Fixed Income, Broken Wind

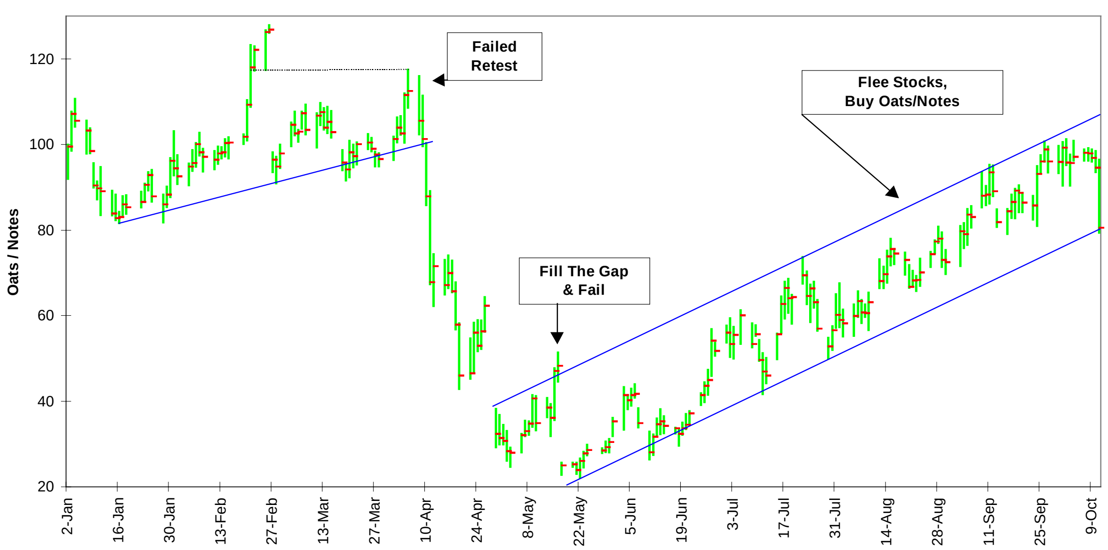
"You can't fix stupid"
-- Ira Krulik, CSFB Derivatives

What have been the bare essentials for the bear market? First and foremost, nothing would have served you better than closure of your various sensory orifices via blindfolds, nose-clips, earplugs and maybe even a well-sculpted cork. The record of various market pundits over the past three years has proven once again that forecasting is an inexact science, as we shall see in detail below. See no nonsense, hear no nonsense, and smell no nonsense is always a winning trade.

Second, you should have paid attention to the oats/notes spread.

Yes, it's that time of year again when we update that simplest and most reliable arrow in the analyst's quiver, the difference between the front month contracts of oats and ten-year Treasury notes. That's it: If you want fancy, please leave now and we really don't care if the door hits you on the way out. If you want Doomsday, wipe the glistening sheen of insanity off your brow and start studying various waves and cycles (but remember Kondratieff's fate at the hands of Josef Stalin). If you want Pollyanna, she's on vacation. No, we just run the numbers, let the chips fall where they may and call 'em as we see 'em. So, let's see what kind of year oats/notes, a fictitious spread compiled from actual data, put together in 2002.

