

PREDICTABLE INVESTING
HISTORY LESSON – February 2007.
THE STOCK OR BOND MARKET – WHICH ONE IS RIGHT?

1.0 Introduction: Over the past 6 months, the stock and bond markets have been going their separate ways, and signaling very different outcomes for future of the US economy. The FOMC stopped raising rates in the middle of last year, and has since left the Federal Funds interest rate at 5.25%. The reaction of the bond market has been to invert the slope of the yield curve, which is almost always a precursor to a slowing economy, lower corporate profits, lower stock prices, and which often leads to an outright recession.

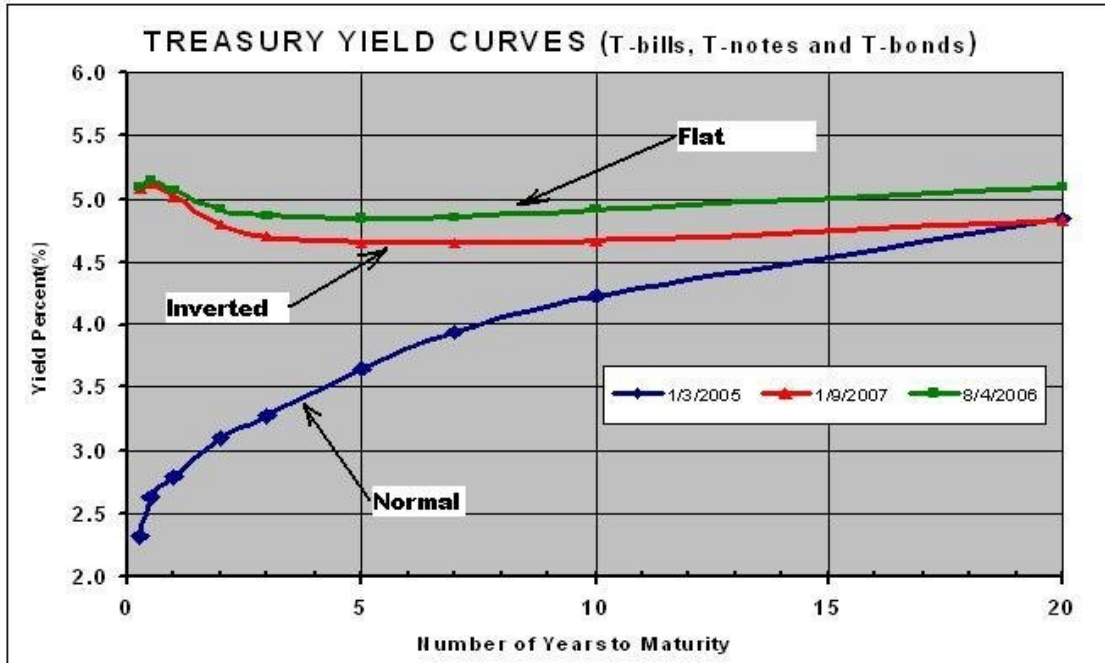
On the other hand, the stock market has ignored the negative yield slope, and has continued pushing bullishly higher. It is predicting a moderately growing economy, and growing corporate profits with reasonable inflation.

These are two very different scenarios for the market during 2007. Which one is correct?

2.0 Slope of the Yield Curve: The Slope of the Treasury Yield Curve is the difference in interest rates between the 3 month Treasury-bill and the 20 year Treasury-bond. This was discussed in detail in the History Lesson for April, 2006, "Slope of the Treasury Yield Curve and Recessions" (Archive Page has links to this article).

A **normal yield curve** is where investors are paid more interest to tie up their money for longer periods of time, resulting in a positively shaped yield curve; the longer the maturity of the bond, the higher is the interest rate.

However, there are infrequent periods of time where the yield curve is **flat** (the interest is the same for long and short maturities) or actually **negative** (longer maturities pay lower interest than shorter ones). Examples of these are shown in the figure below:



