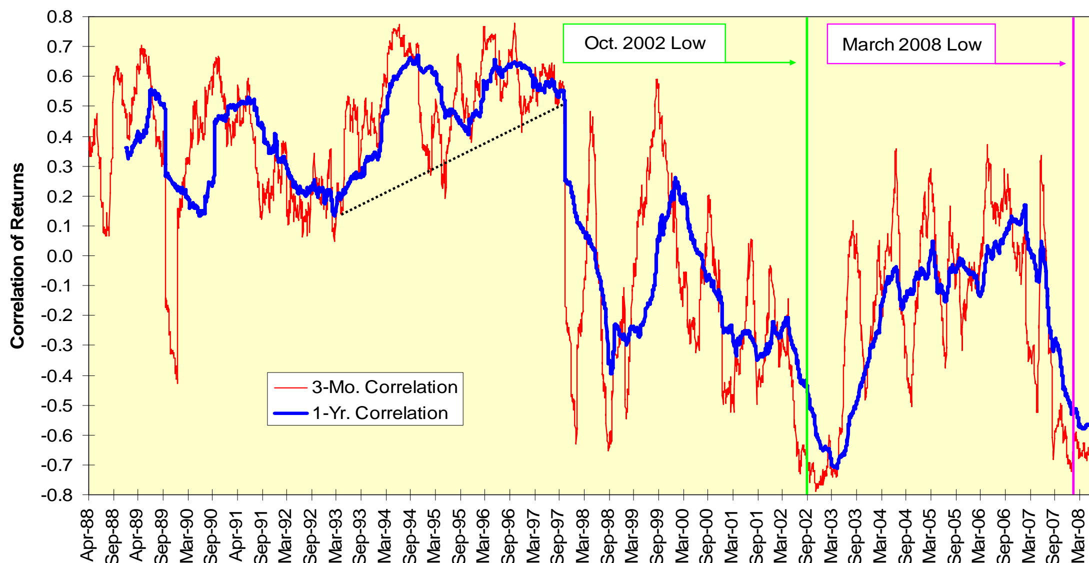
# Who's Afraid Of 4%?

One of the more interesting aspects of investing psychology is how quickly the unthinkable becomes the normal. A year ago, $100 crude oil was still the stuff of science fiction; now it would be the end result of a very nasty selloff. Five years ago, ten-year Treasuries rose from a multi-decade low of just under 3.1% in June 2003 to just over 4.5% in August 2003 when the bond market got the idea Greenspan's 1% federal funds rate was going to let inflation out of the bag.

Turn the calendar ahead five years. Even though inflation has reared its ugly head and is taunting us with the rest of its anatomy, bond yields remain trapped within that range established in the summer of 2003. Bond yields have just broken through a key retracement level at 3.937%, give or take, and have moved north of 4%. As a similar move over 5% last June caused momentary distress, we have to ask ourselves whether, in light of the importance of realized borrowing costs for corporations detailed here two weeks ago, the investment climate has changed for the worse.

**No Fixed Relationship**

First, let's take a look at the long-term relationship between stocks as measured by the S&P 500 total return index and ten-year Treasury notes. The chart below depicts their rolling three-month and one-year correlation of returns, and what is striking is the wide range these values take. Correlation coefficients are bounded by -1.00 and 1.00; here the range extends all the way from -.80 to .80. That exceptionally wide range of values in two markets with a common factor between them, long-term interest rates, should tell us right away a single-equation model of stocks' fair value based on interest rates is dangerous nonsense at best.




In addition, please note how the correlation regime changed once the Asian Crisis, now being reprised on a smaller scale in Vietnam, came on the scene in the fall of 1997. The Federal Reserve shifted into a "risk management" mode from which it has yet to emerge; it has elected to fight every financial downturn by serial bubble inflation. A dotted black trendline highlights this change.

Next, please note how the correlations hit extreme negative values during both the October 2002 and March 2008 lows. We never breached the October 2002 lows, but we came close enough. Unlike the post-October 2002 market, however, we have not witnessed a strong move higher in these correlations. Restated, this stock market has less intrinsic strength than did the late 2002 market. Do not expect an abrupt move higher to emerge soon.

