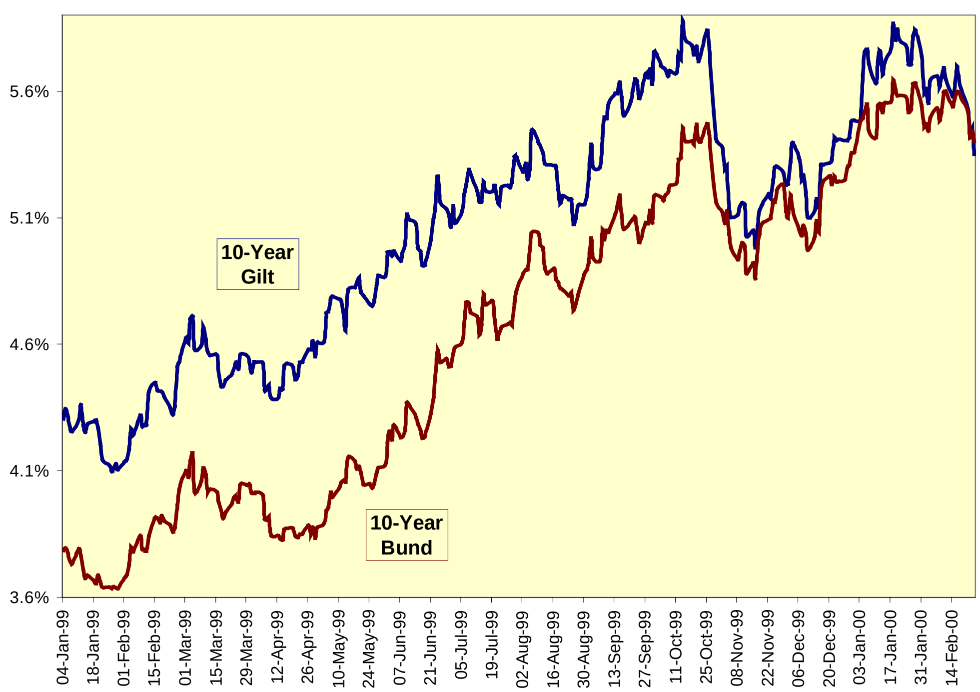
Convergence/Divergence: A Real Gilt Trip

Stocks and bonds don't always move together, and our recent experience with the NASDAQ divergence from other indices tells us stocks and stocks don't always move together, either. That's not only true here, but it is true in Europe now as well.

Too much bond buying now is of the white-knuckle variety, which is a shame as bonds have an important role in everyone's asset allocation mix. This "flight to quality" response -- and does this imply we flee from quality given the chance? -- shows up throughout the world of fixed income. When the going gets tough, the tough sell anything with risk and buy Treasuries.

If we look across the Atlantic, which would require an exceptionally clear day, we also find investors buying British government bonds, or Gilts, against German Bunds. This is a stark reversal of recent European history; for most of the past quarter-century, the Deutsche mark and Swiss franc, along with German Bunds were the repositories of scared money in Europe. The introduction of the euro has changed a lot of old habits, however (see "A Tale of Twelve Cities," January 12, 2000).

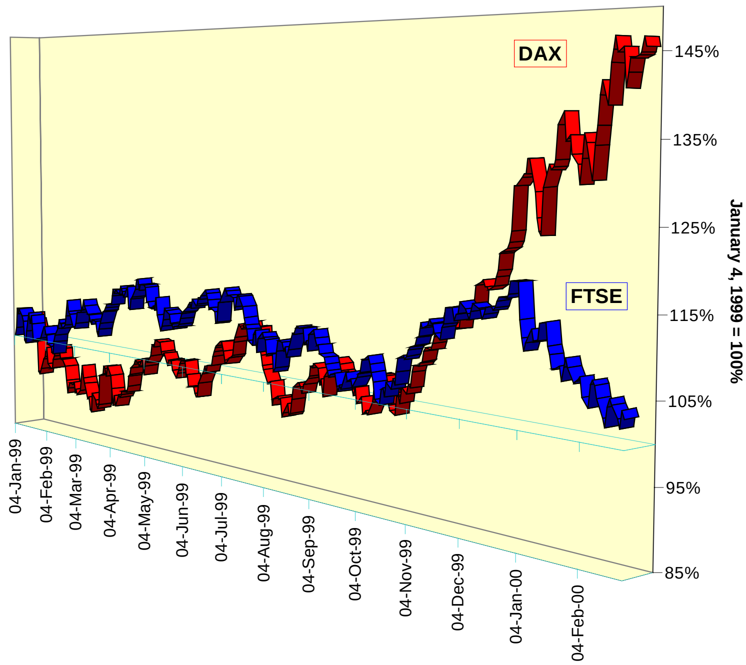
British And German 10-Year Government Yields



All Right, Don't Sink The Bismarck!
At the same time the Gilts and the British pound (GBP) are performing well relative to the Bunds and euro (EUR), we find the German DAX, the principal stock index, doing quite well relative to the British FTSE index. The divergence between the two indices is not quite as extreme as the American divergence between the NASDAQ and either the Dow Industrial or S&P 500, but it is still quite pronounced, and is rather confounding given the currency and interest rate environment.