Yields From The Fields: Oats/Notes In 2002

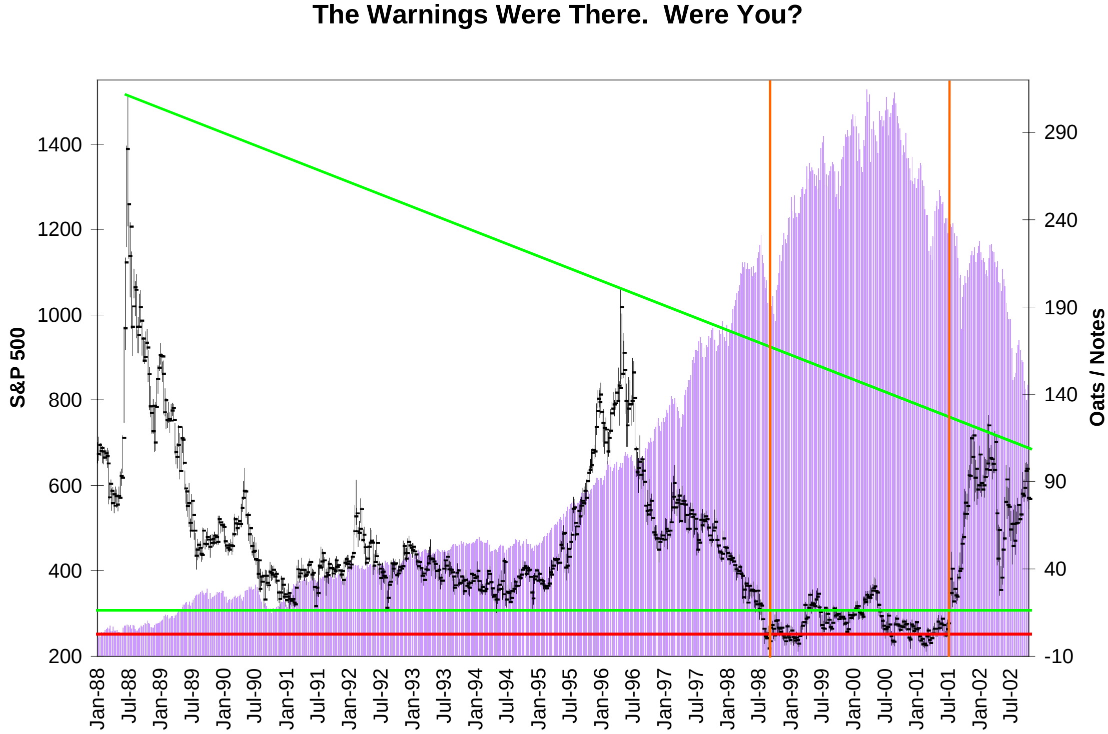


The oats/notes spread started off the year inauspiciously, but that should have been the tip-off right then and there. Support broke like the wind in mid-April, and by the time anyone got their wits about them, the S&P 500 was on its way from a March high near 1175 to an early October reading near 775. However, as equity portfolios melted under the summer sun, the oats/notes spread remained under control. This calm certitude under fire was totally in character for the dashing differential.

This is seen best on a weekly oats/notes chart. The spread has been in a long-term declining wedge pattern, seen in the green lines. Once the Long Term Capital Management and Russian default crises occurred in 1998, oats/notes fell out of this wedge, and even went negative, as seen in the red line. This was no less shocking than $800 gold or $40 crude oil, and experienced market technicians with social consciences held their breath and their tongues: Why risk scaring the public with this yelling fire-in-a-crowded-theatre news?

But if this wasn't the end of the beginning of the end, it was certainly both the end of the beginning and what may be the midpoint of a happy medium. The era of oats/notes oscillating around the zero-line and unable to break conclusively back into the downward wedge corresponded with the final glorious and indeed millennial surge of the

S&P 500, as seen in the orange vertical lines. The left line was Fed's fall 1998 rate cuts; the right line was their January 2001 rate cut. So, it is pretty clear that the Fed relies heavily on the oats/notes spread, and their denials to the contrary are falling on increasingly deaf ears.

