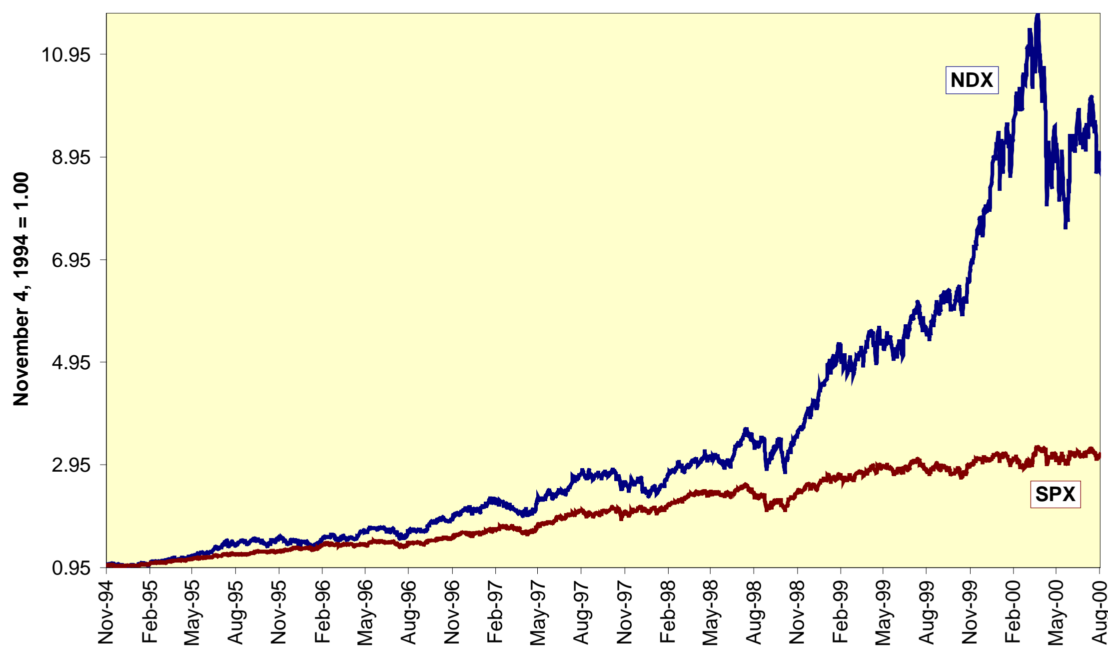
The Converging Divergence

One of the toughest parts of becoming a trader is recognizing "Can't go there" and "Can't stay there" are two very different things. Markets have an annoying habit of moving much faster and much further than economic theory might dictate. Such has been the case with the spectacular divergence between the NASDAQ 100 (NDX) and the S&P 500 (SPX) since the general market low of October 8, 1998 (see "High Rates And A Strong NASDAQ Don't Go Together," December 15, 1999)

In theory, value stocks should outperform growth stocks during periods of rising interest rates. The logic is simple and compelling: The earnings from growth stocks are going to lie further in the future, are at greater risk, and therefore should be discounted more heavily. Value stocks have more predictable earnings lying closer to the present time.

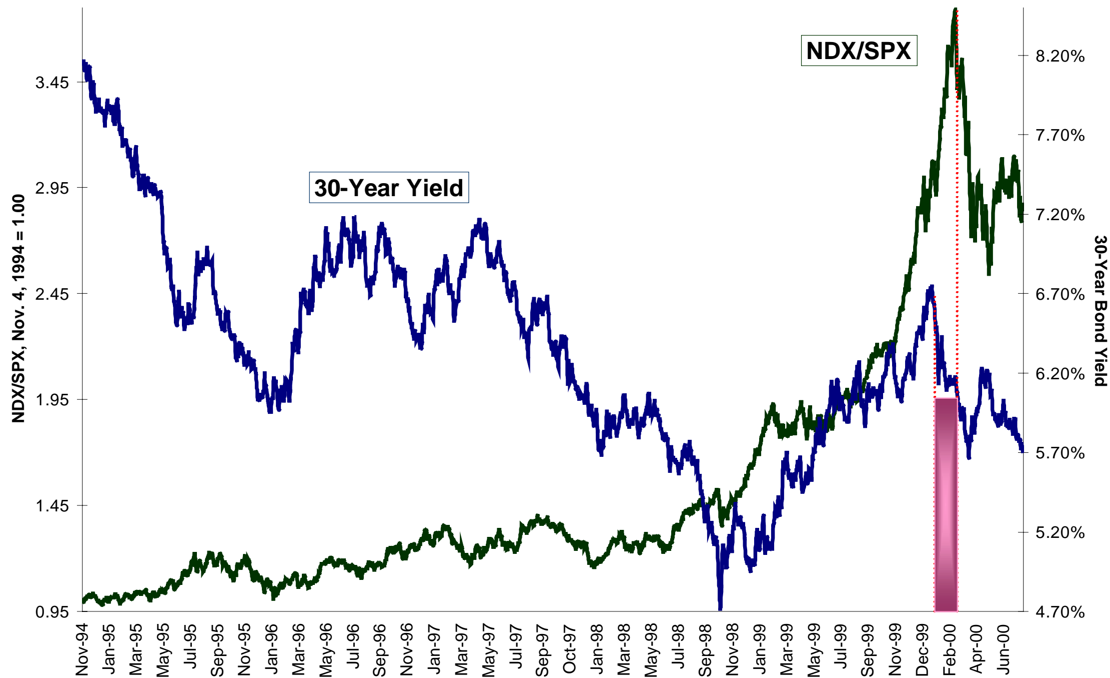
Of course, this logic was turned on its head spectacularly during the great tech rally ending this past March. The higher economic growth rates seen worldwide were due in large part to the productivity-enhancing effects of the technology industry -- whenever you lower the costs of production, you increase output -- and the central banks, our dear Federal Reserve included, tightened credit in response to these higher growth rates. The result was an awful bond market between October 1998 and January 2000, and a huge divergence in performance between the tech-heavy NDX and the SPX. This divergence is more remarkable when we consider that 36.2% of the SPX as presently constituted is in the NDX as well.



