These Still Are Not GDP Futures You Are Trading

As the 2004 election season - or, given the time of publication, the pre-lawsuit phase of the election season - draws to a close, what better time to remind ourselves of the folly of letting facts get in the way of a good story. After all, any fool can look at the data, run all sorts of statistical analyses, interpret the results using accepted principles of economics and draw a reasoned conclusion. Why, then, do so many take the easy way out of simply interpreting the data as they please?

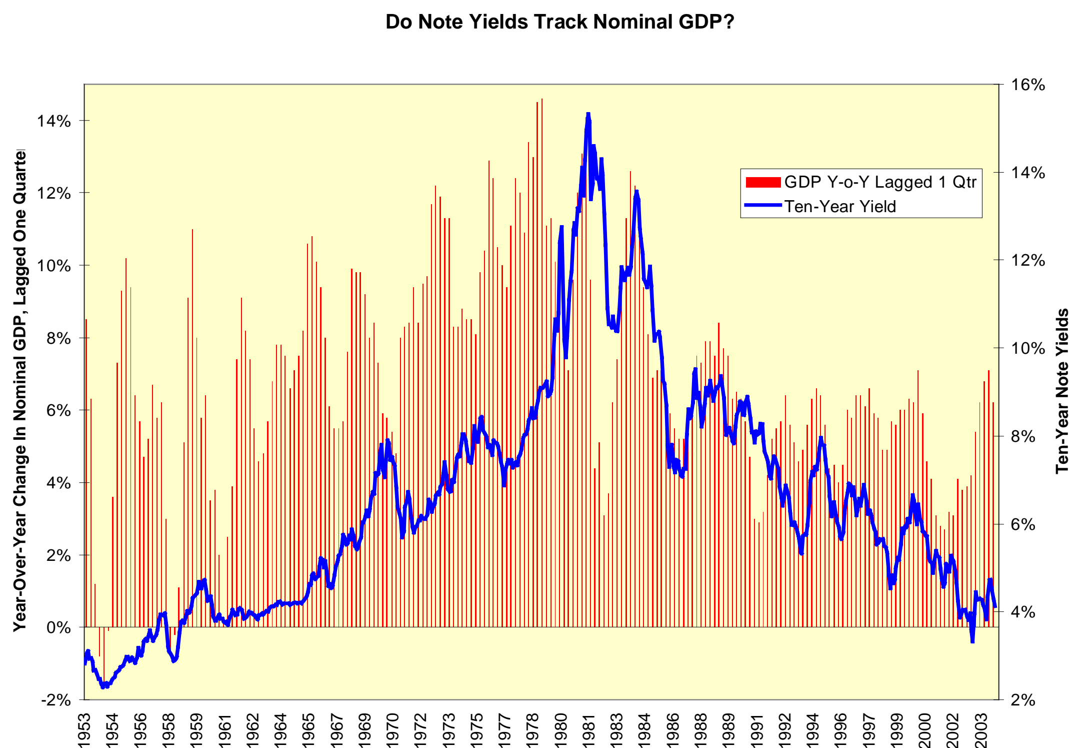
The release last Friday of the preliminary GDP data provide us with another opportunity to test the hypothesis of whether markets "tell us" anything about the future course of the economy. I examined this in a pair of articles in July 2003, the first of which concluded that stocks and GDP were related to each other poorly, and the second of which concluded that measures such as capital investment, inflation and corporate earnings were not very good predictors of stock prices.

Many forms of investment research are based on a chain of causation between the economy, earnings and stock prices. If the conclusions in the articles referenced above are correct, investors and analysts are far better off working from either a bottoms-up, company-by-company approach or a relative value approach.

Notes On Notes

The weaker-than-expected GDP data reported this past Friday raised the question whether the continued drift lower in long-term interest rates is signaling an impending downturn in the economy. Has either this signal or its opposite, higher yields signaling stronger growth, ever worked in the past?

We can compare the yield on ten-year notes and the year-over-year change in current dollar GDP lagged one quarter over the past half-century. Both measures are unadjusted for inflation, which removes the never-ending battle over hedonic adjustments and the like.

