

MARKETPLACES AND POLICIES- MAKING CONNECTIONS

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Alfred Hitchcock's 1944 World War Two movie drama, "Lifeboat", has this conversation: "Lady, you certainly don't look like somebody that's just been shipwrecked." "Man, I certainly feel like it."

CONCLUSION

Observers devise and debate relationships between (and within) assorted stock, interest rate, currency, and commodity realms and their variables. Experts heatedly argue regarding convergence and divergence between marketplaces (and the relevant factors creating and sustaining these motions). For example, to what extent do United States Treasury rate yield trends (and levels) coincide with or confirm (or lead or lag) those of the US stock domain? In many perspectives, commodities in general have tracked the S+P 500's path. Will a famed hymn and its variations continue to be widely and loudly sung? For example, think of "strong US dollar equals weak US stocks, feeble US dollar means strong US stocks".

Since the current economic crisis emerged in 2007, a rough pattern has been that major movements and levels in US Treasury ten year note yields have preceded or coincided with those in the S+P 500. Thus, "in general", plummeting UST yields have been paralleled by diving stock prices. And rising interest rates are connected to rallies in stocks. So in today's world, gurus and guides often underline that higher and higher UST rates fit an economic recovery (health) scenario. In contrast, collapsing rates indicate looming (or actual) disaster; hence the popularity of flight to quality and safe haven commentary in regard to UST. Such relationships between the UST 10 year note and stocks (and variables allegedly bound to them) of course help forecasters to assess probabilities for and predict important debt and equity trend changes. Looking forward, this ongoing pattern may well persist.

Yet at some point, and arguably within the next several months, the present relationship between the US ten year and the S+P 500 may change. Thus rising UST yields eventually may coincide with sinking stocks. What key trading levels for the 10 year should one keep an eye out for? Such trigger point ranges will vary over time. So anyway, what guidelines for nowadays? If the US 10 year note yield floats decisively above the 2.50 percent level, and if stocks rally very little as that yield barrier is breached, that would hint the current (2007-2011) UST/S+P 500 relationship is altering.

US RATES AND STOCKS IN THE CURRENT CRISIS: THEIR VOYAGE SO FAR

"We all live in a yellow submarine
Yellow submarine, yellow submarine
And our friends are all aboard
Many more of them live next door". The Beatles, "Yellow Submarine"

Let's survey the period from end of the beloved Goldilocks era in 2007 to the present. The following table presents the US Treasury 10 year note in yield terms. The table has eight sections. In general, the beginning of noteworthy US Treasury 10 Year trends have preceded (or started right alongside) important ones in the S+P 500. Thus significant movements in longer term US

government interest rates and those in equities have “confirmed” (and in practice, helped to reinforce) each other. In this mid-2007 to 2011 (to date) period, substantial falls in yields (rises in prices) for the 10 year UST are associated with impressive declines in US stock marketplace prices. Conversely, large upward moves in yield are linked to rallies in equities. Thus “falling yields/falling stocks, with rising yields/rising stocks” has been a rule of thumb for many watchers.

This UST/S+P 500 “relationship” is not exact. It is not inflexible. Also, perceptions of convergence/divergence (and relationship itself), the extent and timing of leading (lagging), and the importance of any given price levels and movements are matters of opinion.

Of course numerous variables interrelate to establish, sustain, and change the viewpoints regarding the UST, the S+P 500, and how and why they intertwine. The following table, although it depicts ties between the UST 10 year and the S+P 500, easily could expand to include other stock and debt marketplaces around the world. Some of these stock and interest rate marketplaces might show a somewhat different travel path relative to the UST and American equities. The table could include references to short-term rates. Analysis of yield curve trends (US two year versus the 10 year) would provide insight. So would credit spread relationships; think of the 10 year UST versus a 10 year US corporate industrial note, or the sovereign debt yield spread between Germany (or the US) and that of various European nations). In addition, analysis of the US dollar (and other currencies such as the Euro FX) and commodities in general can help to understand moves in US Treasuries and stocks and to assess probabilities regarding them.

US TREASURY

TEN YEAR NOTE (percent)

S+P 500

1. Yields peak at
5.32pc 6/13/07
(note 6/18/06’s 5.25pc)

Initial price top 7/16/07, major peak
a bit later, on 10/11/07 at 1576

2. As the economic disaster unfolded, note the interim- and lower- peaks in yields:
12/26/07 at 4.28pc; 6/13/08 at 4.27pc

S+P 500’s final top 5/19/08 at 1440

After the 10/5/08 top at 4.10pc, yields crashed through support at around 3.25pc (at the 1/23/08 and 3/17/08 3.29pc lows). Stocks capsized.