Take Note Of Bonds

We suggested last December that the theory of higher interest rates affecting growth stocks more was still valid, but that it simply was being overwhelmed by the breakneck demand for technology. After all, your time in an airplane is not a repudiation of the law of gravity, the jet engines simply are overwhelming its effects temporarily. We also suggested the divergence would continue for as long as growth was strong, but once growth started to slow, the divergence would narrow, the SPX would start to outperform the NDX, and bonds would rally.

So far, this analysis has been on target. While yields on the 30-year Treasury have been distorted recently by its gradual disappearance, they were still the benchmark interest rate for most of the period in the chart below. Their spread to the now-benchmark 10-year note has not been so directional as to distort the conclusion that the NDX/SPX spread and interest rates are related.

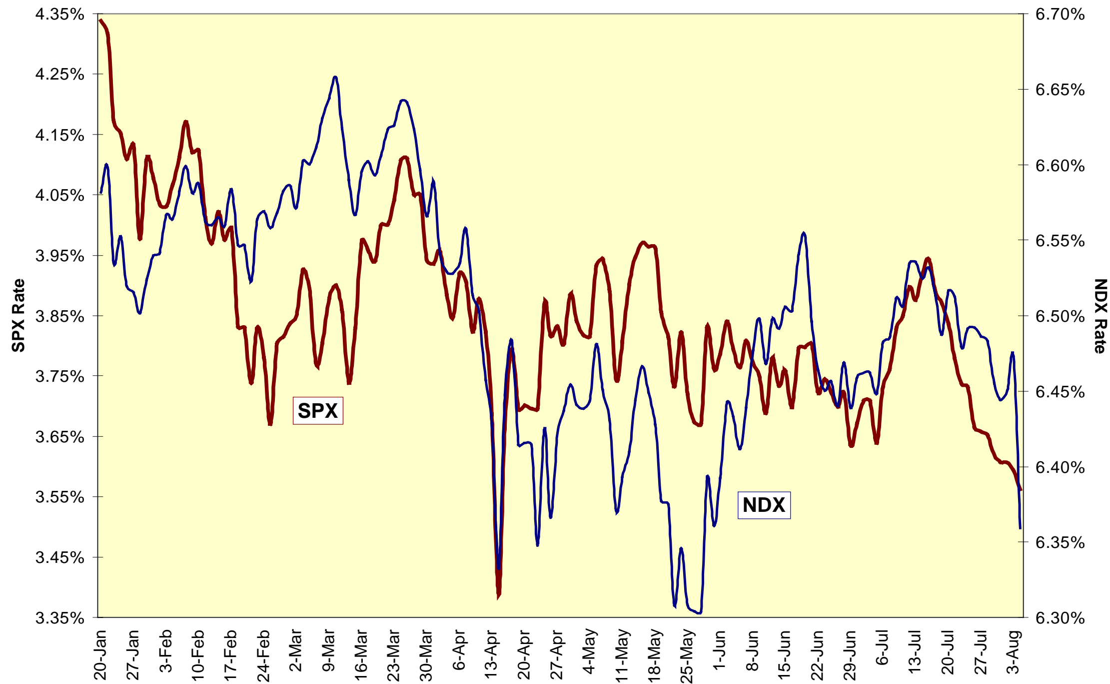


The bond market, which doesn't get it right all that often, got it right this past winter. Yields peaked in January, and the NDX peaked relative to the SPX a scant two months later. Maybe the Fed will succeed in bringing about its vaunted "soft landing," whatever that is. However, they certainly succeeded in ending one of the great investment booms / stock market bubbles of all time, an action whose ultimate consequences are still uncertain. That's our Fed: Ready, fire, aim.

Huh? I Thought *You* Hit The Brakes

Central to the notion that a long SPX / short NDX spread will be a winner are a slowing economy and slower profit growth in the NDX. Our evidence of a slowing economy is anecdotal and is made difficult by a mismatch between our economic statistics and the New Economy. We can measure the widgets and gadgets of an industrial economy very well, but the intellectual capital and information-as-a-good of the New Economy frustrates the best efforts of Washington's numbers mills. Let's look instead at where investors are placing their bets.

We can deduce earnings growth rate expectations relative to the risk-free rate available on Treasury notes (see "Derivatives May Give Clues To Net Stock Prices," January 5, 2000). It should not surprise us to learn earnings growth rate expectations for the NDX are high; on August 4, the market priced the growth rate for NDX and SPX earnings at premia of 6.359% and 3.562%, respectively, over the 10-year note yield for the next ten years. How have these premia changed since bond rates hit their high this past January 20?



In both cases, investors have lowered the premium they are willing to pay for corporate earnings even as they raised the premium they are willing to pay for Treasury income. In other words, we are less willing to pay for risk and more willing to pay for certainty. This is not a sign of growing confidence in the economy, nor is it something we should take lightly. Much of our economic boom was due to an increased willingness to take on additional risk at both the individual and the corporate level.

The implications are profound. We probably are entering a period much like the early 1990s when the economy had to undo the damage from the 1988-1989 tight money period (see "Moving Ahead Of The Curve," January 26, 2000). Stocks will have difficulty outperforming bonds for a while, and the tech issues we've come to know and love will struggle to stay ahead of value issues on a risk-adjusted basis.