It Keeps Going And Going

"When you trade a sympathetic market, all you get is sympathy." -- Anon.

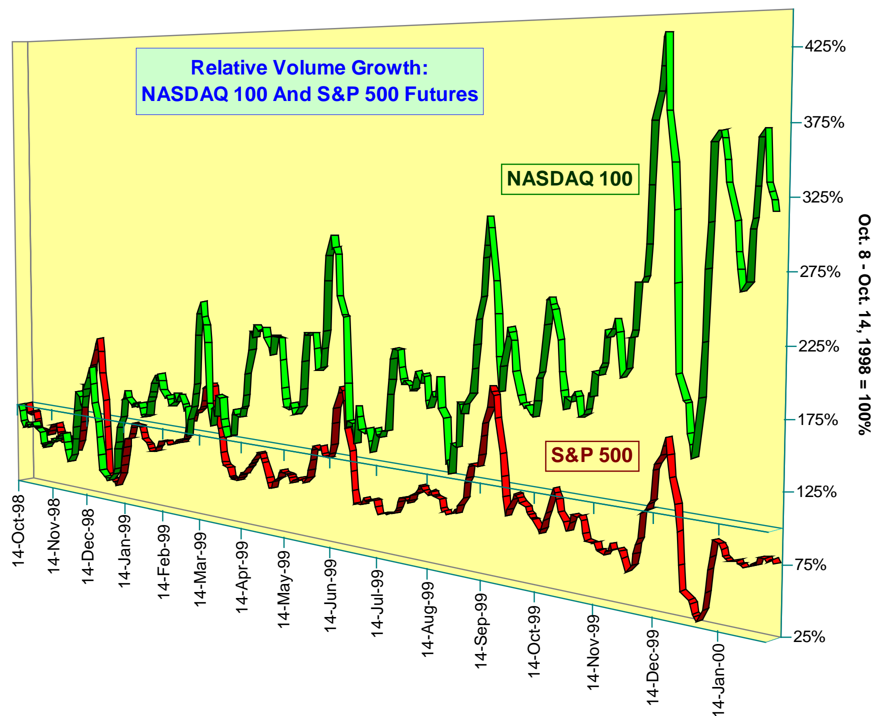
Can anyone forgive Alan Greenspan for feeling like Wile E. Coyote in pursuit of the road-running NASDAQ? A few quarter-point rate hikes here, a 16-ton Acme anvil there, a doubling of oil prices and a vicious bond market thrown in for good measure, and whaddya got? The trading year is less than six weeks old, and the NASDAQ has already survived two drops in the 10% neighborhood to move back to record levels.

Beep, Beep!

Get Used To The Divergence

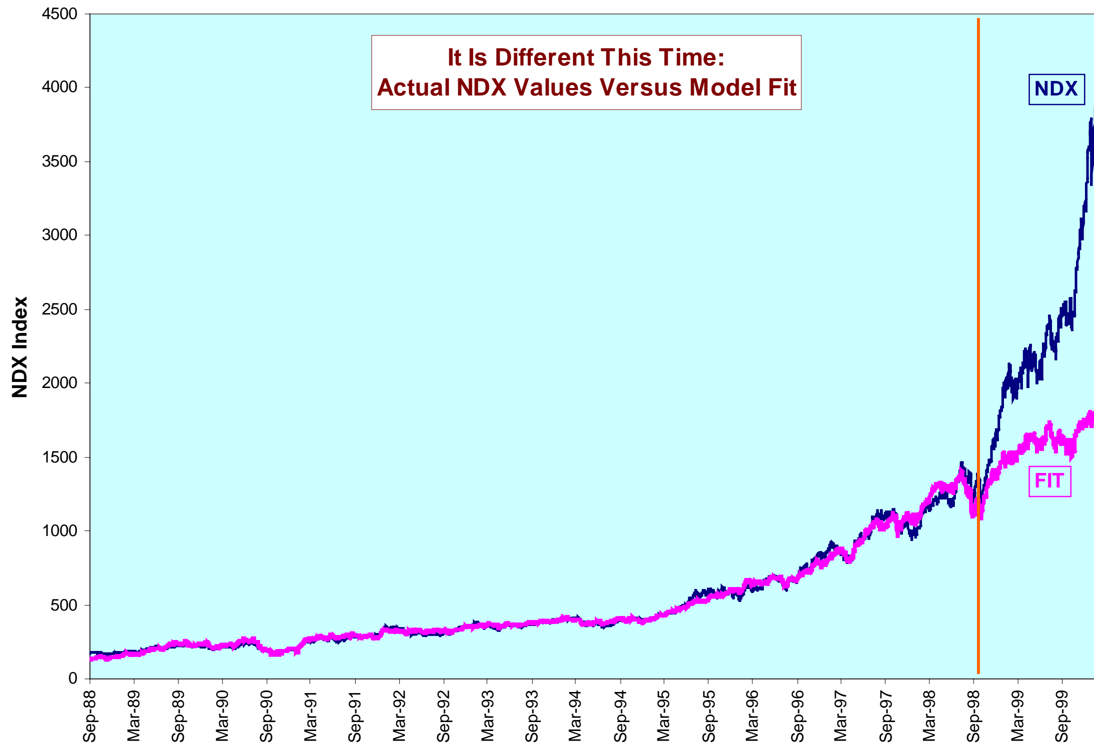
Conventional investment analysis always held higher interest rates should affect growth stocks more than value stocks since the former's profits lie farther in the future (see "High Interest Rates And A Strong NASDAQ Don't Go Together," December 15, 1999). This argument has fallen down since, apparently, it is the high-tech boom itself that is responsible for the strong economic growth and the surge in credit demands that have combined to push interest rates higher. As business capital spending on technology increases -- and it must for competitive reasons -- a wealth transfer occurs between technology consumers and technology producers. This wealth transfer will stop only when technology buyers around the world run out of money and credit with which to stay in business, and this calamity is not yet visible over any horizon.

