Stocks And Treasuries: Is One Market Smarter?

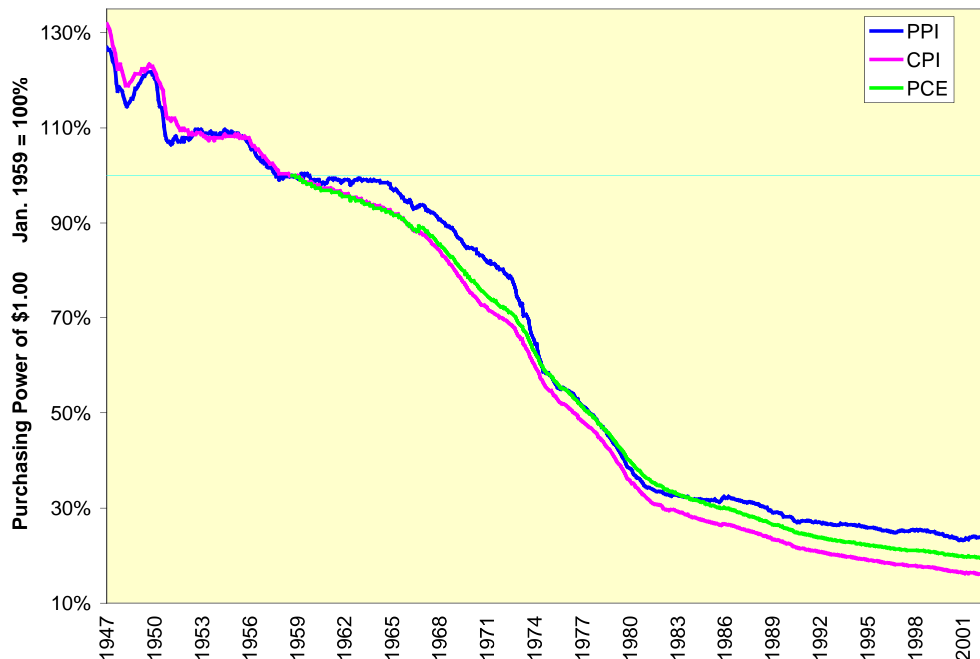
"One has to belong to the intelligentsia to believe things like that.
 No ordinary man could be such a fool"
  -- George Orwell

The famed author of *1984* and *Animal Farm* and satirist of political doublespeak would feel right at home discussing the Federal Reserve and its latest depredation, the panicked assault upon a deflation that may or may not exist and may or may not be "good" deflation if it does. Good deflation, for purposes of definition, is prices falling due to increases in productivity - think computers and long distance telephone service - while bad deflation is prices falling due to a collapse in demand.

It was not so long ago, November 2001 by my count, that the FOMC was congratulating itself for being sufficiently accommodative and opining that the risks were balanced between slowing growth and rising inflation. More recently, Sir Alan was pontificating about a "soft patch" in the economy, whatever that is or could be.

The job of a central banker is to promote price stability, not to engage in the Orwellian worry whether inflation is not high enough. A dollar in my birth month of August 1954 is worth only 14.68¢ today based on consumer prices, which is prima facie evidence that the Fed has failed in its primary task. The measure of their failure is independent of the yardstick, be it the producer price index, the consumer price index, or the personal consumption expenditure deflator.

Is This Price Stability?