[Recall that Lehman Brothers filed for bankruptcy 9/15/08. Note that the UST yield increased from 9/16/08’s 3.24pc to 10/5/08’s high around four percent. This should be a warning sign for the present situation. If the ongoing worldwide economic disaster gets sufficiently fearsome (picture credit getting really tight in general), interest rates may increase, at least for a while.]

[What about commodities in general? The broad GSCI pinnacle was not long after that in the S+P 500, on 7/3/08 at 894.]

[Note the broad real trade-weighted dollar (“TWD”) slumped to 84.2 April 2008 (near prior TWD record low floors; the Federal Reserve reports the broad real TWD as a monthly average, 1973=100). This occurred near the 5/19/08 final high in S+P 500; think of the “weak dollar equals strong stocks, strong dollar equals weak stocks” chant.]

3. Yield bottom 12/18/08 at 2.04pc.
A higher low followed: 3/18/09 at

Major low 3/6/09 at 667

2.46pc (compare the March 2009 timing in regard to stocks)

After this yield trough and subsequent rate rise, stocks bottomed and rallied sharply. Economic recovery talk became more and more widespread.

[The broad real TWD reached a key peak in March 2009 at 96.8.]

[Broad GSCI low 2/19/09 around 306]

4. Yield high 4/5/10 at 4.01pc

S+P 500 summit 4/26/10 at 1220

This April 2010 yield high was beneath the 10/5/08 one; a sign of the continuing crisis. Chartists will note this yield top links to others close to it in level (though several months distant in time). See 6/11/09's 4.00pc plateau and 12/31/09 at 3.91pc.

[Broad GSCI crest 5/3/10 at 556]

5. 2.33pc low 10/8/10

Stock low 1011 on 7/1/10' but note 8/27/10
at 1040 and 1174 on 11/30/11 surround
the UST's October 2010 bottom

The stock marketplace low in late August 2010 occurred as the Fed indicated it would unveil its second round of quantitative easing. The yield low was reached as details on money printing emerged over the course of autumn. The US and worldwide economic recovery sailed forward into 2011.

[Key GSCI lows after 5/25/10's 459 were 490 on 8/25/10 and 556 on 11/23/10]

[The dollar began to wither versus the Euro FX starting from 6/7/10's 1.1877. However, the greenback slumped more and more versus the Euro FX during the onset of QE2. Recall Euro FX lows of 8/24/10 at 1.2588 and 1/10/11 at 1.2867.]

6. Yields peak again, stocks make top later.
Tops 2/9/11 3.77pc, 4/18/11 3.61pc,
7/1/11 at 3.22pc

(2/18/11 1344 initial high) 5/2/11 1371;
then 7/7/11 1357, 7/21/11 1347

[Broad GSCI pinnacles again around those in the S+P 500. Recall 4/11+ 5/2/11 at 762; then 7/26/11 key high at 705.]

[The nominal broad TWD has daily prices. The timing of its 5/2/11 bottom around 93.9 fits that of the highs for the S+P 500 and broad GSCI. Compare its 7/26/11 bottom at 93.7 with the summer 2011 final tops in stocks and commodities. The all-time low in the broad real TWD was July 2011's 80.5.]

[Note the Euro FX top against the dollar on 5/4/11 at 1.4940, as well as its further falls from 6/7/11's 1.4697, 7/26/11's 1.4536, and 8/29/11's 1.4549.]

7. Low 1.67pc on 9/23/11

S+P 500 rally from 10/4/11 low at 1075

Before descending to the depths of the 9/23/11 low, in mid-August the UST was buoyed around the two percent level (2.03pc 8/9/11, compare the yield of the 12/18/08 bottom. See the time of the related S+P 500 low 1101 low on 8/9/11 (and the broad GSCI low of 598 on 8/9/11).

[Again, compare commodities with the S+P 500 as a confirmation of intertwined trends. The broad GSCI low was on 10/4/11 at 573, a precipitous fall-off from its spring/summer 2011 heights.]

[Euro FX cross rate low at 1.3146 versus the dollar also 10/4/11]

8. UST 2.42pc high on 10/28/11 S+P 500 attains 1293 on 10/27/11

The UST yield fell to around 1.90 pc as of 11/23/11, with stocks sagging lower alongside. Thus the “current” pattern (relationship) apparently continues. Yet note the timing of the IMF’s policy statement discussed below in “Shifts in the Wind”.

[The nominal broad trade-weighted US dollar hit a low 10/28/11 around 96.9. See the Euro FX cross rate high versus the dollar on 10/27/11 near 1.4250. Thus the weak dollar, high in US stocks song continued. The most recent nominal TWD daily data, 11/18/11 at 99.6, shows a stronger dollar alongside the weaker S+P 500.]

