

Collateral Damage In The Brokerage Sector

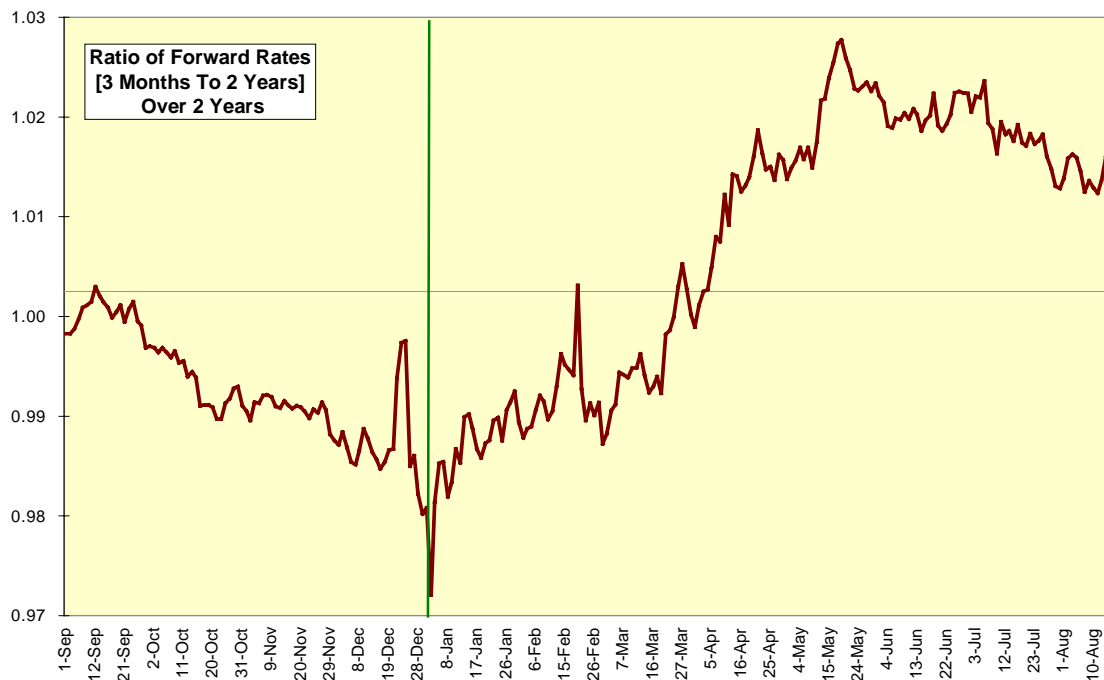
One of the neat things about being an economist is you're always the life of the party. Fill up a room with some ER doctors, some policemen, and a supermodel or two, and after twenty minutes they're all listening to an impromptu lecture on the J-curve implications of last week's rally in the euro. You get used to it after a while.

Why the fascination? It's really quite simple: While the others have individual life experiences, we economists have data on the entire world. We can create tables, formulas, and graphs, and as I told Rod Stewart long ago (not really), "Remember, Rod, every picture tells a story."

Such is the case with the brokerage sector. Back in the old days, when people still thought the Federal Reserve had a six-shooter loaded with magic bullets, the assumption was these stocks benefited from lower interest rates and a steep yield curve. Such credit market conditions facilitate the underwriting of securities and the financing of portfolios. However, since the general equity market peak of early September 2000, the brokerage sector as measured by the 13-member equal-weighted AMEX Security Broker/Dealer index (XBD) has a total return of -36.3%, far below the S&P 500's drop of 21.99%.

Of course, monetary policy has not been as loose as you might imagine given all of the rate cuts so far in 2001. We can measure credit conditions at the short end of the yield curve by the forward rate between three months and two years. This is the rate at which we can lock in funding for seven quarters starting one quarter from now. If the ratio of this forward rate to the two-year rate is greater than 1.00, then the yield curve is positively sloped. Incredibly, this condition did not pertain until the Fed's third rate cut the one on March 20. More important, this measure has reflected less-loose credit conditions ever since the May 18 rate cut. This backsliding coincides with the stock market's retreat since the April-May rally.