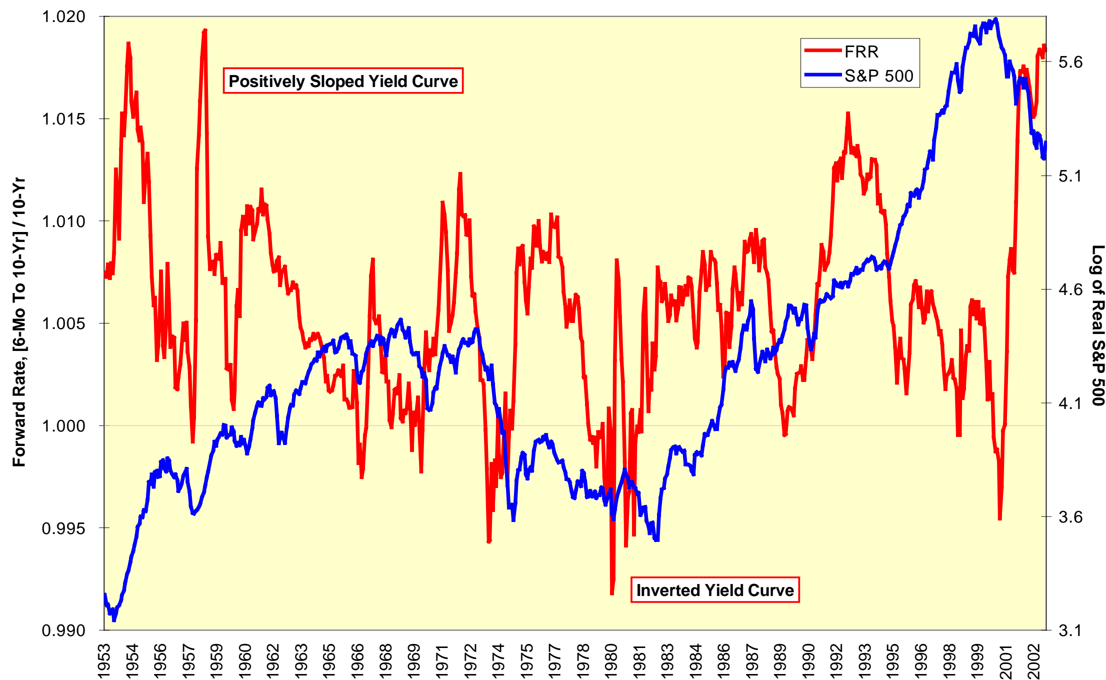
More important, no evidence exists that a deflationary cycle can be broken by monetary policy alone, which raises the very real risk that the Fed is going to create all sorts of other problems by persisting in its present course without actually forestalling deflation. The precedents are grim: Only World War I broke the deflationary pressures of the end of the 19th century, and only World War II broke the deflation of the 1930s. Japan's post-bubble deflation persists despite near-zero interest rates and a breathtaking level of public debt.

Which Market Leads?

The question addressed here last week, whether stocks or bonds are the more predictive market, slightly but inconclusively favored stocks as the more foresighted market. Let's take a look at the question from another

perspective, whether stock prices or Treasury yields are better leading indicators of two key macroeconomic variables, unemployment and industrial production.

Before we begin, we should establish that the abrupt lurches that have characterized monetary policy have had less effect on real equity prices than is commonly supposed. We can measure the steepness of the yield curve by taking the ratio of the forward rate from six month to 10 years - the rate at which we can lock in a note rate starting six months from now - to the ten-year note rate itself. If this ratio is compared to the logarithm of the deflated S&P 500, we see almost no discernible pattern of causality. The late 1990s bubble occurred in the face of a flattening yield curve. The recent bear market has occurred in spite of the most panicked reaction on the part of the Fed since 1958, a year which seems to be getting a lot of attention in interest rate circles of late.



If the stock market in turn is supposed to discount future corporate earnings, we in turn should conclude that all of the Fed's histrionics and incantations have no effect whatsoever on the real economy. Let me repeat, none. They have no more effect than a Stone Age shaman on New Guinea does in leading a cargo cult ceremony, and while my basis for comparison is somewhat incomplete, I suspect they are less entertaining. And yet we let them play with matches.

Comparative Prediction

In testing for whether either market can forecast either industrial production or unemployment, we once again will use the concept of called Granger causation. We can say X causes Y if the past values of X can be used to predict Y more accurately than simply using the past values of Y will be used. In other words, if past values of X statistically improve the prediction of Y, then we can conclude that X "Granger-causes" Y.

Just as was the case last week in our discussion of stocks and corporate bond spreads, we have to conclude that neither market is truly causative. However, stocks once again get the advantage. Returns on the deflated S&P 500 lead changes in industrial production and unemployment with lags of 3 and 7 months, respectively, with R-squares of 5.70% and 2.93%, respectively. Returns on ten-year notes had much shorter leads, one month and no lag, respectively, and R-squares of 0.48% and 0.57%, respectively, for industrial production and unemployment. Both macroeconomic variables explained themselves - autoregression - at much higher R-squares, 10.50% and 7.41%.

Autoregressive

Ind. Prod	Unemployment
10.50%	7.41%

Cross

	Dependent	
Independent	Ind. Prod	Unemployment
S&P 500	5.70%	2.93%
Ten-Year	0.48%	0.57%

The first two tests of stocks and bonds indicate that when the two diverge, stocks should be given the benefit of the doubt. In the present situation, this means we should be placing greater faith in the combination of stronger equities/weaker dollar/narrowing corporate bond spread than in the giddy Treasury rally.

Yes, you can pour your life savings into ten-year paper yielding less than 3.5%, fully taxed and with no protection against inflation should it recur as a problem, which is still my bet. Implicit in this investment is a belief in the powers of the Federal Reserve to affect the world as it intends. At this point, I would recommend abandoning Orwell as a political philosopher and following the teachings of Clint Eastwood: How lucky do you feel?