[GSCI 11/17/11 high at 677 not far from 8/31/11’s 677]

In any event, compare the second UST 10 year low at 2.46 percent on 3/18/09 (a key economic recovery take-off point) with this 10/28/11 2.42pc high. A sustained move in yields above 2.50pc, and especially above the 3.15/3.25pc resistance (7/1/11’s 3.22pc high and the 3/16/11 Japanese earthquake low of 3.14pc) without a corresponding equity rally would be very suggestive of a break in the “ongoing” 2007-11 relationship framework of the UST and the S+P 500.

Would rising UST rates (especially if German and other key yield barometers likewise jumped; also watch credit default swap levels) primarily signal increased credit demand due to an economic recovery? Or, might this instead indicate a scramble by marginal (less creditworthy) borrowers to grasp available funds and stay afloat? Less cash may be available and floating around (watch for lending shortage, credit crunch talk). Deleveraging in some circumstances could involve some rate boosts (or even spikes). Some savers (creditors) increasingly may not want to throw a life raft to certain debtors/borrowers. Why throw good money after bad (or accept certain kinds of collateral) without getting much more in yield, some lenders may ask. Or, why take great chances with the money I have by giving it to just anybody (or to anyone)?

SHIFTS IN THE WIND

“Sittin’ in the mornin’ sun
I’ll be sittin’ when the evenin’ come
Watching the ships roll in
And then I watch ‘em roll away again, yeah
I’m sittin’ on the dock of the bay
Watching the tide roll away”. Otis Redding, “(Sittin’ on) the Dock of the Bay”

In any event, marketplace history is not marketplace destiny. Economic recoveries, especially those involving upward creeps in inflation (think of rising consumer price indices, higher commodity prices, increasing wages), are not the only potential source for higher interest rates. And even assuming inflation expectations are supposedly well-anchored, a push for higher interest rates may come from elsewhere.

As the global economic crisis flows on and on, many of its intertwined actions and participants (and thus marketplace relationships) may remain relatively unchanging. But they are not stagnant. Today's marketplace voyagers should wonder if the crisis has drifted closer and closer to a new round of difficulties. Look at European yields, and place Germany on the sidelines. Focus instead on Greece, Portugal, Ireland, Spain, and Italy. These countries show that severe economic problems (and downturns) are not always or inevitably associated with falling (or low) government interest rates. The sovereign debt and banking (and economic downturn) problems of the so-called European periphery have edged closer and closer to the European center of France and Germany. Will France eventually have its credit rating cut? In late November, America's federal fiscal fiasco evidenced continued lack of progress toward a solution. Despite a joyous rise from their early October 2011 lows, equity benchmarks such as the S+P 500 have ebbed lower since end October.

In this context, the recently unfurled International Monetary Fund (11/22/11) program, "Enhances Liquidity and Emergency Lending Windows", represents a noteworthy new warning flag. This IMF policy statement deserves extensive quotation and a close reading.

These IMF "reforms" aim "to bolster the flexibility and scope of the Fund's lending toolkit to provide liquidity and emergency assistance more effectively to the Fund's global membership." They "will enable the Fund to respond better to the diverse liquidity needs of members with sound policies and fundamentals, including those affected during periods of heightened economic or market stress—the crisis-bystanders—and to address urgent financing needs arising in a broader range of circumstances than natural disasters and post-conflict situations previously covered." The IMF's Managing Director stated: "This is another step toward creating an effective global financial safety net to deal with increased global interconnectedness."

First, note the timing of these reforms in light of the titanic European debt saga, the American fiscal mess (and political party squabbling), "heightened economic or market stress" and "broader range of circumstances" verbiage, and the S+P 500's nosedive over the past month from around 1293 on 10/27/11. Globalization and its worldwide consequences (risks) existed prior to the emergence of the international economic crisis in 2007. Indeed, "increased global interconnectedness" has been manifested in an assortment of ways since 2007. However, these IMF's "reforms" indicate increasing awareness by the IMF (and other guardians) regarding the existence and strength of these global links and ties- and their recent growing fearfulness about such interconnections. Moreover, this additional effort "toward creating an effective global financial safety net", since it is merely called a "step", shows that the necessary safety net is not currently in place.