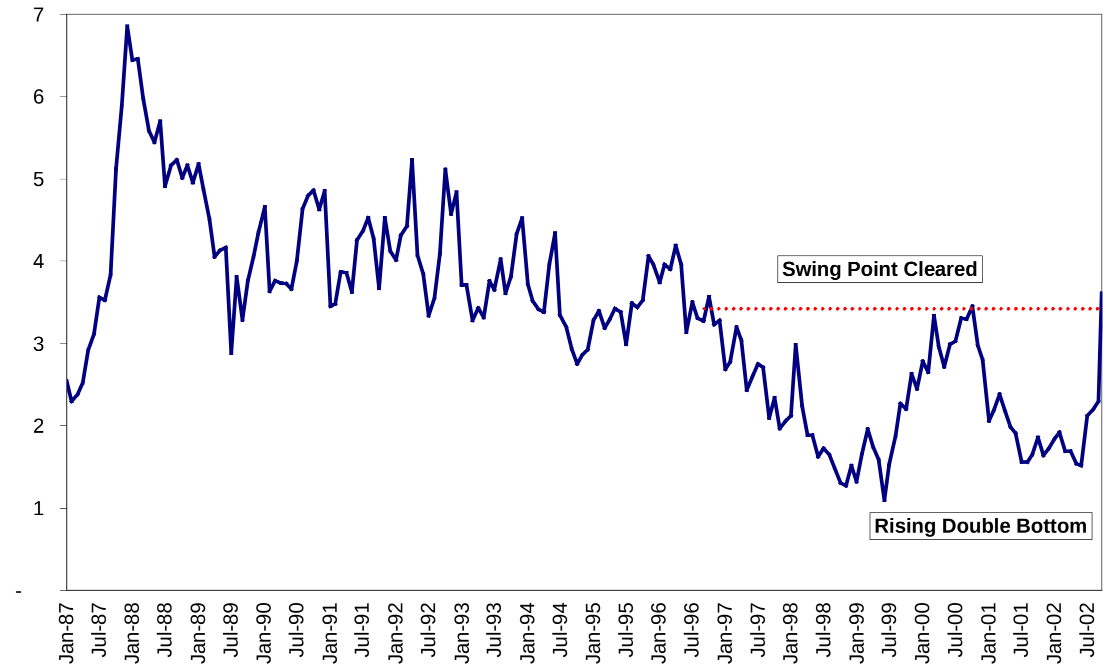


Intercontinental Ballistic Chicken

The success of the oats/notes spread has encouraged imitators, all of which have been found in this column. Past entries have included the HU/NG spread between gasoline and natural gas, the hog/log spread between lean hogs and lumber, the heat/meat spread between heating oil and live cattle and the ARS/dong spread between the Argentine peso and the Vietnamese dong. It's time to roll out the Dixie Chicks spread, the ratio of the dollar index (DXY) to five times the stock price of poultry producer Pilgrims Pride (CHX).

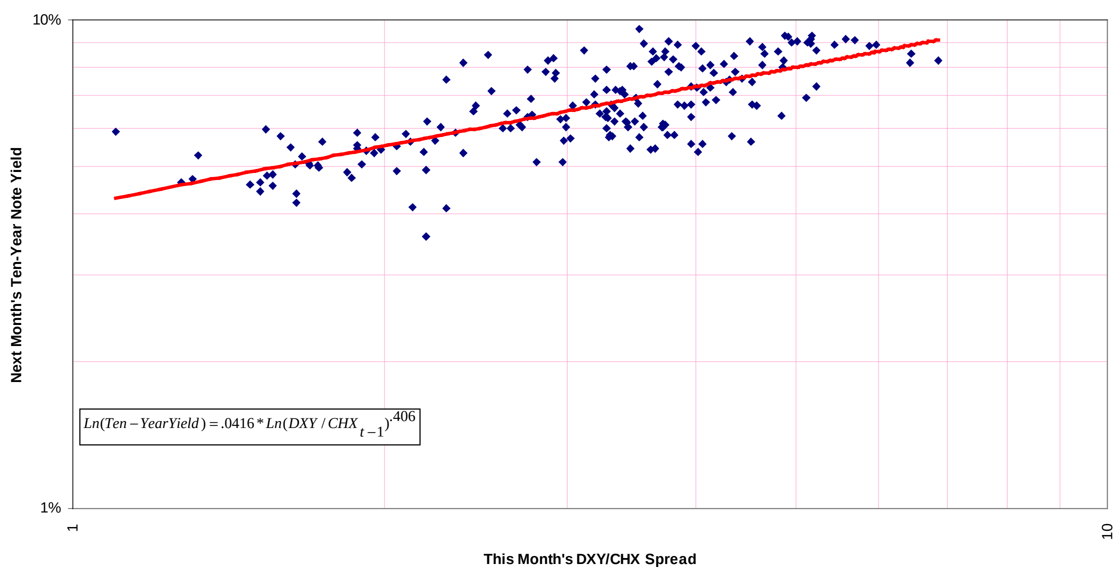
What, snort thee, is the fundamental logic for this trade? If 2002 was a bad year for you, it wasn't much of a treat for the poultry industry. It was buffeted by higher feedgrain costs and a Russian boycott in retaliation for the Bush administration's imposition of steel tariffs (like Richard Nixon before him, George W. Bush often implements bad Democratic ideas in an attempt to buy domestic peace for foreign adventures). By late October, Pilgrims Pride was down close to 56% on the year. The dollar, on the other hand, recovered from a late spring swoon when global investors realized the grass was not greener on the other side, and neither were the markets. As a result, the DXY/CHX spread is threatening to break out of its long-term secular bear trend.