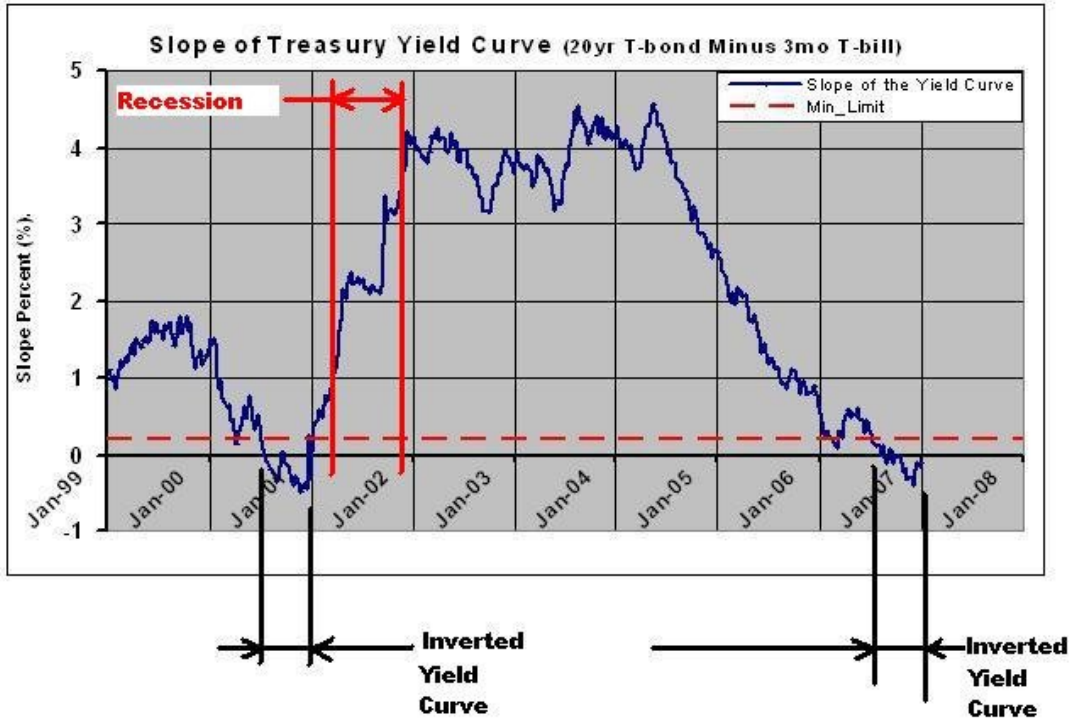
The **blue** curve on 1/3/2005 is an example of a normal upward sloping yield curve. The 3 month T-bill, the lowest data point in the blue curve was paying an interest rate of 2.3%, while the 20 year T-bond was at 4.8%.

The **green** curve on 8/4/2006 is an example of a flat yield curve. Both the 3 month T-bill and the 20 year T-bond were paying about the same rate of interest of about 5.1%.

The **red** curve on 1/9/2007 shows an inverted yield curve, where the 3 month T-bill paid 5% and the 20 year T-bond was paying a lower interest rate of 4.8%.

Inverted yield curves are unusual conditions where the bond market is signaling that an economic slowdown is imminent. It is saying that this slowdown will force the Open Market Committee of Federal Reserve (FOMC) to cut interest rates, in an effort to stimulate the economy and make it grow again.

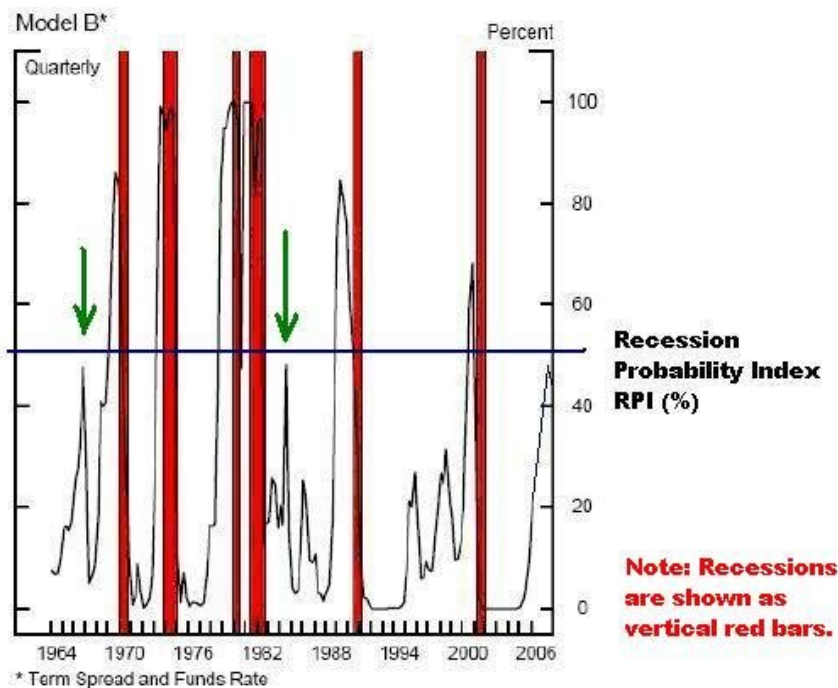
The Slope of the Treasury Yield Curve over the last 8 years is shown below.



The yield slope inverted in June 2000 as shown in the black lines on the left, and did not revert to a positive shape for about 6 months till January 2001. This inversion was followed 9 months later by a recession, shown between the pair of red lines in the figure. This recession lasted from March 2001 to November 2001, before the economy started expanding again. Note that during the recession the FOMC was significantly reducing the Fed funds rate as evidenced by the sharply rising yield slope, but it took a full 3 quarters for this effect to feed through and start growing the economy again.

