Flatten Down The Hatches

"Insanity: Doing the same thing over and over again and expecting different results." – Albert Einstein

A rigorous and literal interpretation of Einstein's definition might classify all practitioners of monetary policy as mentally defective. Whether they recognize it or not, policymakers always are pushing on a string, to adopt the phrase first developed in the late 1930's to describe what the "liquidity trap," or inability of low interest rates to stimulate demand in an excess-capacity environment.

Three behavioral adaptations make this so. The first is the inability of central bankers to direct investment into what they may feel are the best alternatives. Did the Federal Reserve intend for so much investment to be directed into real estate, regardless of whether you consider this to be a bubble? Or, for that matter, did they intend to stimulate consumption in the United States and forget this selfsame spending spree would be satisfied not by the output of American, but rather of Chinese, producers? In both cases, I presume the answer to be "no," but cannot prove it.

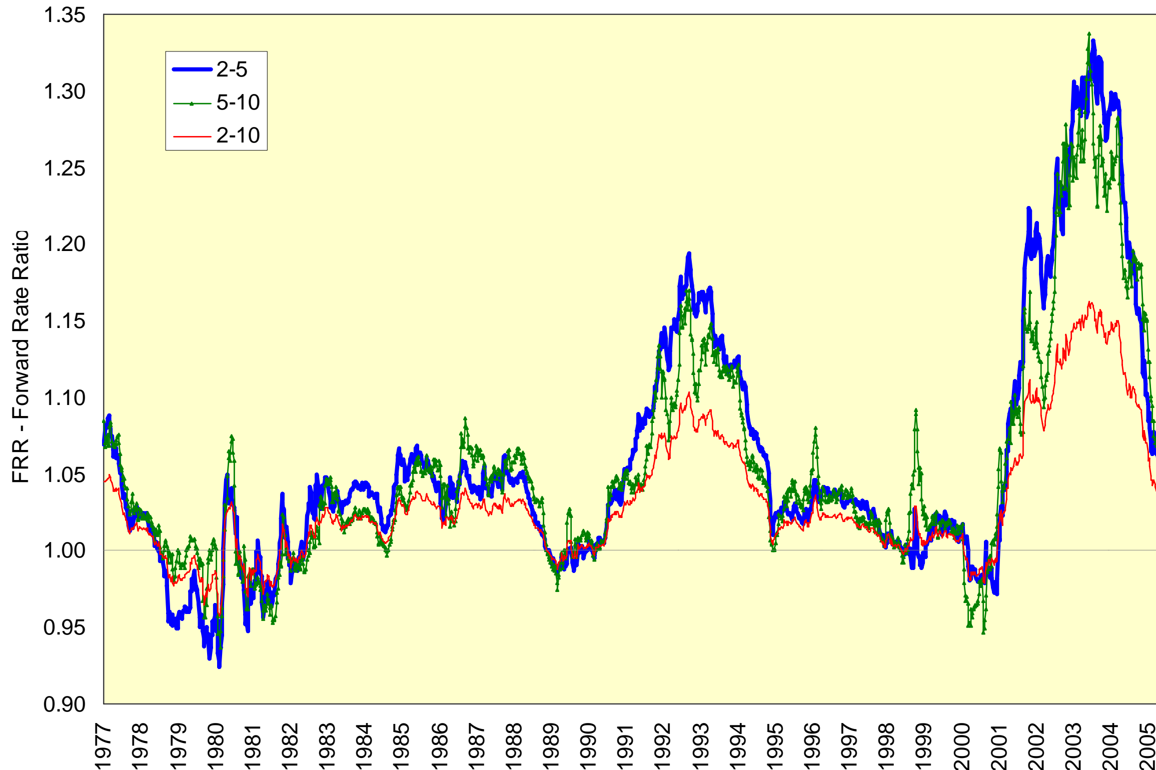
The second trump card held by the market is the exchange rate. As I noted here all the way back in January 2001 in an article about what to expect from rate cuts, the exchange rate of the dollar is at least as important as interest rates themselves as a transmission mechanism for monetary policy. The dollar's persistent strength into mid-2002 was one reason why the Federal Reserve's rate cuts took so long to stimulate the economy.

