We've Lost That Bullish Feeling

Editor's Note: It's that time of year again, when we delve into statistical mischief and feats of deftly derived data-driven daring-do for a light-hearted look at technical analysis. The dates and numbers are real; the conclusions are another matter altogether.

The year 2000 got off on the right foot. The infamous and quickly forgotten Y2K bug deflected management attention from the important work of granting itself stock options and golden parachutes. While much of the world foolishly spent hundreds of billions of dollars in computer-related expenditures, the Russians solved the problem efficiently and elegantly: Hope nothing happens, and maybe you'll be right.

After the right foot came down, the left foot was careless where it stepped, and things went downhill in a hurry. Technology investors discovered the consequences of pushing the NASDAQ Composite up to a P/E of 400 by its March 10 high. The woebegone euro played havoc with the repatriated earnings of multinational corporations. The Fed pushed the funds rate up to damaging levels. And the U.S., in accordance with its Constitution but in what turned out to be its better judgment, decided to have a presidential election. To top things off, the price of natural gas increased by 150% from the end of 1999, and the crude oil prices regularly hit post Persian Gulf War highs.

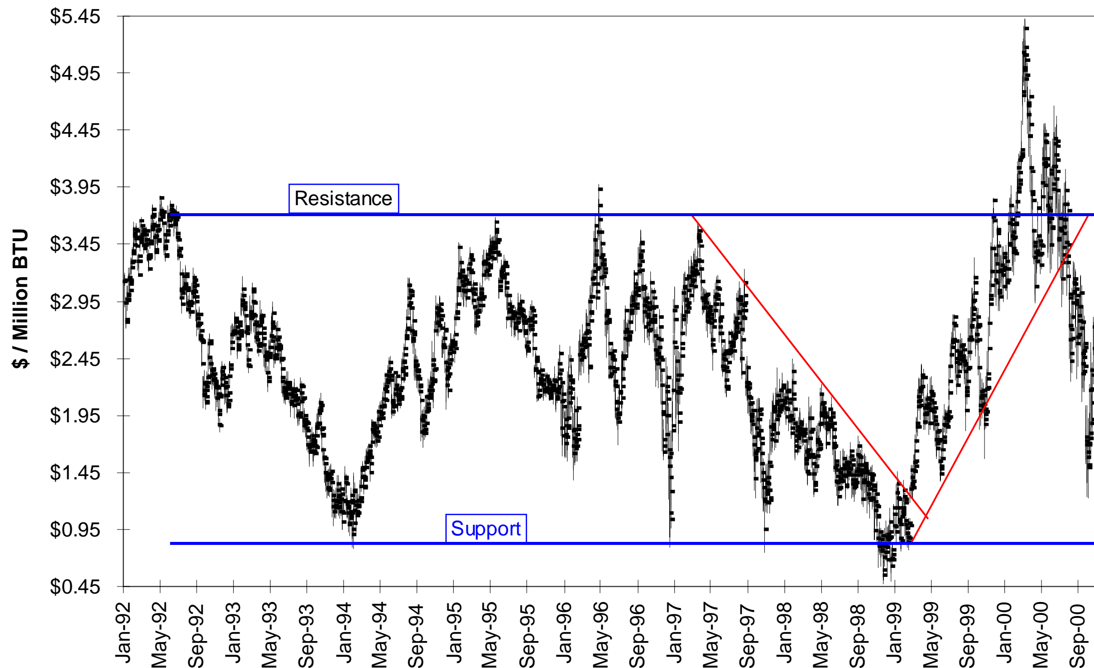
We're in trouble folks, so let's take a look at the energy situation and revisit our old favorite, the oats/notes spread to see what it's telling us. Then we can turn our hopeful eyes to the winner of the 2000 Abby Award - the most prestigious prize in economics that doesn't require you to shake hands with the King of Sweden - to see how we're going to get out of this mess.

