Party Like It's 1987

Well, ladies and gentlemen, we're not here to indulge in fantasy, but in political and economic reality. America, America has become a second-rate power. Its trade deficit and its fiscal deficit are at nightmare proportions. …
"Wall Street," 1987

In yet one more example of the law of unintended consequences, the fictional Gordon Gekko went on to decry management's lack of a stake in the company. An update of the movie might decry the excesses wrought by managements besotted with stock options and their massive incentives to manipulate same. The part quoted above about American trade and budget deficits could be left intact; the script writers might want to update the external bogeyman from Japan to China though.

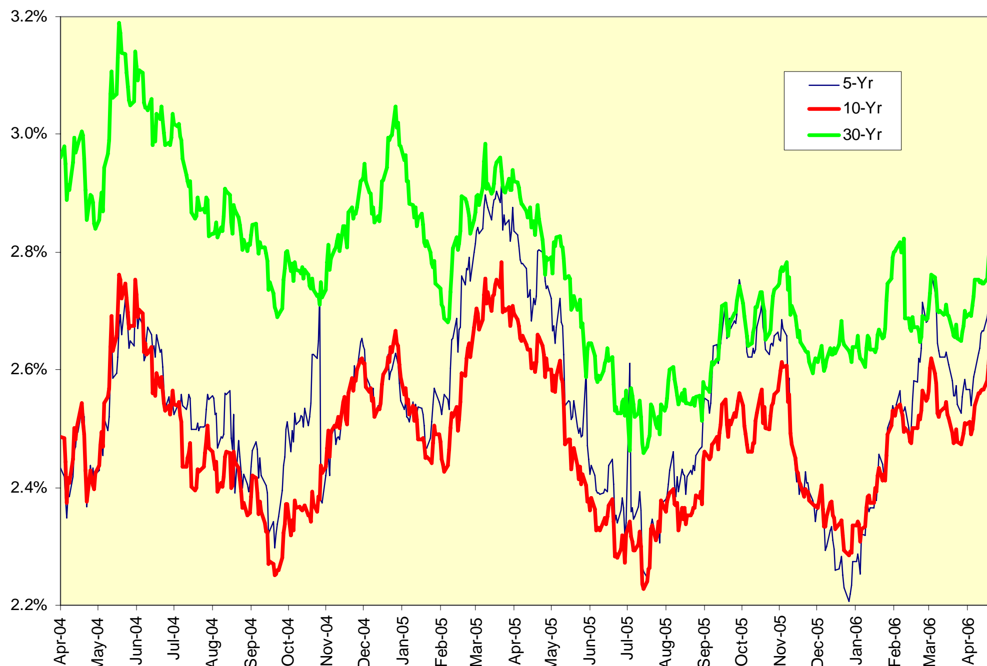
But the real parallels to 1987 are occurring not in the movies but in the markets. Last week's trapdoor-opening in the silver market was eerily reminiscent of a similar move in April 1987. The breakout of long-term bond yields in recent weeks is parallel to a similar breakout in March-April 1987. What about the ability of the stock market to advance in the face of higher interest rates? Yes; U.S. stocks gapped higher right after Memorial Day and put on one of the true summer rallies in market history. The dollar, while not under as much pressure in 2006 as in 1987, appears ready to move lower, too.

I don't know about you, but I'm tearing October off my calendar. Been there, done that.

The Inflation Parallel
In both 1987 and now in 2006, fears were growing the Federal Reserve was behind the curve. We did not have as many ways of expressing this opinion then as we do today. Had TIPS, whose near-term prospects were discussed here last week, been available in 1987, they no doubt would have been fairly popular.

But TIPS exist today, and even though their total return has lagged in recent months, they remain popular with investors and economists who love to read their signals. At present, the TIPS market is giving us a path-dependent view of how future inflation will progress. Briefly, the shorter the maturity of the bonds is, the more rapid is the rise in the breakeven rate of inflation. The 30-year breakeven rate of 2.78% is scarcely over the five-year breakeven rate of 2.73%. The ten-year breakeven rate, curiously enough, is the lowest of the three, 2.63%.