What about liquidity needs and emergency assistance? Flights to safety of course may help to push interest rates (in the safe haven marketplaces) down. But picture someone drowning in debts, with credit hard to find, and family and friends no longer willing resources. Lenders, if they can be found, probably will force that borrower to endure higher rates in order to keep its head above water. A trip to the loan shark means paying very high rates. Or, imagine even a well-

run corporation (or nation; prudent Main Street individual) in a situation where its credit lines (or access to credit) is drying up. When credit is scarce for borrowers, the price of credit can be bid higher and higher. Suppose this happens on a widespread and significant basis for a nation (or region or marketplace sector). Thus higher interest rates can happen even if “times are bad for nearly everybody”. Battling for financial survival (envisage a debtor gasping for the necessary air of credit to stay alive) can mean higher rates.

The more widespread the problem (imagine it reaching to Germany or America), the greater the risk of some degree of higher interest rates everywhere. Even if the safe haven allure continues for some while longer, in an interconnected world, Germany and the USA are not immunized against having higher yields. Comments about helping the “global membership”, including those with “sound policies and fundamentals”, does more than underline the international economic integration. It hints at the increasing seriousness of the current crisis.

In sum, the IMF’s wordplay of “crisis bystanders” is rather misleading. Major nations are not relaxed summertime voyeurs sitting out on the side of the neighborhood swimming pool, contentedly drinking coffee or tea or soda or beer or cocktails. In today’s global economic sea (some might say whirlpool), at least (and especially) when major nations are substantially involved, there are no bystanders. Looking at the ongoing worldwide economic crisis from a broad perspective, we’re all stuck together in the same boat.

Will this new IMF facility have sufficient resources if the current stormy troubles in Europe (and elsewhere) continue to worsen? What dangerous creatures may venture from the dark depths to surprise economic lookouts and political guardians? Which financial institution or corporation may go under the waves next? What are the risks lurking from or related to the so-called shadow banking system?

CROSS-CURRENTS

There of course are numerous contending forces in today’s interest rate and stock (and currency and commodity) marketplaces. Deflation risks have not disappeared, which obviously tend to shove rates down. And from the interest rate perspective, perhaps German and American government debt will be seen by many as safe harbors for quite some time, thus keeping their rates low. But given its massive money printing and deficit spending after 2008, is the US still as much a land of “high quality” as at end 2008, when the 10 year UST tumbled to just over two percent? How much faith is there in the US political leadership these days? Not only does the US federal government face headwinds; what about many states and municipalities?

Central banks in general are trying to keep the world liquid and avoid widespread credit crunches. Certainly the Federal Reserve is determined to keep its policy rates near the floor. Various substantial quantitative easing (money printing) strategies by the US and others are well-known. Up to some point, such easing policies act as a life preserver for many nations (and corporations and individuals), and help to bar interest rate rises or reduce their consequences.

However, at some point sustained massive money printing (and particularly enormous deficit spending) could propel rates higher. Will there be a QE3 rescue effort, perhaps if the S+P 500 slips to 1000/1050 or lower? What if unemployment rates increase further? What would induce the European Central Bank to embark on quantitative easing? Suppose it develops severe deflationary fears, or that it decides that some inflation is worth the preservation of the current

European (Eurozone) setup. The European Financial Stability Facility (rescue fund) at the end of the day may possess less firepower than hoped (Financial Times, 11/25/11, p4).

Would a new round of US money printing (or other clever uses of the trusty toolkit) be interpreted as a sign of weakness and desperation rather than as a means of imparting genuine, sustained economic strength? Might the same eventually be said of new creative actions (whether money printing or otherwise) by the European Central Bank?

Suppose rates rise in both Germany and America, and that the S+P 500 and European stocks in general do not rally much. That would underscore the signal that the higher rate, higher stock price relationship is becoming one of higher yields, lower stocks.

Suppose US rates march somewhat higher from current levels. Could both the UST and stocks nevertheless then drift broadly sideways for years and years? Compare Japan's experience.

China, Japan, India, Russia and other lands of course are not calmly isolated from Europe and the United States. What happens if China, an engine of growth, is much less robust than sentinels expect? If the US dollar depreciates substantially from current levels or if interest rates in the US start to rise (and especially if these events coincide), will foreigners remain substantial net buyers of US government debt? Might some mutiny and insist on higher yields, or even elect to abandon ship? A sharp rise in government yields could do a fair amount of mark-to-market damage on interest rate portfolios (think not only of foreign central banks, but also of pension funds, households and their net worth, and bank balance sheets).

Suppose the Fed captains stubbornly refuse to raise rates in the face of some inflationary evidence. Admittedly many nations want their currencies to weaken (be less strong). But what happens to US stocks (and to US government yields, even if only eventually), if the broad real trade-weighted dollar falls five percent or so beneath its record low of summer 2011? A very weak dollar may equal weak stocks in some circumstances, right?