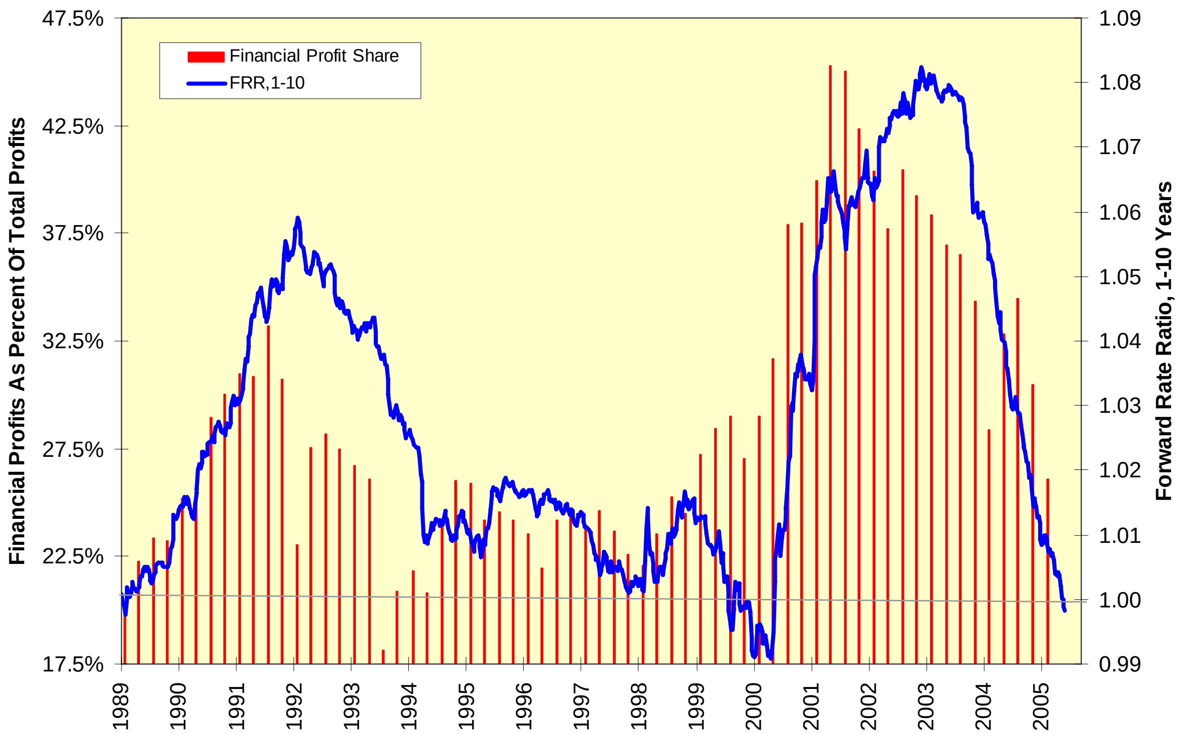
CSI Wall Street: Yield Curve Victims

The S&P 500 casualty list from last Friday's selloff included financial giants Citigroup, Bank of America, JP Morgan Chase, AIG and General Electric. The first four are included in the S&P 500 financial groups; General Electric is classified as an industrial firm despite its huge GE Capital business.

This is, as I noted in a Columnist Conversation posting, no accident. What we are seeing, and will continue to see through the first quarter of 2006 at least, are the effects of the yield curve on financial stocks. This is especially and particularly true for those firms whose core business is the "carry trade" of borrowing short to lend long. Stripped of all the folderol, this is essence of the banking business. We will get to the distinctions between various kinds of financial firms later.

The profits of financial firms as a percentage of total U.S. corporate profits has tended to rise and fall in advance of changes in the yield curve as measure by the forward rate ratio (FRR) between one and ten years. This is the rate at which we can lock in borrowing for nine years beginning one year from now, divided by the ten-year rate itself. The more the FRR exceeds 1.00, the steeper the yield curve. The present FRR of .9982 indicates an inversion.