That Darn Energy Crisis

The 1970s energy crisis was so long and painful because we as a society assigned the wrong people to solve the problem. Let's not make the same mistake twice. Shove the scientists and engineers to one side and let the market technicians take a crack. And what better place to start than the spread between unleaded gasoline (HU) and natural gas (NG)?

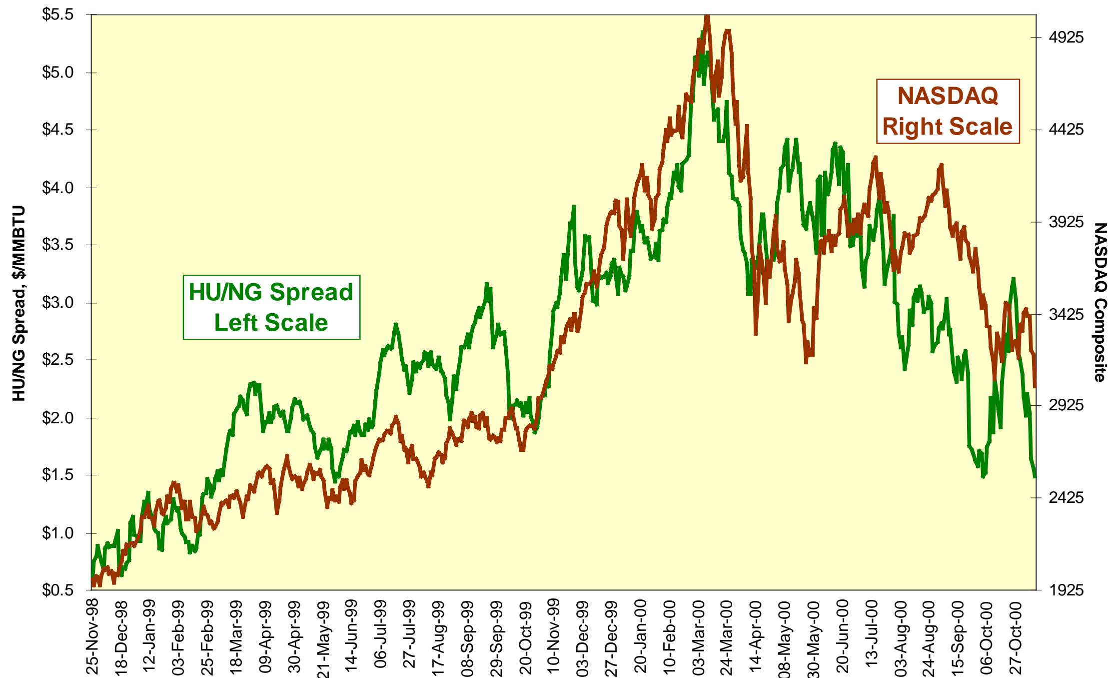
First, let's dispel the notion that there's no economic logic behind the HU/NG spread. The primary use for gasoline is motor fuel, and compressed natural gas can be used to power vehicles. Does anyone doubt a clever automotive engineer's capability to design and manufacture a dual-fuel HU/NG-mobile? Second, gasoline prices can be converted from the familiar cents per gallon to dollars per million BTU by multiplying it by .0799. Third, and most important, electric utilities and heavy industrial users make substitution decisions between residual fuel oil and natural gas all the time. A drop in crude oil prices, and residual fuel oil is correlated quite closely to crude oil, will increase oil demand at natural gas' expense, and vice versa.

The HU/NG Spread: Dangling At The Margins



Finally, and experienced market analysts know it always comes down to this, the charts tell you there's a relationship. Clear horizontal support and resistance exists at $0.90 and $3.70. The support level was violated in the fall of 1998; the HU/NG spread reached its all-time low of $0.469 on November 25, 1998, a scant week after the Fed's third and final rate cut in the aftermath of the Russian financial meltdown. The HU/NG spread then embarked on a massive rally culminating in an all-time high of $5.431 on March 8, 2000, a mere two days before the NASDAQ's peak. Since that time, both the HU/NG and the NASDAQ have fallen precipitously.

