Get Ready For A Recovery

With apologies to Rare Earth…

I never owned a stock that makes me feel the way that you do
You're all right
Whenever I'm asked what makes forecasts real, I say that you do
You're out of sight
So fee fi, fo fo fo fum
Look out bond yields, 'cause here they come
Ocean freight rates, they are so true
Get ready, 'cause here they come

To turn an old Wall Street adage on its head, money walks, ship talks. Or something similar: Economic indicators such as freight rates, tanker rates and other transportation tariffs are so useful because they are wholly devoid of speculative content. No one will book an ocean freighter on a hunch, and that cannot be said for much of market analysis.

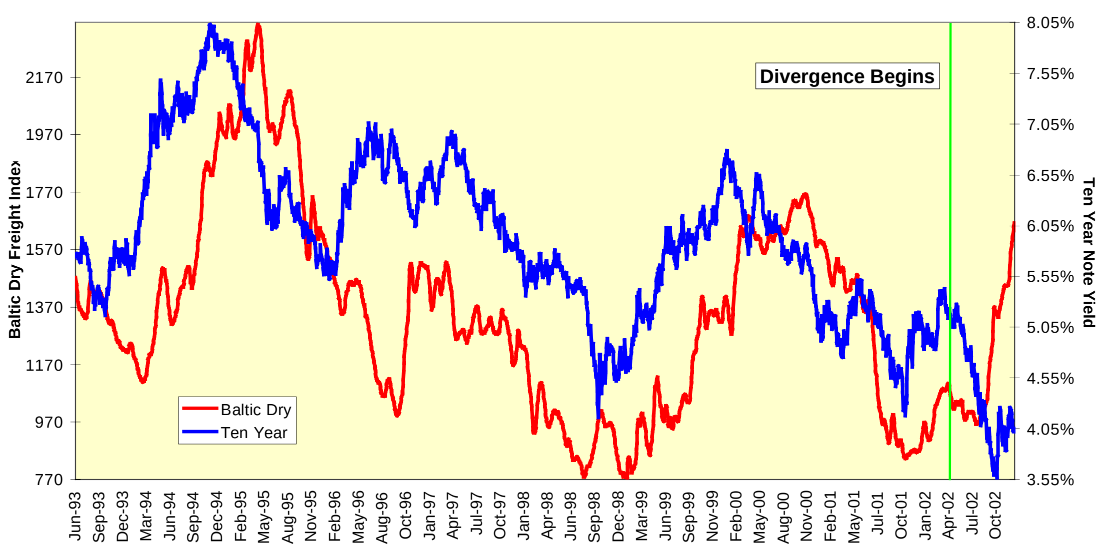
While macroeconomic data as reported by the government and various industry groups continues to paint a mixed picture at best, ocean freight rates as represented by the Baltic dry freight index, a topic visited on this page before, have been rising sharply since August. This index is available on Bloomberg as BDIY Index, or you can register at the [Baltic Exchange Web site].

The Freight/Rate Spread

Bond traders always are surprised at how often their market gets it right. While the stock market is supposed to be more forward looking, I will beg to differ. As too many of us have found out the hard way, stock investors will chase a dream past the point of silliness, but bond traders have to be more circumspect. After all, their goals more often are current income and capital preservation as opposed to growth, and oftentimes their upside is limited simply to getting their money back.

With one notable exception, the present, note yields have done a remarkable job of leading changes in the BDIY over the past decade.

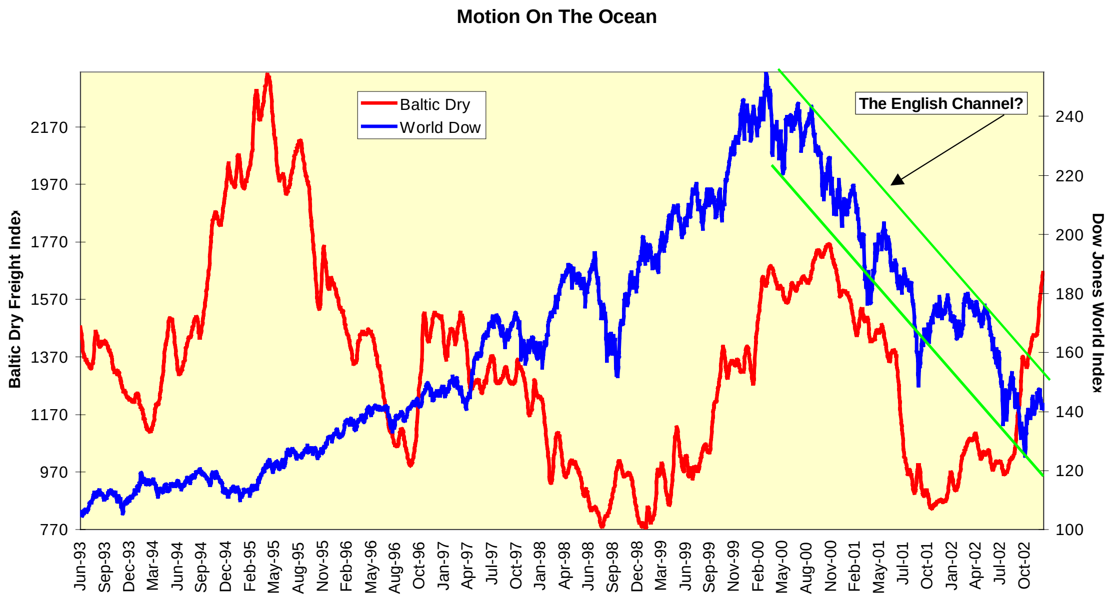
The Great Note-Boat Divergence of 2002



The present situation, one in which the BDIY is shooting higher without note yields having moved higher first, is unique. It suggests that in the absence of an external force note yields should have been moving higher months ago. Implicit in this observation is the risk of bond yields shooting higher at the first sign of this force's demise.