DXY/CHX: Long Time Gone, But Coming Back



Well, that is data but is it information you as a trader can use? Absolutely: The year 2002 will be remembered for note yields breaking their bonds. Who or what could have predicted this? Only the DXY/CHX spread, and what is better, it did it a month in advance. The age-old question of which came first, the chicken or the bond trader, is answered firmly in favor of the chicken. A new pecking order is indicated on Wall Street.

When Your Tool Fails, Use This



The Abby

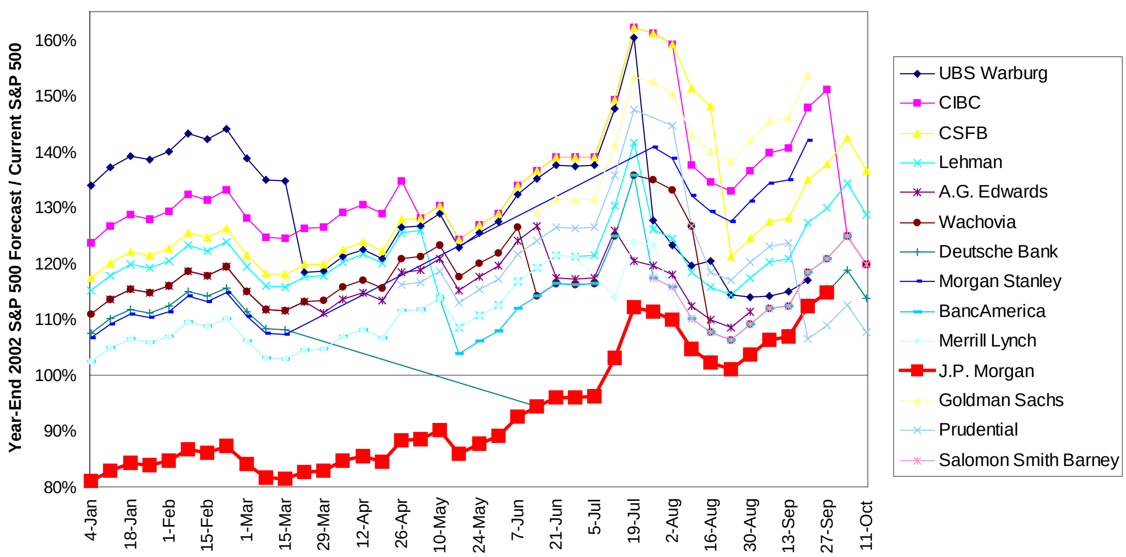
The year 2002 is a palindrome, which means it reads the same forward and backward. The forecasting profession might have done better this year if it got to forecast the year's close in reverse order. Before you cry "foul!" consider the record: Each Friday our good friends at Bloomberg report on Wall Street strategists' forecasts for the year-end for the S&P 500 and the Dow Jones Industrial Average. Let's examine the data for the S&P 500 and decide in an objective and unbiased manner who amongst them deserves the Abby, the highly coveted statuette inscribed with Druid incantations and adorned with a symbolic broken clock. The contest extended from the beginning of the year to the middle of October; at such time forecasting something only ten weeks away would be meaningless.