The third and perhaps most important weapon we have against our monetary masters is the yield curve. Just as the dollar remained strong into 2002, long-term interest rates, the determinants of capital spending and investment, remained stubbornly high into mid-2002. Once both long rates and the dollar weakened in mid-2002, the bear market in stocks started to bottom.

The Economy As A Broken Car

Have you ever had a car, preferably one made by manufacturer with investment-grade bonds, go haywire on you? Say you stepped on the brakes and the windshield wipers started flapping away and the turn signal began blinking. This is how Alan "Conundrum" Greenspan must feel. The Federal Reserve's efforts to de-leverage the economy and (possibly) quell real estate speculation through higher interest rates have succeeded only in flattening the yield curve.

Let's revisit a topic from last September and February on the consequences of a flatter yield curve and see which industry groups are positioned to be helped or hurt by a continued flattening. First, the observation made at those times that the then-historic flattening of the yield curve could continue proved correct. The forward rate ratio, which measures the rate at which you can lock borrowing in for a period of time starting at some date in the future divided by the rate at the ending date of that borrowing period, remains greater than 1.00 at each of the three segments – 2-5 years, 2-10 years and 5-10 years - displayed below.

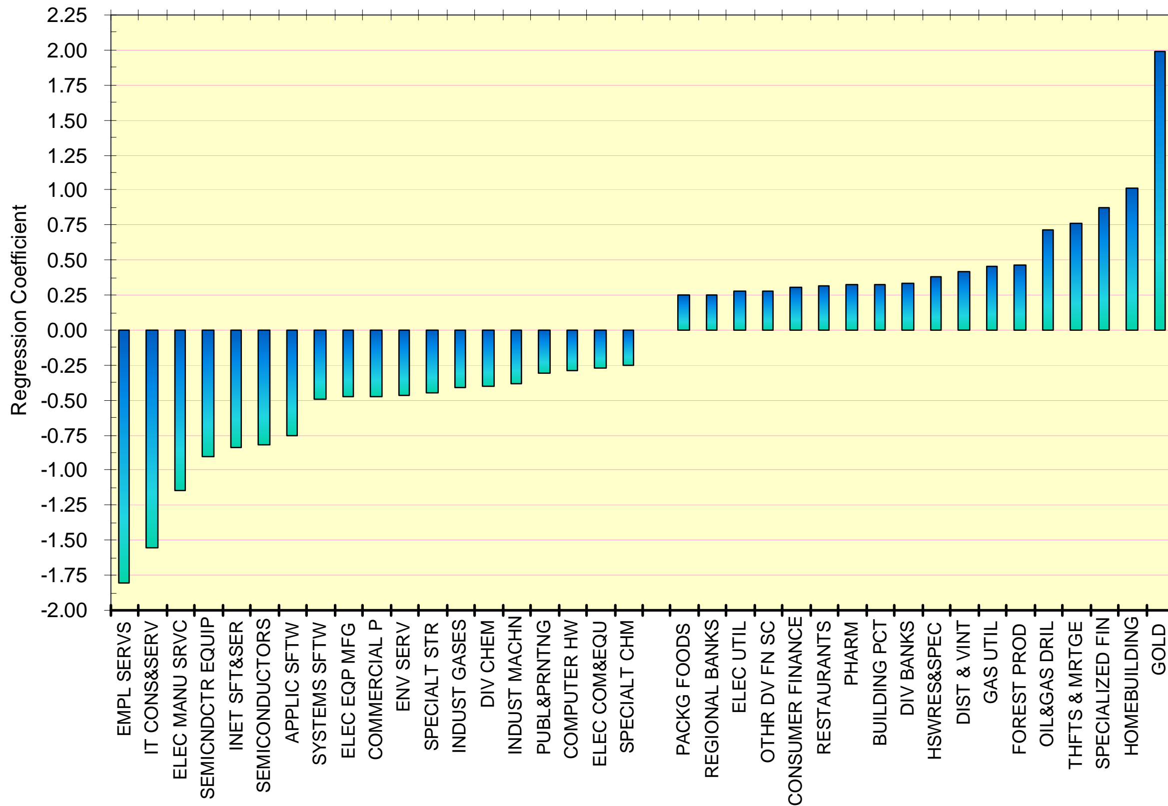


The long-term history of the yield curve flattenings indicates they end in inversion, a forward rate ratio less than 1.00. The end of inversions tends to come during periods of economic and financial stress; the present indigestion in the corporate bond market hardly qualifies as major stress. The Federal Reserve, as is its wont, will keep on tightening until someone dies.