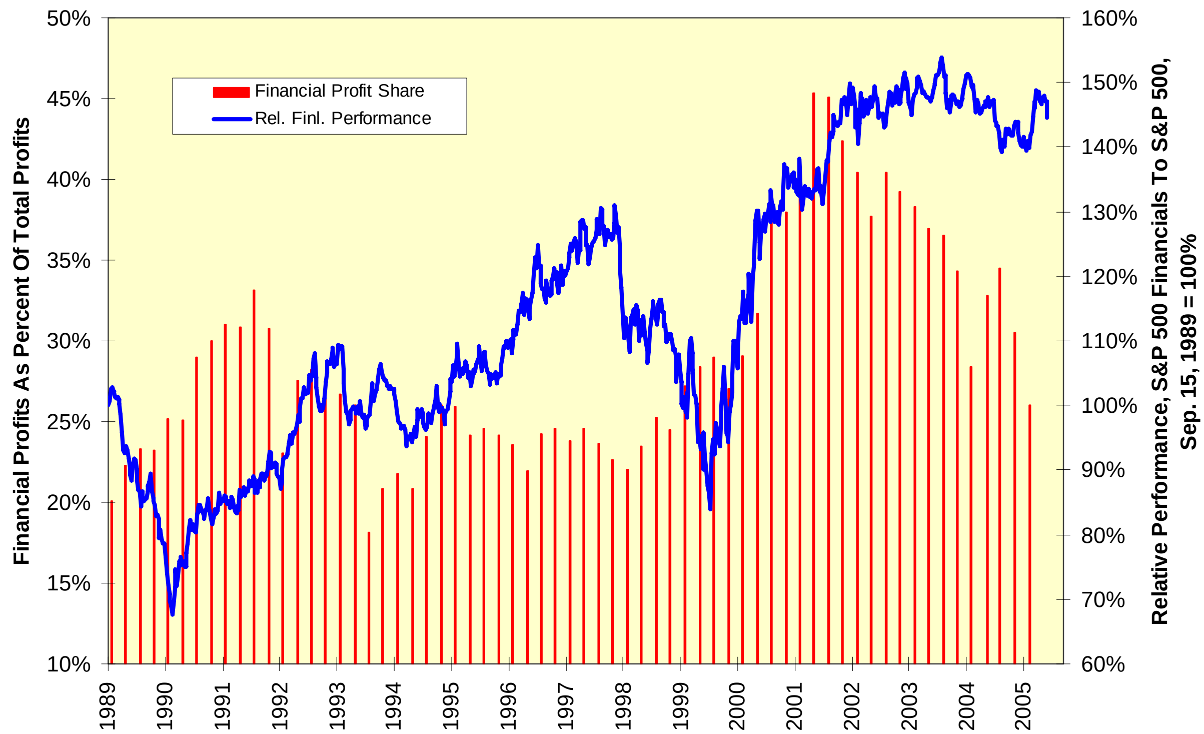
Financial Profits And The Yield Curve



Identifying The Victim

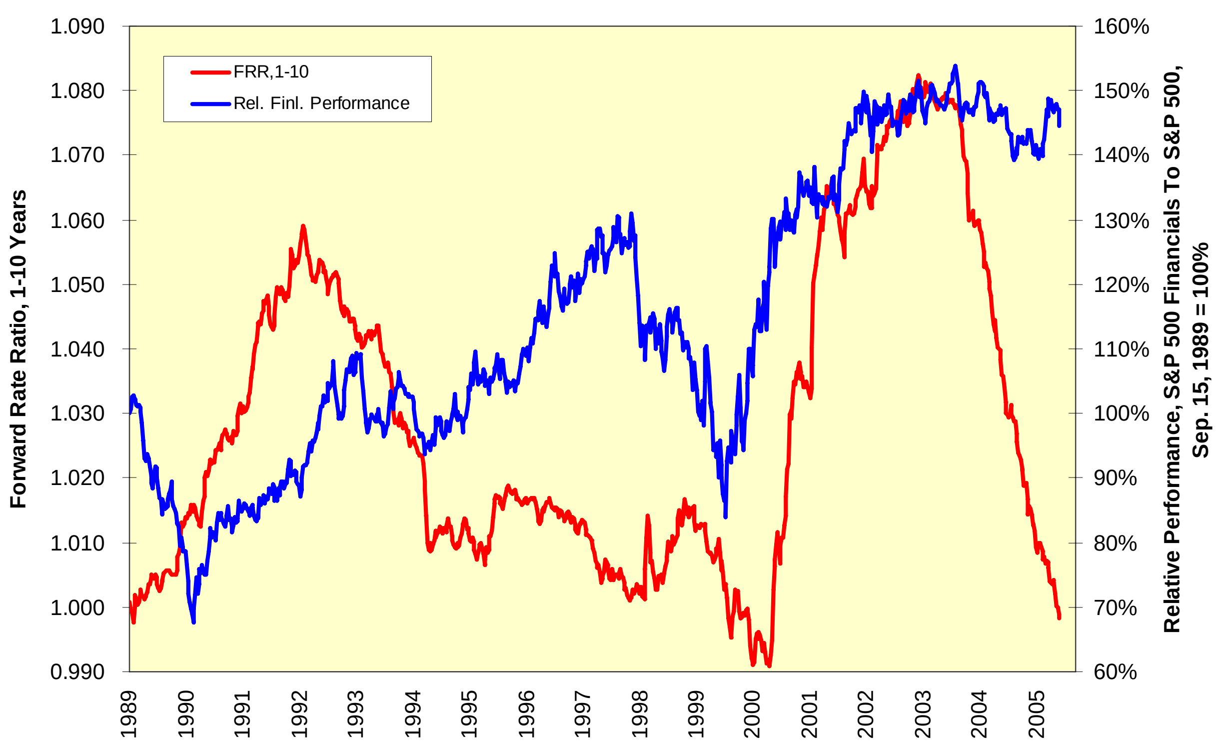
The first step in any interesting whodunit is the misdirection, the piece of evidence inconsistent with our reasonable beliefs. Here we have a beauty: While the financial sector's share of U.S. profits has declined since mid-2002, the relative performance of the S&P 500 financial index to the S&P 500 has levitated. This would suggest to some that the stock market is either ignoring profits entirely, a conclusion that would mean all those analysts and prognosticators are really more useless than we imagined, or that investors were willing to assign an ever-higher risk multiple to the sector. We could also throw in some gibberish about "looking over the valley" if we were feeling particularly sarcastic.

Financial Profits And Financial Stocks



We can even bring in yet another misdirection. The relative performance of financial stocks, which climbed in advance of the huge steepening of 2001-2002, has ignored the massive flattening of the yield curve from late 2003 onwards. What gives? Are financial stocks somehow immune to both profits and to the macroeconomic factor known to affect them, the yield curve?

The Yield Curve And Financial Stocks



The Solution

The answer to this, the final conundrum of the Greenspan era, lies in the disaggregation of the financial sector into its constituent groups. As only the hard-core index wonks might have any clue as to which stocks go into which groups, let's present the following as a public service of sorts.

Insurance Brokerage	Multiline Insurance	Life & Health Ins.	Property & Casualty Ins.
AON	AIG	Aflac	ACE
Marsh & McLennan	Genworth	Jefferson-Pilot	Allstate
	Hartford Financial	Lincoln National	AMBAC Financial
	Loews	Metlife	Chubb
		Principal Financial	Cincinnati Financial
		Torchmark	MBIA
		UnumProvident	Progressive
			Safeco
			St. Paul Travelers
			XL Capital