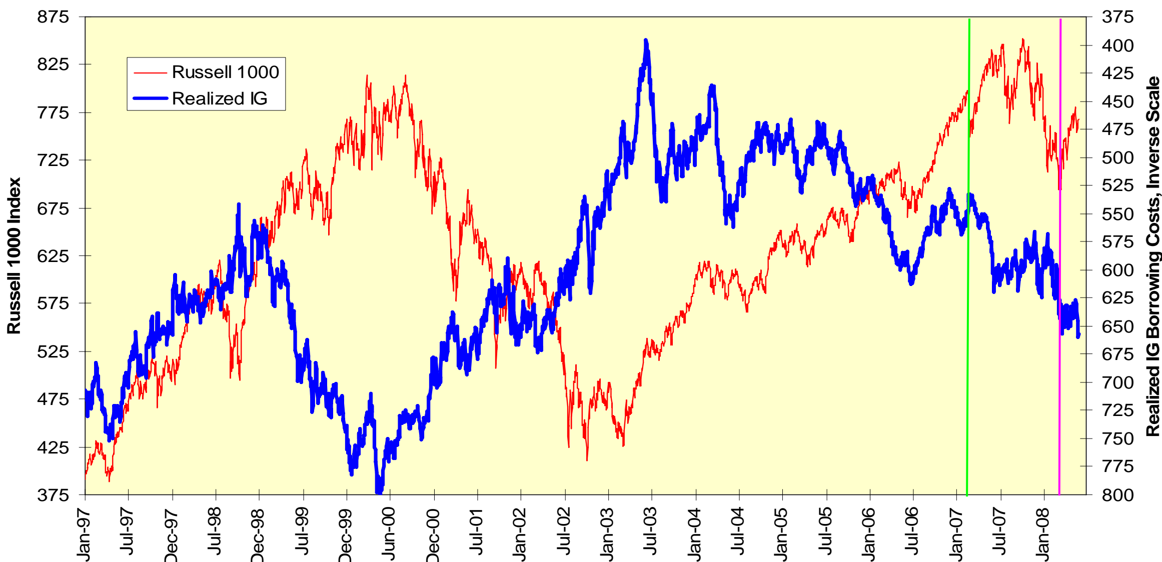
**Stop Crunching Me**

The reason for this more lackluster outlook at a analogous low in correlations of returns is, of course, the recessionary effects of the housing downturn and financial system impairment along with the aforementioned inflation.

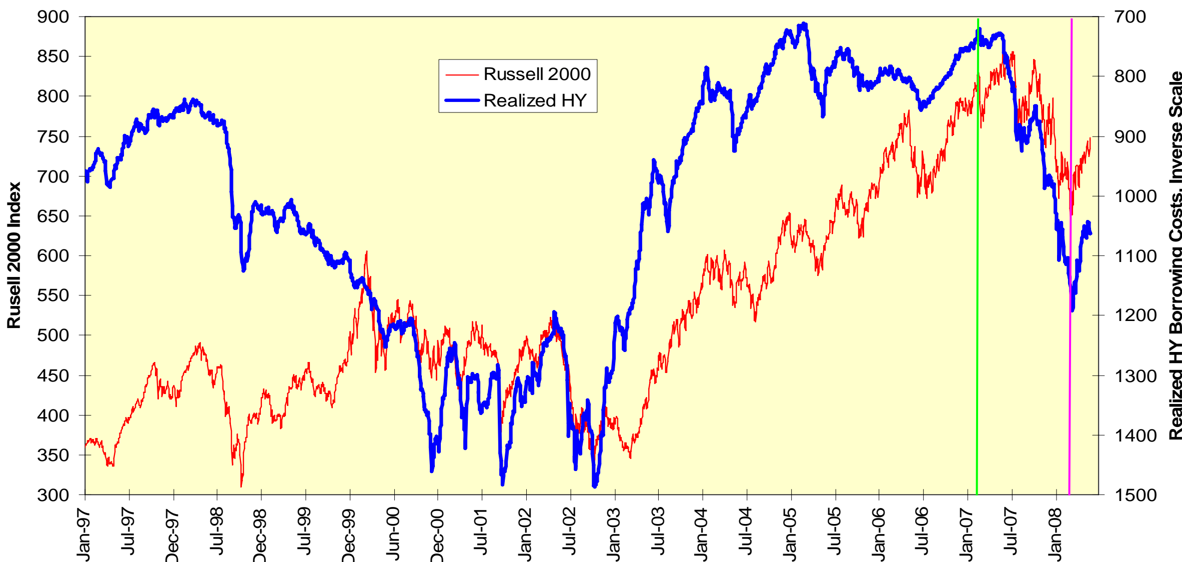
Let’s stipulate the subprime era began on February 27, 2007, the date of a 400+ point drop in the Dow Jones Industrials, and ended with the rescue of Bear Stearns – *alav ha-shalom* (may peace be upon it) – on March 17, 2008. These dates are marked with green and magenta lines on the two charts below.

The first chart maps the large-capitalization Russell 1000 index against the realized borrowing costs for investment-grade corporate bonds; the second maps the small-capitalization Russell 2000 index against the realized borrowing costs for high-yield bonds.

**Large Capitalization Stocks And Realized Investment-Grade Borrowing Costs**




**Small-Capitalization Stocks And Realized High-Yield Borrowing Costs**




Now let’s ask the question “Was it different this time?” If we regress both the Russell 1000 and Russell 2000 indices against both their lagged values and the realized investment-grade and high-yield borrowing costs, respectively, we can compare the three periods statistically.

The first test, was the credit crunch different from the January 1997-February 2007 period, is decisive. It was different for both stock indices at near 100% confidence intervals. The answer changes radically if we compare the credit crunch period to the post-March 2008 period. Here we can be only 77.5% and 91.2% confident of the Russell

1000 and Russell 2000, respectively, being different between these two periods vis-à-vis their realized borrowing costs. And, for sake of completeness, we can be 86.0% and 100% confident the post-March 2008 period is different from the pre-credit crunch period.

A little confusing? Yes, so let's distill the answer down to a simple yes or no: It was different this time. The credit crunch period produced a significant change in the relationship between stocks and corporate bonds, and that difference has persisted past March. The world has changed.

The good news in hindsight for stock investors is stocks never completely followed corporate bonds lower. The bad news is we can attribute this relative resilience to the massive monetary stimulus between August 2007 and March 2008.

This is the bad news. As the cost of that monetary stimulus, inflation, becomes apparent to one and all, the Federal Reserve will have to tighten credit. When that happens, look for stocks to underperform bonds, perhaps severely.