Coincidence and spurious correlation, you say? Well, the burden of proof is on you, and good luck. The chart below depicts the strikingly parallel paths of the NASDAQ and the HU/NG spread since November 25, 1998.



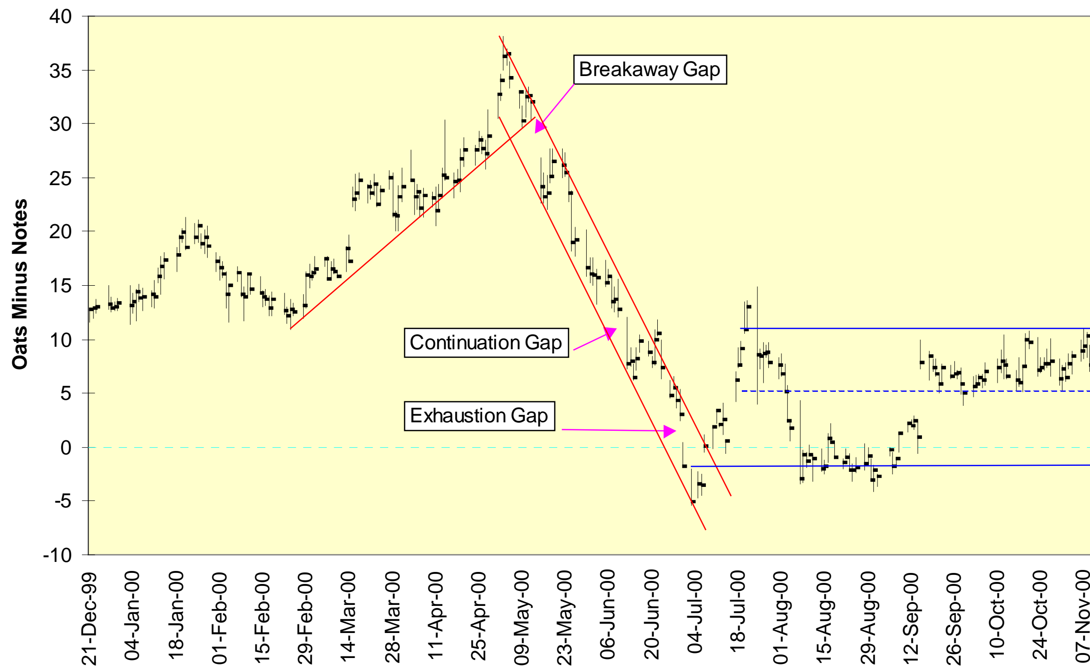
At the mid-November time of this writing, the HU/NG is still pointed lower. The implications for the NASDAQ and its still-lofty P/E of 121 are not encouraging, to say the least. Over the long-term, there's even more cause for concern. A structural change in the electrical utility industry has made natural gas the marginal fuel of choice. This produced 2000's record price levels for natural gas and kept the HU/NG under major pressure. The situation for 2001 does not look much better unless we either 1) stop using electricity, or 2) find a few natural gas fields quickly.

Oats/Notes: The Magical Mystery Spread

In each January article since 1997, we have awakened the world to the forecasting properties of the oats/notes spread (see "A Modest Proposal," *Futures*, January 1997, "Hedgers Don't Wear Chains," *Futures*, January 1998, "As Goes January," *Futures*, January 1999, and "If You're Reading This, It Didn't Happen," *Futures*, January 2000).

For those of you wondering whether the oats/notes spread still has what it takes, fret not. An oats/notes chart for 2000 still has all of the channel lines, gaps, congestion zones, and intermediate horizontal support lines we might expect for an actual underlying price series.

The Oats/Notes Spread: The Last Piece Of The Puzzle



The most prominent feature on this chart is the strong downward channel with three gaps in mid-year. This channel corresponded to the stock market's recovery from the March-April selloff. The oats/note spread again fell during the August rally, only to rise toward horizontal resistance during the fall decline. With oats prices still skittering along near two-decade lows, the prospects for a jump in the oats/notes spread, a breakout into a major bull market, appear better than ever. Given the generally inverse relationship between oats/notes and the stock market, however, this is cause for concern for most investors.