Diversified Banks	Regional Banks	Other Div. Fin'l Services	Thrifts & Mortgages
Bank of America	AmSouth	Citigroup	Countrywide
Comerica	BB&T	JP Morgan Chase	Fannie Mae
US Bancorp	Compass Banchshares		Freddie Mac
Wachovia	Fifth Third		Golden West
Wells Fargo	First Horizon		MGIC Investment
	Huntington Bancshares		Sovereign Bancorp
	Keycorp		Washington Mutual
	M&T Bank		
	Marshall & Ilsley		
	National City		
	North Fork		
	PNC Financial		
	Regions Financial		
	SunTrust		
	Synovus		
	Zions		

Specialized Finance	Asset Management	Investment Banks	Consumer Finance
Moody's	Ameriprise	Bear Stearns	American Express
CIT Financial	Bank of New York	Charles Schwab	Capital One
	Federated Investors	E*Trade	SLM Corp
	Franklin Resources	Goldman Sachs	
	Janus Capital	Lehman Brothers	
	Mellon Financial	Merrill Lynch	
	Northern Trust	Morgan Stanley	
	State Street		
	T. Rowe Price		

The dry wits at S&P stuck the two banking behemoths of Citigroup and JP Morgan Chase into the drably named Other Diversified Financial Services, as if they were an afterthought. Bank of America, a pretty good-sized bank in its own right, is off in the Diversified Banks group. But let's not quibble over classification; instead, let's update a table presented last November on the industry group impact of the yield curve as measured by the FRR from 2-10 years.

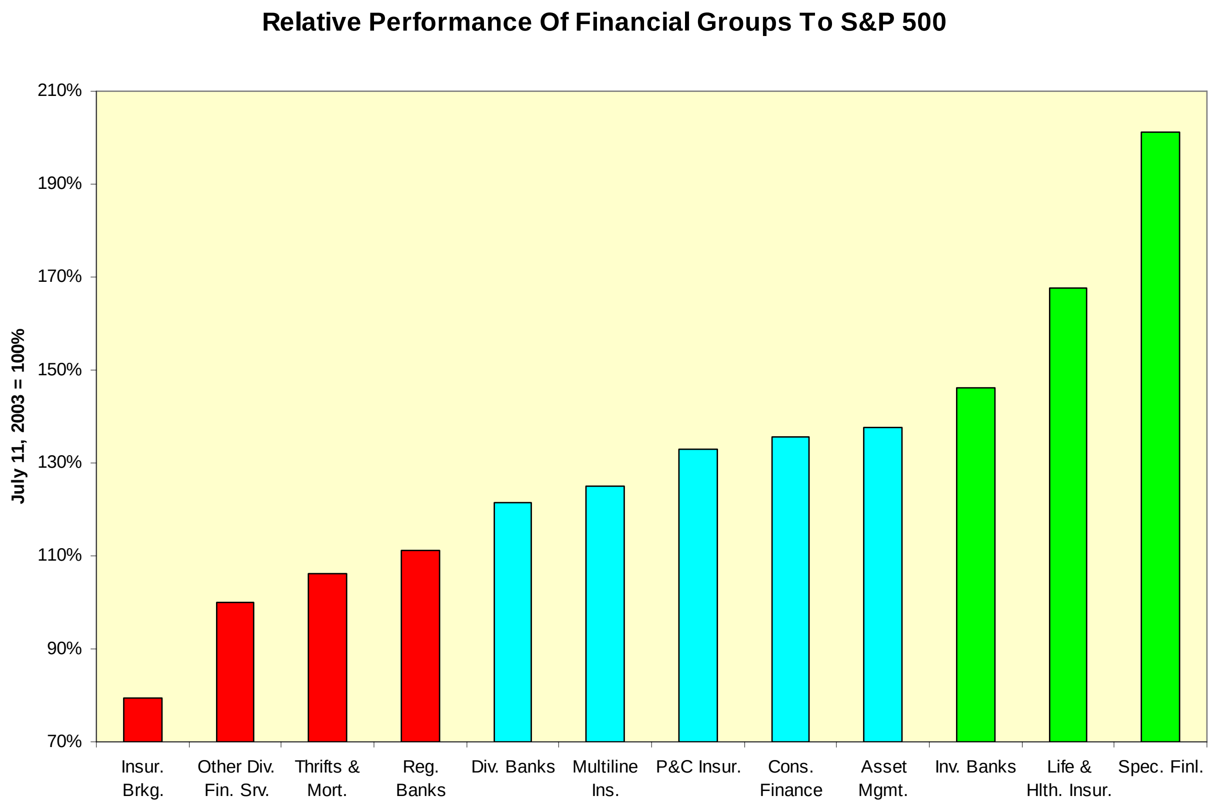
Negative numbers in the table below indicate groups benefiting from or at least not hurt by the flatter yield curve, while positive numbers indicate groups hurt by the flatter curve. The groups with statistically significant relationships (90% confidence interval) against the S&P 500 are displayed. Note how the Diversified Banks, Thrifts & Mortgages and Specialized Finance groups have a statistically significant relationship to the FRR.