How Now, World Dow?

The obvious candidate for the external force is the global equity market. It is linked both to the safety premium in bonds and (allegedly) to the overall level of global macroeconomic activity. Let's compare how the BDIY and Dow Jones' world stock market index have tracked each other over the past decade.



The answer is surprisingly poorly. The BDIY's abrupt move higher in 1994 and early 1995, a period highlighted by the Fed's seven rate hikes, a bond market massacre and the first and only economic "soft landing" in recorded history, saw no real advance in the World Dow. Of course, those rising interest rates had something to do with it: The fact that equities went nowhere during a period of rising rates had to mean that expected earnings were rising just as quickly. The old run-faster-to-stay-in-place routine.

Ships And Chips

The BDIY dropped fairly rapidly from mid-1995 to late 1996, a period coinciding with the takeoff of the late 1990s mega-bull market. The world's central banks, led by the oh-so-brilliant Bank of Japan and our very own Federal Reserve, were pumping out liquidity. This led to financial inflation without a corresponding surge in ocean freight demands. The real growth was in information technology and telecommunications, and you can ship a byte on a beam of light.

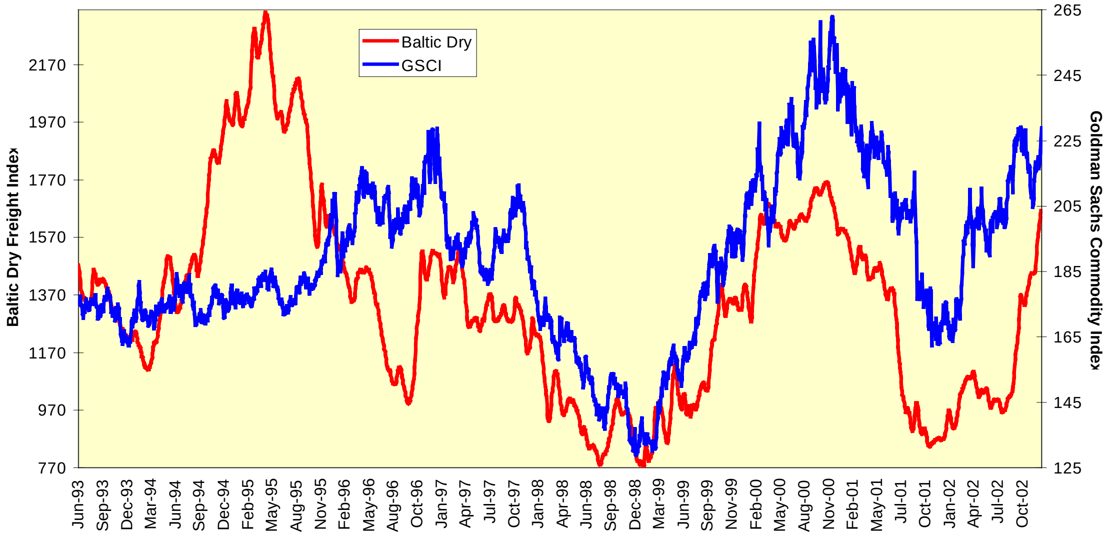
It was not until the eventual resolution of the various Asian/Russian/Brazilian/Clinton crises that the BDIY moved higher in pace with the world's stock markets. The BDIY started to fall in late 2000, just after the last attempt to recover from the bursting of the bubble in the spring of that year.

The BDIY's present (irrational?) exuberance has not been mirrored yet in the world's stock markets. After all, we have been getting pounded for close to three years at this point, and it is certainly reasonable to expect skepticism on the part of depleted investors. But before we attribute the lack of confirmation of the BDIY's rise by both stocks and bonds to fear itself, we should look for at least something that confirms the BDIY.

What Sayeth Commodities?

That confirming something would be the Goldman Sachs commodity index (GSCI). This index is the most heavily weighted toward energy of the four principal commodity indices, and therefore is subject to various seasonal and cartel distortions, but its strong correlation to the BDIY since 1997 is telling.

Commodities Are Sailing Higher



Both of these indices are sailing higher at the moment, and neither could do so in the absence of strong industrial demand somewhere in the world. The strong commodity performance also stands as one of the few compelling arguments against deflation at the moment.

So let's wrap all of this up as we get ready to kiss the tail end of 2002 goodbye and good riddance. The Fed and other central banks have been pouring money into the system, to little avail. Bond yields have plunged, economic activity is perceived as soft, war fears abound, everyone's boss is in the slammer and Michael Jackson is still loose upon the land.

The whole situation reminds me of trying to start a charcoal barbecue by squirting on ever-greater quantities of lighter fluid. At some point the economy will ignite and profits will abound. Money will flow abruptly from bonds to stocks, and the Fed will start to mop up liquidity in response. We'll enjoy a few strong quarters, maybe a year, in stocks before the party cools off.

Oh, here's another bold prediction while I'm at it: Greenspan will resign near the rally's top, accept congratulations all around, and leave his successor with the cleanup chores. You did hear it here first.