Very profound, professor, now how do I make a buck off of it? Increasingly, traders are turning to the NASDAQ 100 futures on the Chicago Mercantile Exchange. Since the general market low on October 8, 1998, the rolling five-day average volume on this contract has surged, while S&P 500 volume has remained trapped in a narrow range except for its quarterly expiration weeks. To be fair, the total volume for the S&P 500 futures is still far higher than that of the NASDAQ futures -- 472,037 versus 82,722 in the week of January 31 - February 4 -- but the relative growth trend is unmistakable.



It's A New World, After All

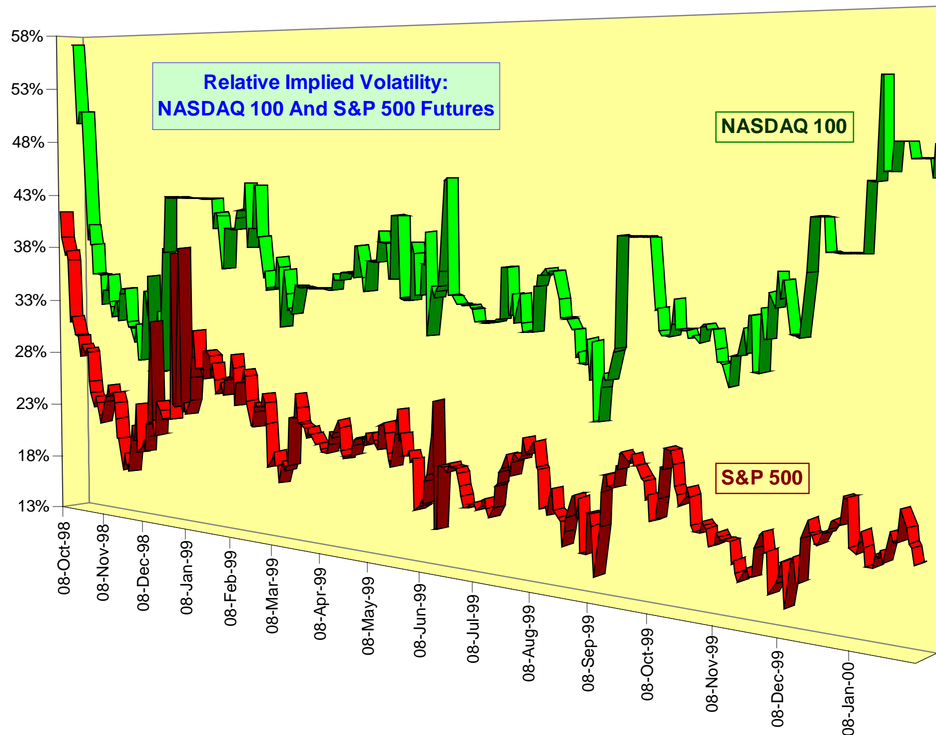
It's one thing to join the New Economy chorus, but it's quite another to demonstrate quantitatively just how different the period since the general market low on October 8, 1988 has been. We can take cash market prices for the S&P 500 index, the NASDAQ 100 index, crude oil, and ten-year note yields and fit a model between September 9, 1988 and October 8, 1998. We can then project the model forward since that date to see how well oil prices, interest rates, and the S&P 500 -- which together could explain 99% of the NASDAQ's variance up to October 19998 -- could account for the NASDAQ's surge.



The answer, in a nutshell, is "not well." Given the rise in bond yields and oil prices over the past year, and the S&P 500's slow growth rate, the model expected a value of 1,740.48 on February 4, 2000. The actual value was 3,874.37, more than twice that level. While the very words and even the thought are considered signs of a top, the data have spoken: It is different this time.

Strap On Your Seat Belts

A major word of caution is in order for prospective NASDAQ 100 futures traders: If you blanch at the high volatility of the S&P 500 future, you'll faint at the sight of the NASDAQ 100 future. You'll also pay more: The initial margin for a NASDAQ future is $31,875, as opposed to $23,438 for the S&P. The higher margin for the NASDAQ future actually fails to reflect completely its higher implied volatility, as seen below.



Implied volatility in S&P 500 futures and options, and on such instruments as the Chicago Board Options Exchange's Volatility Index, (VIX) tends to surge in market downturns and fall in rallies. This is consistent with the fact few people are naturally short stocks; most of us seek to buy protection from lower prices since we are long the market. Recently, however, the NASDAQ 100's volatility has been increasing as it swats away 10% drops like so many mosquitoes. This behavior is far more consistent with that of physical commodities like soybeans or natural gas, where commercial buyers seek protection from higher prices.

Which buyers are panicking for protection? While hard data in the form of a Commitment of Traders Report from the Commodity Futures Trading Commission are not available for the NASDAQ 100 futures, we can surmise hedge funds who have shorted the stratospheric index, mutual funds who need to buy in order to maintain their competitive rank, and market makers who must take the opposite sides of long option trades to be the likely suspects.

Wall Street legend holds a bull market is over when the last bear surrenders. You'll know this will have happened when you seen option volatility decline in the NASDAQ on a rally. Until then, you'll continue to profit on the long side.

[February 6, 2000]