An Extinction At The End Of The Curvaceous?

The late paleontologist Stephen Jay Gould of Harvard University wrote an extraordinary series of essays in *Natural History* on the mechanics of evolutionary biology and on one of his major contributions thereto, the theory of punctuated equilibrium. This theory describes how life regenerates and re-diversifies after a mass extinction such as the disappearance of dinosaurs.

Gould and others observed the best way to survive such unpleasantness is to be small, simple and able to eat anything. Come the next catastrophe, complex organisms highly specialized to unique environmental conditions will disappear, while crud in its various incarnations will diversify and cover the planet.

Financial markets provide similar and much more rapid cycles of extinction and rebirth. Consider the flourishing of the highly specialized and certainly gaudy technology and Internet sectors of the late 1990s. Many of these firms were so specialized and interdependent on each other as supplies and customers that they could not survive any shock to their sector. When the tide pulled out, many were disgusted by what they found lying on the beach.

Mystery Flattening

Policymakers in the U.S. and elsewhere sought to recreate conditions friendly to a rapid economic rebirth after the bubble burst. Whether their intention was to resurrect the technology sector we will never know, but they did create perfect incubator conditions for businesses able to flourish in the environment of a steep yield curve. The lifeblood of all these firms could be traced back to the "carry trade" of borrowing short and lending long in a positively sloped yield curve environment.

The carry trade has been eroding for most of the year as traders correctly anticipated the rise in short-term interest rates. The yield curve's flattening accelerated last week as short-term rates rose in response to the Federal Reserve's rate hike. The curve flattened as well from the long end as these rates fell in response to a number of factors, none of which has been proven to be the culprit. The not-yet-usual suspects include the surge in oil prices, preemptive buying of the long end by mortgage lenders and even by Fannie Mae itself (herself?). Fannie Mae was reputed to be under-hedged against the prospect of rising mortgage prepayments. The list also includes buying of Treasuries against agencies in response to Fannie's troubles and an aversion to risk in the stock market.

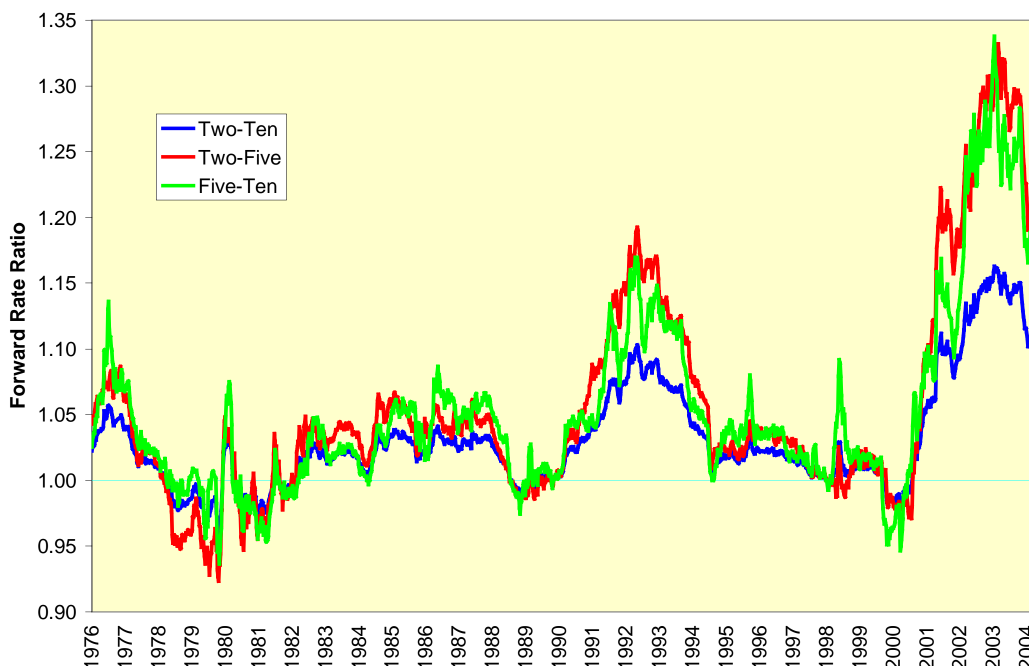
The probability you have identified the reason behind a market move correctly is inversely proportional to the number of causes proposed. Translation: Collectively, we do not have a clue as to why the bullish flattening of the yield curve was so strong last week. Such a move, if taken in a vacuum, would indicate a high likelihood for an impending recession, but that inference is seen nowhere else in any market but crude oil. And, as we shall see shortly, a flattening curve is not inimical to other financial markets.