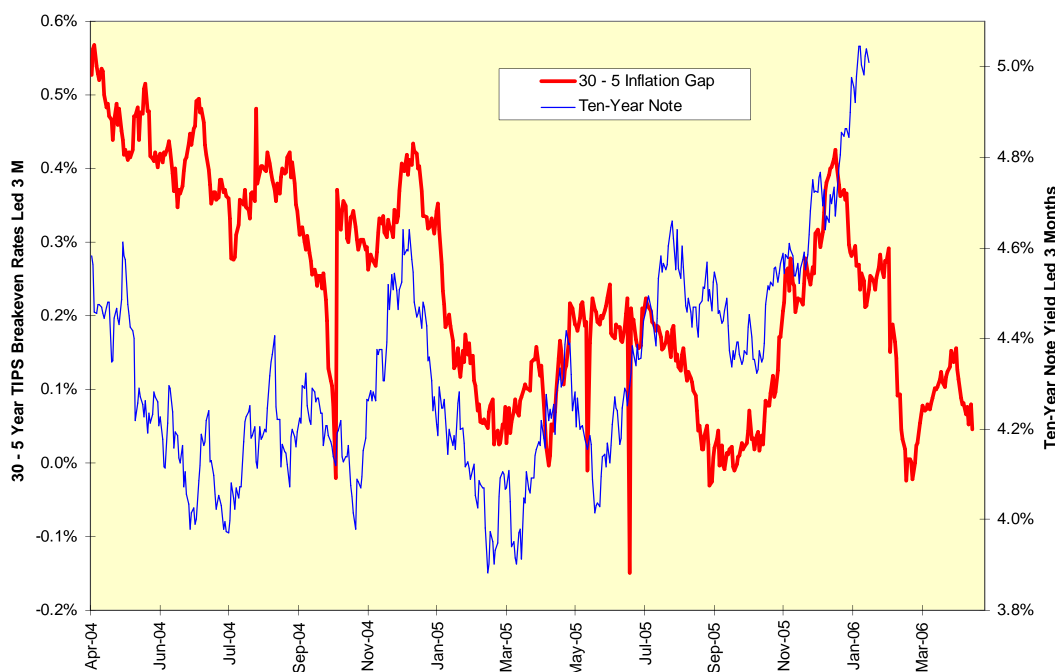
Inflation Expectations Losing Their Term Structure



Yield curves reflect market expectations. Should we expect the term structure of TIPS breakevens to convey anything about the course of interest rates?

The gap between 30-year and 5-year TIPS breakeven rates has led changes in the ten-year note rate itself by three months over the past two years of credit tightening. As inflation expectations for the 5-year note converge upwards to those for the long bond, the market has priced in the worst of all inflation expectations. This bearish outlook is consistent with the usual interpretation of sentiment indicators: When everyone has sold or reduced their duration, the market has nowhere to go but down in yield.

I cannot emphasize enough this is a short-term indicator. Curiously enough, ten-year note yields fell from 8.9% on May 20, 19987 to 8.2% on June 23, 1987. It is called a retracement in a bear market. Yields went much higher later in the summer and fall, and exceeded 10% going into the October 1987crash.



The Race Is On

Will the Federal Reserve tighten credit and *create the impression it will continue to tighten as necessary* at a rate exceeded the growth of expected inflation (emphasis added to add emphasis)? If the FOMC minutes and statements by Governor Yellen last week were any clue, they are looking for an excuse to avoid tightening credit too much. Chairman Bernanke is nothing if not a scholar of the Great Depression, and we have every reason to believe he does not want the monetary mistake of excess tightening laid at his doorstep.

So saying, which stock market groups are most affected by inflation expectations? Let's return to an analytic technique first introduced here in February 2005 and used several times since of measuring the relative impact of a market factor on industry groups. The table below presents the statistically significant relative performance of S&P 500 industry groups against the ten-year TIPS breakeven rate. The negative numbers in the top cells are those groups expected to lag the S&P 500 in a rising inflation expectations environment. The positive numbers in the bottom cells are those groups expected to outperform in a rising inflation expectations environment.

Ten-Year TIPS Breakeven

S&P 500 Group	Relative Performance Beta
Airlines	(0.180)
Homebuilding	(0.167)
Tobacco	(0.127)

General Merchandising	(0.123)
REITs	(0.109)
Hotels	(0.082)
Consumer Finance	(0.074)
Thrifts & Mortgages	(0.068)
Air Freight & Logistics	(0.067)
Diversified Banks	(0.061)
Housewares & Specialty Stores	(0.060)
Systems Software	(0.049)
Electrical Components & Equipment	(0.049)
Regional Banks	(0.045)
Advertising	0.061
Aluminum	0.131
Diversified Metals & Mining	0.169
Integrated Oil & Gas	0.174
Gold	0.178
IT Consulting	0.183
Internet Retailers	0.194
Steel	0.274
Oil & Gas Refining	0.277
Oil & Gas Explorations	0.281
Oil & Gas Equipment	0.303
Oil & Gas Drilling	0.314

The table above can be summarized while holding a lit match: Buy oils and sell banks. We can add a few things to this list, such as buy Steel, Aluminum and Diversified Metals and sell some minor sectors such as General Merchandising, Hotels, and Housewares & Specialty Stores. But the overall message is clear as to who is helped and hurt by rising inflation expectations.

As noted above, we lacked TIPS in 1987 and we were so unsophisticated in the use of derivatives that we stumbled into portfolio insurance. We can now take a more refined approach. But while impressing yourself with your detailed knowledge of individual trees, do not lose sight of the forest. If we learned anything in 1987 – and that is always open to reasoned debate – it is no equity market can shrug off higher long-term interest rates forever.

I warned of such in a different venue in June-September 1987, during which time no sell orders were being accepted anywhere in the world. Looked pretty foolish, did I. In homage to Mark Twain, a lot of people were impressed by how much I had learned by November.