FRR, 2-10 Years

S&P 500 Group	Beta
Employment Services	(2.010)
IT Consulting	(1.259)
Electrical Manufacturing Services	(0.875)
Department Stores	(0.848)
Computers & Electronics	(0.785)
Motorcycle Manufacturers	(0.782)
Applications Software	(0.693)
Commercial Printing	(0.622)
Railroads	(0.613)
Diversified Commercial Services	(0.540)
Industrial Gases	(0.517)
Drug Retailers	(0.486)
Data Processing & Outsourcing	(0.470)
Systems Software	(0.399)
Electrical Components & Equipment	(0.383)
Industrial Machinery	(0.266)
Diversified Banks	**0.411**
Gas Utilities	0.462
REITs	0.604
Forest Products	0.678
Thrifts & Mortgages	**0.694**
Home Furnishings	0.699
Specialized Finance	**0.838**
Oil & Gas Refining	0.921
Oil & Gas Equipment	0.930
Oil & Gas Exploration	0.968
Oil & Gas Drilling	1.439
Gold	2.995

As an aside, the oil-related groups and Gold tend to have a strongly significant relationship to the FRR as well, but they have done pretty well of late. The negative impact of the flatter curve has been overwhelmed by the positive impact from higher oil and gold prices.

Now let's extend this analysis to all twelve groups within the S&P financial sector from the start of the yield curve's flattening back in July 2003.



One group, Insurance Brokerage, has underperformed the broad market by virtue of Marsh & McLennan's regulatory problems with its Putnam Financial unit. The other three lackluster performers, Other Diversified Financial Services, Thrifts & Mortgages and Regional Banks all can be called yield curve-sensitive businesses. As the curve has flattened, their stocks have suffered, and this is just as it should be.

A second set of groups, consisting of Diversified Banks, Multiline Insurance, Property & Casualty Insurance, Consumer Finance and Asset Management, has outperformed the market. These businesses derive a good deal of their income from fees and from interest-related businesses where they have pricing power, such as credit cards. These businesses have less sensitivity to the yield curve – although it was nice carrying bonds at 1% while the game lasted - and their stocks have benefited accordingly.

Finally we come to the Investment Banks, Life & Health Insurers and Specialized Finance groups. These businesses have profited from trading, pricing power in their core businesses and in the case of firms such as Moody's in Specialized Finance, a real franchise.

The strong performance of those groups with low sensitivity to the yield curve easily accounts for why the combined financial sector looked relatively immune to the flattening yield curve. In reality, the large carry-dependent firms such as those getting clobbered last Friday were suffering for a while.

When will it be safe to wash the chalk outlines off the sidewalk and take down the yellow tape? As noted here a few weeks ago, wait until the Federal Reserve inverts the curve completely and then announces it is done raising rates for now. That still looks as if it will be at their March 28th meeting.