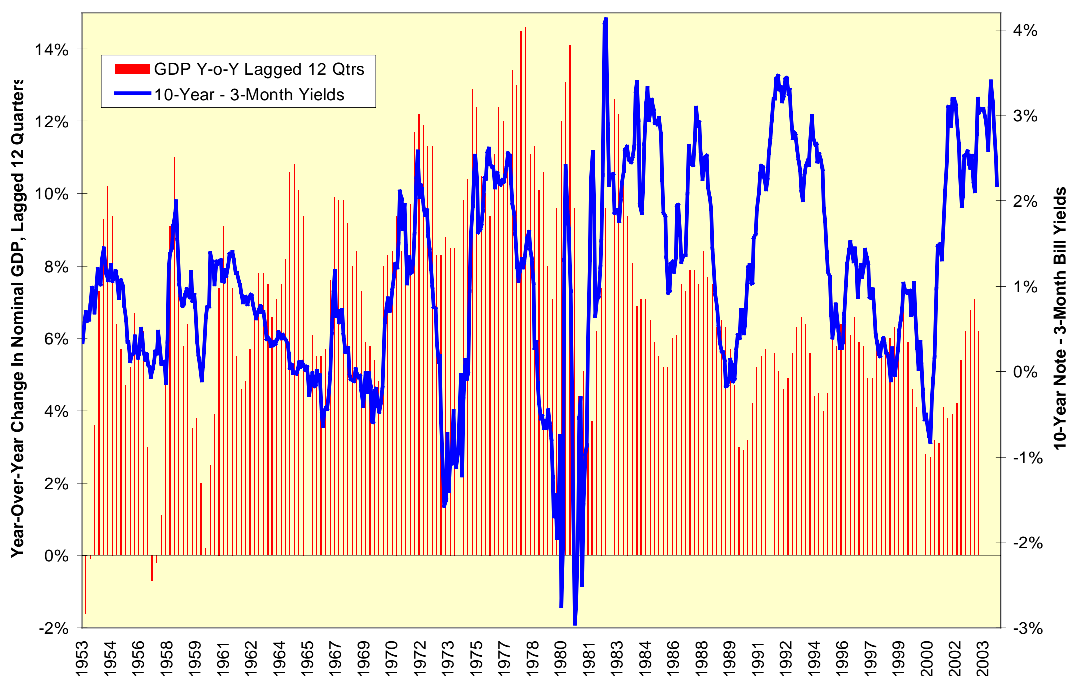


The conclusion is at best inconclusive. Prior to the outbreak of inflation during the 1970s, nominal GDP changes were regularly in excess of note yields. The same relationship has obtained since the early 1990s. The period in which the two variables tracked each other closely overlapped the Federal Reserve chairmanship of Paul Volcker, a man given to abrupt changes in short-term interest rates in response to economic reports.

As an aside, my chief complaint about the Federal Reserve over the years has not been the efficacy of their actions. If you give a group an impossible job to do and fail to equip them with the proper tools, and the fault is yours for assigning the task, not theirs for failing to complete it. No, the problem is and has been the ad hoc nature of the whole process of setting monetary policy. We adopted a Constitution that gave powers to laws and institutions in a system of checks and balances, not to one man or one committee who make decisions by the seats of their pants. Greenspan operates differently than Volcker, who operated differently from Miller, Burns, Martin and so on. The Greenspan era will end by 2006 at the latest; do we know what prize lies in the next box of Cracker Jacks and on what basis he or she will be chosen by whoever is the President?

Long And Variable Lags

Returning to the relationship between interest rates and GDP growth, let's see what happens when we compare lagged GDP growth to the difference between ten-year note and three-month bill yields. This will normalize note yields not so much to inflation as to the risk premium between the long and short ends of the yield curve. Now the relationship changes. The interest rate differential leads year-over-year changes in GDP lagged not by one or two quarters, but rather by twelve quarters. This pays homage to one of the central tenets of monetary policy, that it operates not instantaneously, but rather with long and variable lags.



Low Yields Do Not Mean The End Of The World

The two charts presented above illustrate why we should hesitate to conclude anything negative about the course of the economy. First, the current trend of lower yields has been in place for more than two decades, and as noted here last week, may be destined to go lower for reasons not known yet. Second, nominal GDP growth, either current or lagged has almost no relationship to either the current level or the trend of note yields, and has shown an ability to increase strongly at yield levels at or near current ones. Third, yield levels do not exist in a vacuum; they need to be measured against a yield curve and as the experience of the Volcker years indicates, against interest rate volatility.

Now, what does a glance at the current gap between note and bill yields tell us about the future course of GDP? Almost nothing, really: The current level and trend existed in the early 1990s, a period before the Great Party, but also in the early Carter administration, a period seldom recalled fondly.

As the astute economist and philosopher Tom Petty once noted, "waiting is the hardest part." True then, true today. We are waiting on events, some of which may be set in motion by the outcome of today's election, some of which may originate in China, some from elsewhere. Today's markets are predicting none of these events; that is not their job.