The Abby must be awarded every year to someone who in the grand tradition of fearless forecasting and perspicacious prognostication gets a market variable right. Someone forecasting that a shower curtain could in fact be sold for $6,000 would be disinvited from further competition on the grounds of unwarranted cynicism.

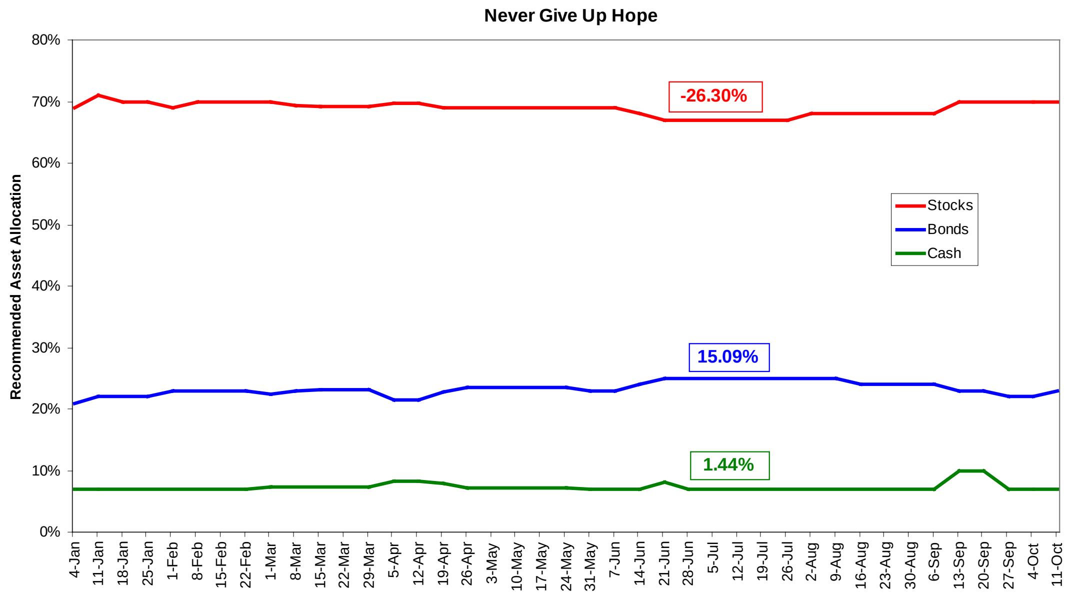
The contest was brutal in more ways than one. Several of the strategists found they had compelling personal interests they had been meaning to pursue, and how many of us don't want to spend more time with our families? Some of the firms sponsoring these strategists ceased forecasting the S&P 500 altogether. Overall, the group's progress had all of the decorum of a group of stragglers returning from the losing end of a nasty battle, which may be an apt description.

However, one firm and one strategist emerged the clear victor: Douglas Cliggott, then of J.P. Morgan Chase and now of Brummer & Partners, which he joined in February 2002 (even the winner carved a notch on the resume stick this year). If we compare all firms' year-end forecast of the S&P 500 to its contemporaneous value, we see that only Cliggott forecast a drop in the benchmark in 2002. It's an outstanding performance, and one that has earned him a spot on the Abby award plate along with this author, Ron McEwan, Chris Costakos and the team of Beth Loeb and Darlene Demor.

The Toughest Game In Town



And, as long as we're on the subject of just how difficult it is to get the market forecasting game right, let's take a look at a similar market poll published by Bloomberg, the consensus asset allocation between stocks, bonds and cash. Bonds had the greatest return, and even cash was positive after the Fed's series of 11 rate cuts in 2001. So, what was the preference of our experts? You guessed it: All through a year wherein the S&P 500 returned a minus 26.3% through mid-October, they wanted you to keep between 65% and 75% of your hard-earned money in stocks. Hope springs eternal.



So, what's the moral of our story? The same as it is every year, and will be for every year we return to the indefatigable oats/notes spread and bestow an Abby: Expertise in the face of a determined market doesn't stand a chance.