The slope inverted again in June 2006, and has remained negative ever since. It reached a peak negative value of -0.20% on 1/9/2007 and has pulled back slightly since then. Is this level and duration of yield inversion sufficient to cause a recession?

3.0 Inverted Yield Curves and Recessions: Does a recession always follow an inverted yield curve? The answer seems to be "usually, but not always". A recent model by Jonathan Wright of the Federal Reserve (Reference 8 on the Links Page, "The Yield Curve and Predicting Recessions", March 2006), shows that the Probability of a Recession (Recession Probability Index – RPI) depends on the extent of the inversion ("term spread") as well as the absolute value of the Federal Funds rate. In other words, a yield inversion that occurs when the Fed Funds interest rates are high, is more likely to cause a recession than when rates are much lower. The results from this model are shown in the figure below.



J. Wright - RPI Model B - Uses Yield Difference between 3 mo and 10 year Treasuries and the Fed Funds Rate

This graph shows that there are two different situations which must be considered; those where a recession is possible but does not occur, and those where it does. In all cases of an inversion followed by a recession (red bars), the RPI rises steadily upwards until it peaks, usually at some level between 70% and 100%.

However, there are some cases, such as in 1966 and 1984, where the RPI rises to near 50%, never really crosses it, and then abruptly falls back down. These cases of inversion which were not followed by a recession are marked with downward pointing green arrows.

The current situation where we find ourselves today may be one of these cases, as the RPI has steadily approached 50%, but has pulled back recently. So evidently there is still a danger of a future recession, but we are on the fence and will not know our ultimate fate till more data is available.

4.0 Stock Market Factors: The stock market is influenced by many factors, but is mainly focused on the outlook for corporate profits and the level of interest rates. Growing corporate profits (earnings "E") means that the future PE ratio is reduced, on account of the larger "E" in the denominator. This encourages investors to correspondingly bid up the stock prices "P" by an equal amount, so as to keep the same PE ratio. Of course there are also cases where investors are willing to pay more

for a given level of earnings, where they bid up to higher and higher PE ratios, such as happened to tech stocks in the decade of the 1990's.

Earnings growth is also enhanced in an environment where the economy is growing moderately and where inflation and interest rates are low. On the other hand if earnings decrease, the market PE ratio will increase and stock prices will usually drop lower.

Corporate earnings have been growing steadily since our buy signal of mid-2003, as shown in the chart from Thomson Financial below. It shows however that the high rate of growth of earnings for this cycle has peaked and is headed down.



The last quarter ending Dec 31, 2006, saw a Year-Over-Year earnings growth of just under 10%, down from an amazing 19% the previous quarter. This continued an amazing 13 consecutive quarters of healthy corporate profit growth. But future estimates show that we are expecting "only" a 6.3% profit growth for the second quarter ending on June 31, 2007. This would only be a below average scenario for the future of the market, since the long-term earnings gains for the market is about 7%. But the stock market is ignoring this slowdown in earnings and driving prices up anyway.

The revised GDP growth of 3.5% for the last quarter of 2006, lends some credence to the fact that the economy is not slowing down, as many economists had

expected. The housing slowdown does not seem to be feeding through and slowing the economy as many had expected. Rather, investors seem more worried about excessively high GDP growth, higher inflation, and the prospect that the Fed will not cut interest rates anytime soon.

5.0 Which is right - Bond or Stock Market: So which of these markets are correctly forecasting the future market direction for 2007? We are sitting neatly balanced on a teeter-totter, where a variety of daily news and economic events can move the market significantly in either direction. For instance a typical morning's news and market action could read like this,

- (a) GDP growth comes in higher than expected. This gets the inflation hawks all concerned as they now expect the FOMC to raise rates. So they sell off the stock market. But the deflation and slowing economy folks are now encouraged that the economy may not go into a recession, so they buy stocks and sell bonds.
- (b) The core CPI number comes in higher than expected. The inflation hawks sell stocks and also sell bonds. But some analyst notes that the higher number was the result of a one-time anomaly in energy prices, so suddenly traders start buying stocks and bonds again.

These are the normal hour by hour fluctuations in the market at this time. Please ignore all this "noise" and the "talking heads", and depend on our long-term indicators to tell us what to do. Remember that the long-term indicators are designed to ignore all the short-term noise and instead to warn us of any changes to the fundamental underlying trends.

Until the direction of the economy and the resulting reaction by the Fed becomes clear, we will continue to precariously perch at this quasi-stable point. Every economic number that comes out will be subject to endless scrutiny and debate, and will cause large swings in the market in both directions. This increased volatility will continue to be with us until some of these questions are resolved.

This does not imply either that the market is headed down or up, but only that the big market gains for this cycle have already been made. There may be further gains yet in this cycle, and a possible pullback from these very high market levels. What's an investor to do?

Why, wait patiently and let our "ever-watchful" indicators and model can tell us when we should act.

Until then, happy investing and enjoy the ride.