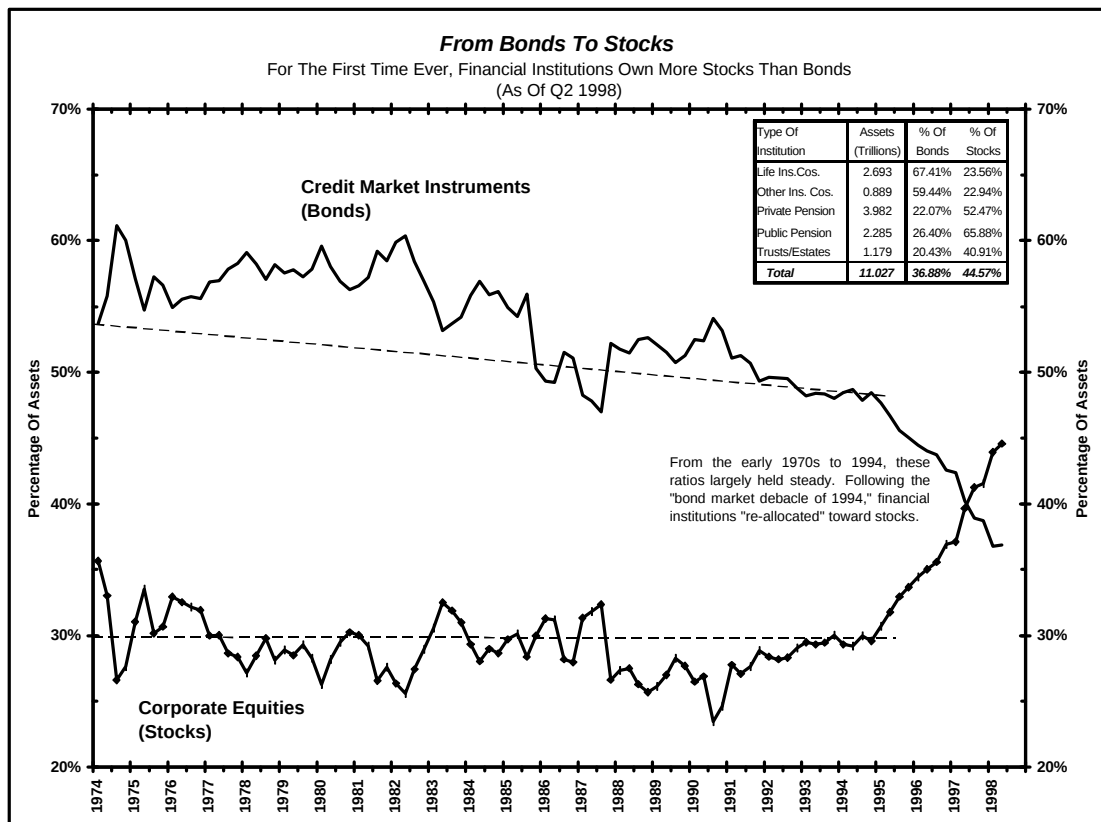


Chart 3

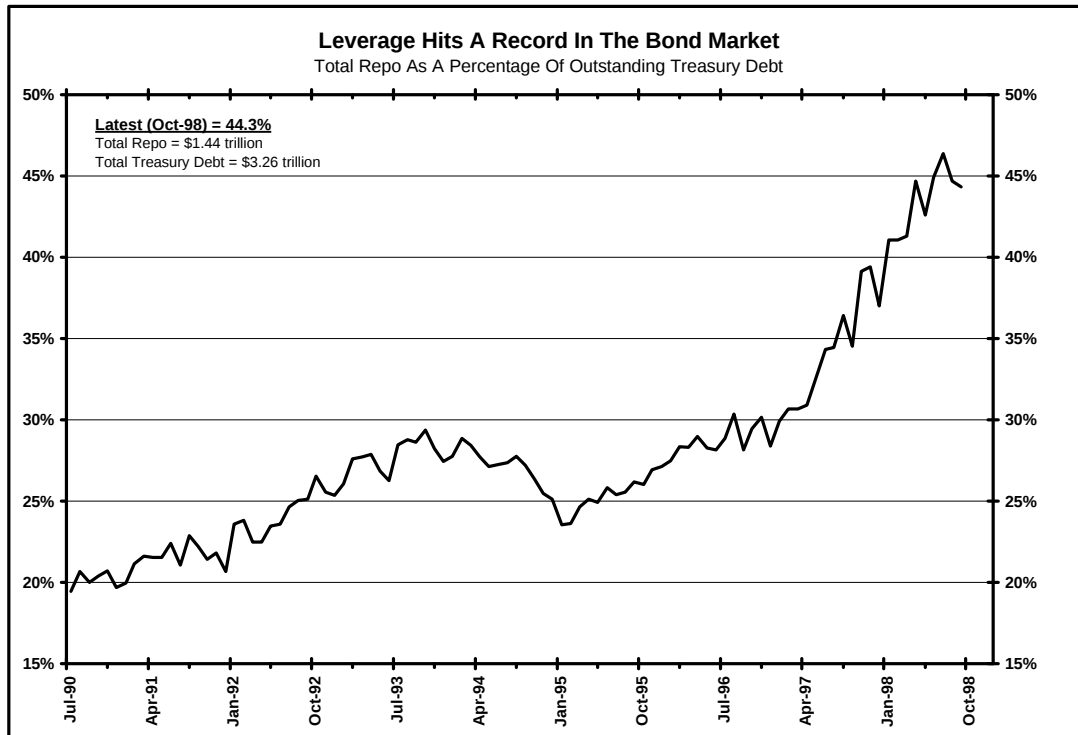


Table 1

The Size Of Selected Derivative Instruments							
	Notional amount outstanding at year-end (trillions)						
	1991	1992	1993	1994	1995	1996	1997
Interest Rates							
Interest Rate Swaps	3.07	3.85	6.18	8.82	12.81	19.17	22.12
Interest Rate Futures	2.16	2.91	4.96	5.78	5.86	5.93	7.49
OTC Interest Rate Options	0.58	0.63	1.40	1.57	3.70	4.72	5.03
Exchange Traded IR Options	<u>1.07</u>	<u>1.39</u>	<u>2.36</u>	<u>2.62</u>	<u>2.74</u>	<u>3.28</u>	<u>3.64</u>
Total Interest Rates	6.87	8.78	14.90	18.79	25.12	33.10	38.28
Currency							
Currency Swaps	0.81	0.86	0.90	0.91	1.20	1.56	1.58
Currency Futures	0.02	0.03	0.03	0.04	0.04	0.05	0.05
Currency Options	<u>0.06</u>	<u>0.07</u>	<u>0.08</u>	<u>0.06</u>	<u>0.04</u>	<u>0.05</u>	<u>0.03</u>
Total Currency	0.89	0.96	1.01	1.01	1.28	1.66	1.67
Stock Market							
Stock Market Index Futures	0.08	0.08	0.11	0.13	0.17	0.20	0.22
Stock Market Index Options	<u>0.13</u>	<u>0.16</u>	<u>0.23</u>	<u>0.24</u>	<u>0.33</u>	<u>0.38</u>	<u>0.78</u>
Total Stock Market	0.21	0.24	0.34	0.37	0.50	0.57	0.99
Grand Total	7.97	9.98	16.25	20.17	26.90	35.33	40.94

Source: Bank For International Settlements Annual Report