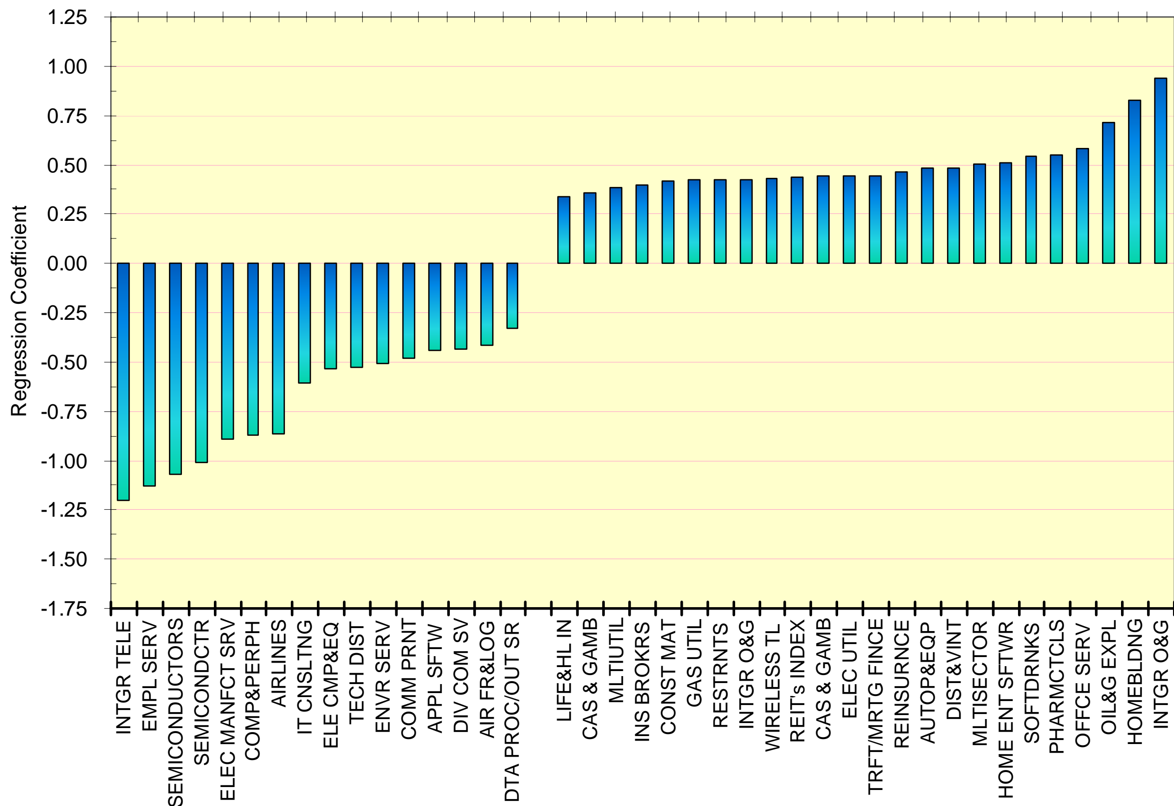
Winners And Losers

Let's quantify using a methodology first introduced here in February which groups are affected most by changes in the yield curve. Each of the three charts below depicts industry groups within the S&P 500, mid-cap 400, and small-cap 600 indices whose betas, or relative volatilities, to the forward-rate ratio between two- and ten-years is statistically significant at the 90% confidence level. The upward-pointing bars on the right side of the charts are groups expected to benefit from a reversal back to a steeper yield curve; the downward-pointing bars on the left side of the charts are groups expected to benefit from a continued flattening of the curve.