Not that the risks of such are trivial: I have noted in separate recent columns how the economy as a whole is vulnerable to an oil shock, a Federal Reserve tightening, widening credit spreads, de-leveraging of risky trades in the bond market and higher tax rates. Any one of these taken individually could be negative for stocks; taken collectively, they could be, to extend my opening metaphors, a financial asteroid. And yet stocks are still sitting right in the middle of this year's never-ending trading range.

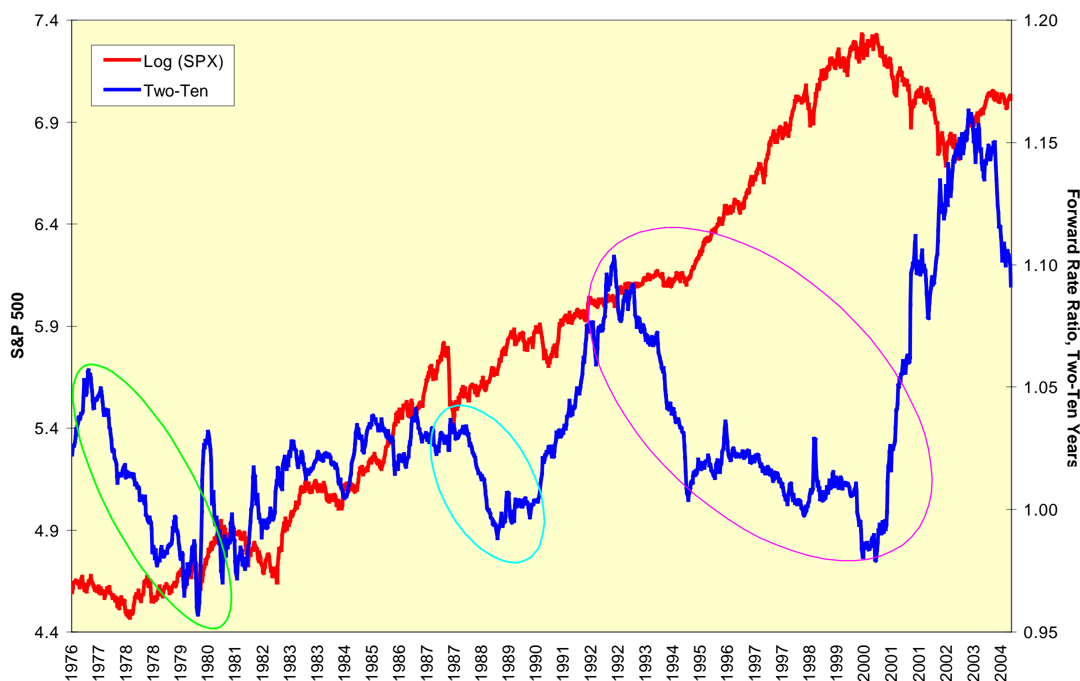
Flat's Where It's At

How rapid has this year's curve flattening been in comparisons to previous episodes, and what were the effects thereof on stocks? We can measure the shape of the yield curve by the ratio of the forward rate, the rate at which you can lock in borrowing today for a period starting in the future, to the horizon rate. This measure is comparable across periods of widely fluctuating interest rates, whereas simple yield differences rise and fall with the level of interest rates at the time. The steeper the yield curve, the more this ratio exceeds 1.00.

The 2001-2003 period is unique in the past thirty years. Whether we look at the forward rate ratios between two and five years, two and ten years or five and ten years, we can see how we are coming off a historic peak. The yield curve inverted - short rates became higher than long rates - during the high and rising rate era of the late 1970s and early 1980s, and again in 1989-1990 and in 2000. No previous period is comparable to the present; the yield curve is now flattening at an extraordinary rate and yet it still remains steep by historic standards and interest rates remain quite low by the standards of the past forty-five years.



Not Necessarily Bad News
Too many commentators conclude without examining the evidence that a flattening yield curve implies a hostile Federal Reserve and a weakening economy, and therefore a weaker stock market. Were it only true: Three times in the past three decades a flattening of the yield curve between two and ten years has accompanied a bull market in equities. The present period is not included in this count.



What can we conclude from all this? If the Federal Reserve does not overdo things and kill the economy through forced de-leveraging of carry trades and a bursting of the real estate market - I hesitate to say "bubble" here - we should be able to do just fine in spite of the flatter curve. If the tide pulls out and uncovers flotsam and jetsam in the fixed income world that would make the various hiccups of 1994 look like a, dare I say, day at the beach, then we will have a problem.