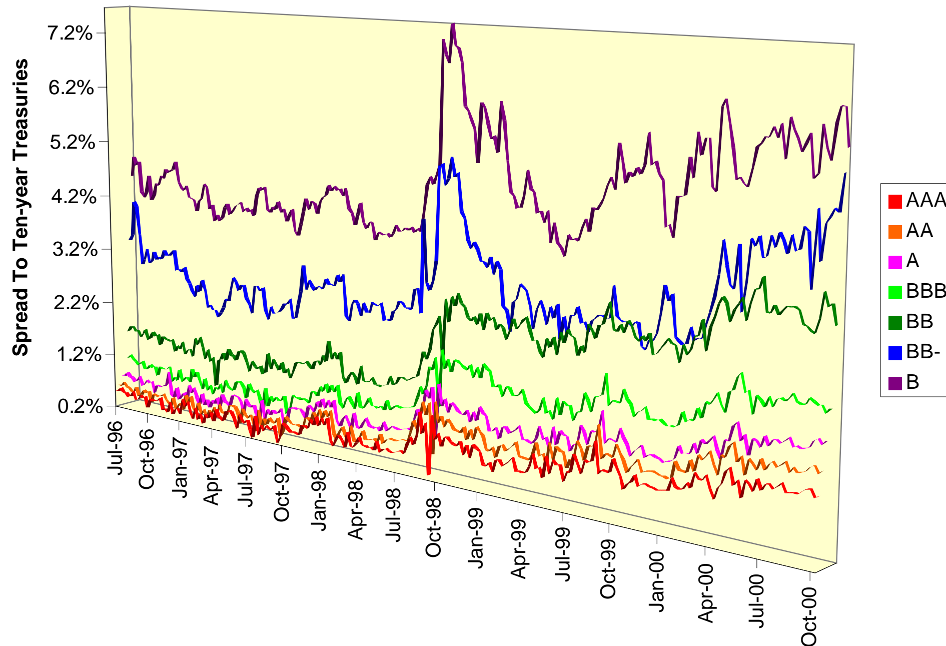
The 21st Century Abby

Market forecasting and analysis are more art than science, no doubt to the relief of proud scientists everywhere. What can we say when a newcomer to the business, a student of your loyal correspondent, emerges from the pack to make, week after week, outstanding calls on the market? About a man who feels "commodities are a lot cleaner than stocks?" About an analyst who sailed the treacherous seas of the yield curve between the Scylla of the Fed and the Charybdis of flights to quality, nautical features not to be found anywhere near his suburban Chicago home?

Congratulations to Chris Costakis, who joins this author and Ron McEwan as winners of the coveted Abby Award for fearless forecasting and perspicacious prognostication. His name will be written in virtual invisible ink on the handsome and still non-existent statuette, complete with its famous Broken Clock and Druid inscriptions.

What's Chris' latest forecast? A steepening of the yield curve; the Fed, he believes, will be forced to drive short-term rates lower in response to a weakening economy. Since long-term rates have fallen already from the combined effects of the Treasury's bond buyback and slowing credit demands, Chris' focus remains on going long the short end without going short the long end. In addition, he thinks it's time to load up on some high-quality corporate bonds, and let's see why.

Rising Credit Spreads For Corporate Bonds



When the Fed executed its aforementioned rate cut in November 1998, it cited rising corporate bond spreads as a justification for its action. These very same credit spreads are as high or higher now than they were in November 1998, especially for the weaker BB- and B credits. Should it surprise us that investors have been less willing to take risk on equities when they also have been less willing to take risk on bonds?

A scary moment in market history: The HU/NG spread, the oats/notes, spread, and the credit spreads all are flashing red. Let's hope the 2001 Abby is awarded under better conditions. And, to paraphrase Benjamin Franklin, if we're not HU/NG together, then surely we will be HU/NG separately.