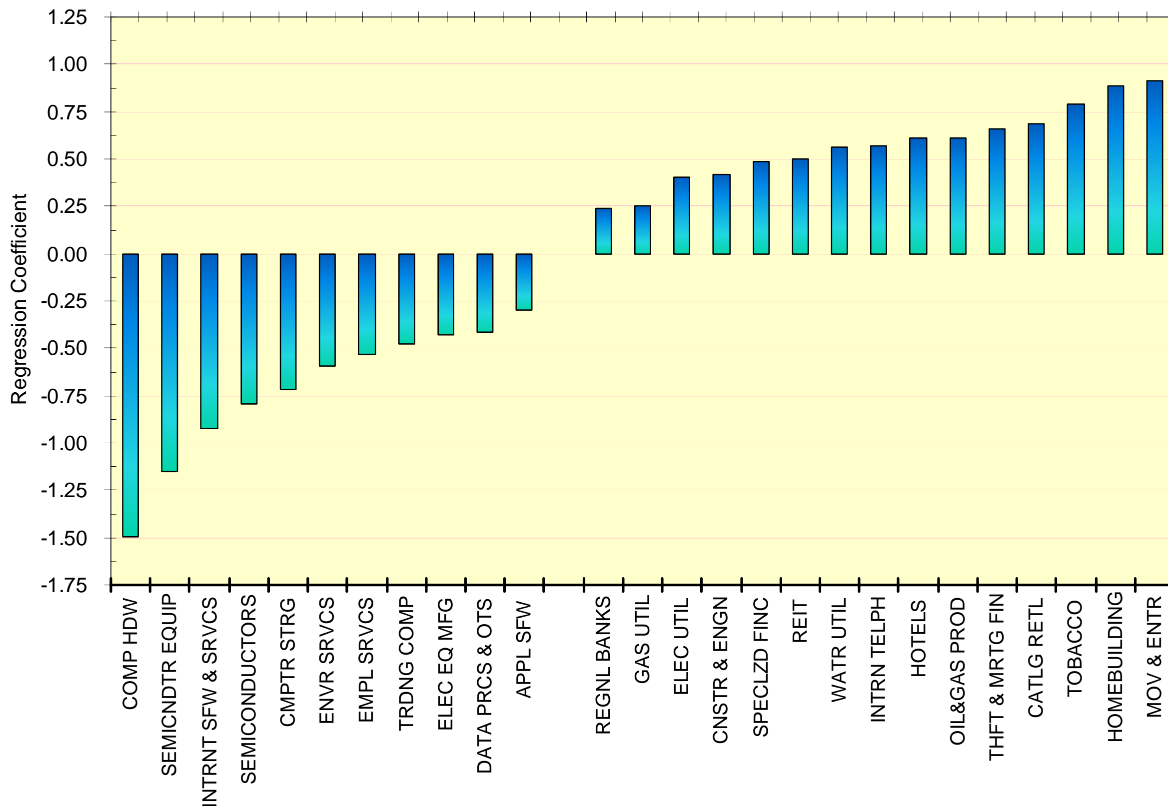
Within the S&P 500, the groups benefiting from a flatter curve are concentrated in technology: IT Consulting, Electronic Manufacturing Services, Semiconductors, Internet Software, Application Software, etc. The victims include Thrifts & Mortgages, Specialized Finance, Homebuilders and Gold.



The distribution of winners and losers within the S&P 400 is similar: The technology groups are the winners. The losers include Oil & Gas Exploration, Integrated Oil & Gas, Pharmaceuticals, Soft Drinks, Office Services along with Homebuilding.



Finally, the same pattern is visible in the S&P 600: Winners are in the technology groups, while losers are in Movies & Entertainment, Homebuilding, Tobacco, Catalog Retail, Thrifts & Mortgages and Oil & Gas Production.



The dominance of the technology groups in the Winner's Circle can be attributed to their low debt ratios and to the simple fact that yield curves tend to flatten in the same economic environment conducive to business capital expenditures. The susceptibility of smaller energy firms reflects their reliance on debt financing, including bank financing. It is interesting to note how the same buy technology / sell energy conclusion reached here three weeks ago in reference to the impact of the yen-euro cross-rate trade shows up here in the yield curve trade.

If we are looking for when the yield curve flattening will cease, let's look to when the energy and real estate sectors die. This happened in the early 1980s. The Federal Reserve would not do the same thing again and expect different results, would it?