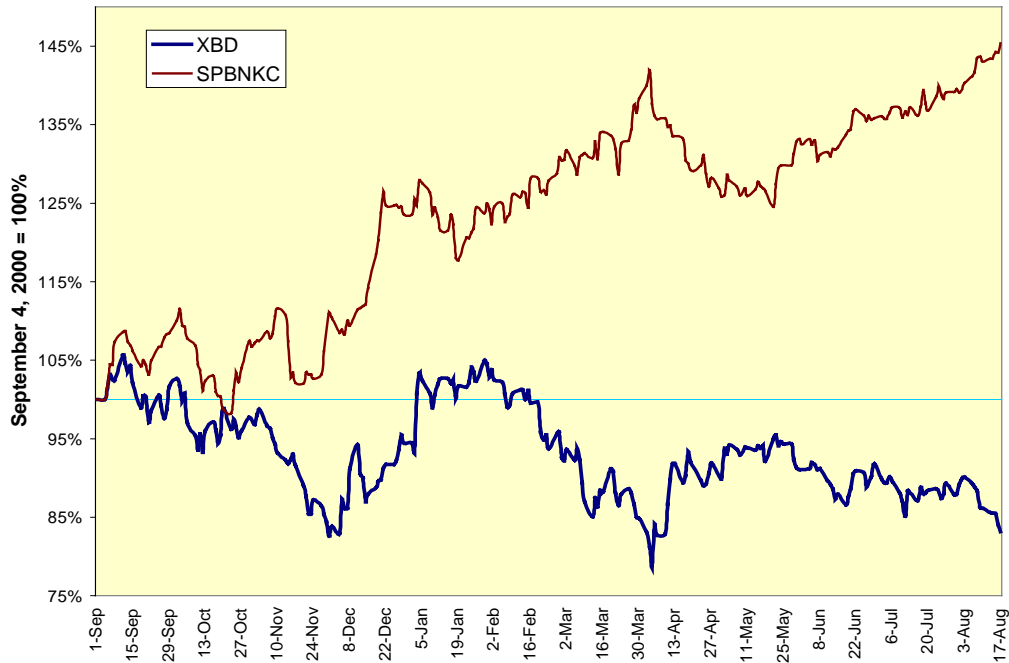
Not That Loose In The Short End



Banks Vs. Brokerages

In fairness, the 24-member S&P capitalization-weighted Bank Composite index (SPBNKC) has a positive total return of 13.31% since last September, which indicates banks have benefited from the wider margins between their funding costs and the return on their loan portfolios. Bank loan portfolios no doubt have a longer duration than do brokerage security portfolios. The relative performance of banks to brokerages since last September is quite striking; the two groups have a near mirror-image track record over the past year.

Relative Performance: S&P Banks and AMEX Brokers Vs. S&P 500



A New Relationship

A general theme of market analysis since the start of the Asian crisis more than four long years ago is "everything you know is wrong." It is time to toss the textbook out once again, for the long-term relationships between various financial powerhouses and key market indices have changed. It shouldn't shock anyone that such members of the XBD as E*trade, Ameritrade, and Charles Schwab have been hurt by the end of the bull market. It may, however, come as a surprise that more traditional investment banks and brokerages are tied almost as closely to the technology-oriented Nasdaq 100 (NDX) as to the S&P 500 (SPX), which has nearly a 10% weight in various financial groups.

Long-term data analysis in the brokerage sector is virtually impossible. Goldman Sachs, Citigroup, J.P. Morgan Chase, and Morgan Stanley Dean Witter all have undergone significant corporate actions in the past three years. What we can do is provide a snapshot of how each of these stocks has fared in relation to the NDX and SPX since last September's peak. For each of the members of the XBD plus Citigroup and J.P. Morgan Chase, we can compare the relative movement of the stock against the SPX and NDX. Two key numbers are provided, the beta, or the slope of a best-fit (regression) line, and the R^2 , or percentage of the stock's variance that can be explained by the index.

A perfect fit would have both a beta and an R^2 of 1.00. A beta greater than 1.00 means the stock is more volatile than the index, and a beta less than 1.00 means the stock is less than the index. In the table below, E*trade is 3.16 times as volatile as the SPX, and the SPX explains only 50% of the variance in E*trade. The table below is ranked by R^2 to the NDX.

	SPX		NDX	
	Beta	R-squared	Beta	R-squared
E*trade	3.16	0.50	1.12	0.49
Goldman Sachs	1.72	0.53	0.56	0.45
Morgan Stanley Dean Witter	2.13	0.54	0.69	0.44

Charles Schwab	2.43	0.53		0.85	0.42
Lehman Borthers	2.02	0.50		0.64	0.40
Merrill Lynch	1.73	0.50		0.53	0.37
A.G. Edwards	1.41	0.49		0.42	0.35
Ameritrade	2.47	0.33		0.89	0.34
TD Waterhouse	1.50	0.41		0.66	0.34
Bear Stearns	1.53	0.44		0.47	0.33
J.P. Morgan Chase	1.56	0.52		0.45	0.33
Citigroup	1.35	0.56		0.35	0.31
Raymond James	1.47	0.40		0.45	0.30
Legg Mason	1.29	0.43		0.38	0.30
Jefferies Group	1.02	0.23		0.34	0.20

E*trade has the closest relationship to the NDX, but Goldman Sachs and Morgan Stanley Dean Witter are close behind. Moreover, the betas of these investment banks to the SPX are quite high as well. The downturn in trading volume and IPO underwriting has taken its toll on all of Wall Street, not just on the retail brokerages maligned in some quarters for their focus on technology.

The sad moral of this story is the burst financial bubble burst over everyone, even those who never had one dollar in the market. It was true for ER doctors, policemen, and supermodels, and that's why they listen so intently.