The four strongest performers in the DAX so far during 2000 have been Epcos, an electronic components manufacturer, SAP, the enterprise software giant, Siemens, another electronics firm, and Deutsche Telekom. The FTSE, not to be outdone in the technology department, has been led by Logica, a computer service and software firm, Cable & Wireless, a telecommunications giant, CMG, a consulting firm, Reuters, Telewest Communications, and Carlton Communications. Since technology stocks are the hot performers worldwide, and since these issues are to be found in abundance in the FTSE, why is there such a divergence between the DAX, up 8.23% in dollar terms at the time of this writing, and the FTSE, down 13.19% in dollar terms so far in 2000?

Relative Movement: German & British Stock Indices



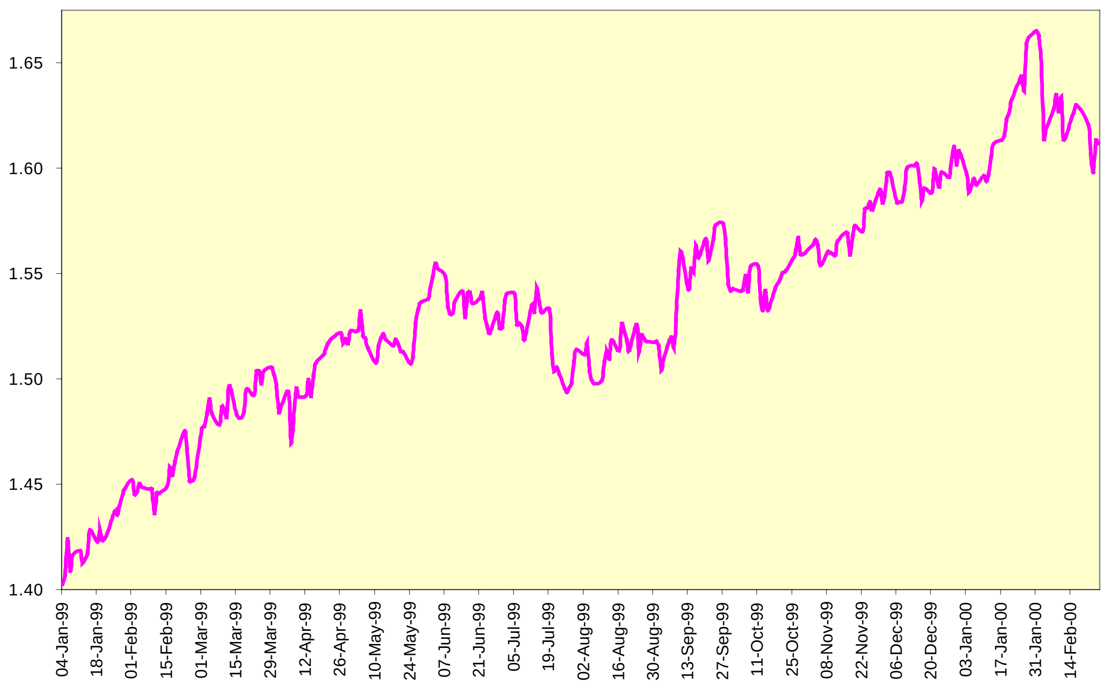
The answer, as we have seen so many times before, is weights. The DAX has 30 members, with the four leading technology-related stocks mentioned above accounting for 43.104% of the index. The FTSE 100, with its 101 stocks, (and remember, these people assembled a pretty decent empire in their day) has a much more diverse distribution with only Vodafone Airtouch, at 15.38%, accounting for a disproportionate share.

Moreover, the FTSE has a much greater representation of financial stocks than does the DAX, and the financials aren't doing any better over there than they are here. FTSE laggards include insurance companies such as Lloyds and Sun Life, and banks such as Abbey National and Royal Bank of Scotland. DAX laggards include auto manufacturers Volkswagen and Daimler-Chrysler, heavy manufacturers such as Thyssenkrupp, and Adidas, the sporting goods and apparel firm. In the event of a role reversal between the DAX and FTSE, guess which group of laggards will respond better in a slowing economy to a relative relaxation of monetary policy?

Bank of England To The Rescue?

The rally in the Gilts, the strength of the GBP, and the weakness of the financial sector in the FTSE all stand as evidence of an overly-restrictive monetary policy and unnecessary economic weakness in the U.K. We opined in "A Tale of Twelve Cities" that the European Central Bank might start to feel some heat over the soft EUR, and indeed, the ECB raised rates by 25 basis points on Feb. 3, with a Fed-like warning of further potential increases. The upward rate path in Euroland is unlikely to be matched in the U.K., leading to a further softening in the GBP/EUR cross, as seen below.

British Pounds Per Euro



These diverging policy paths and converging note yields are ringing the bell for the complex macroeconomic trade noted last month: Buying the EUR/selling the GBP, and buying the FTSE/selling the DAX. We can add to this a trade of selling the Gilts and buying the Bunds. The signal for launching these trades will be a policy announcement from the BOE regarding interest rate harmonization with the rest of Europe.