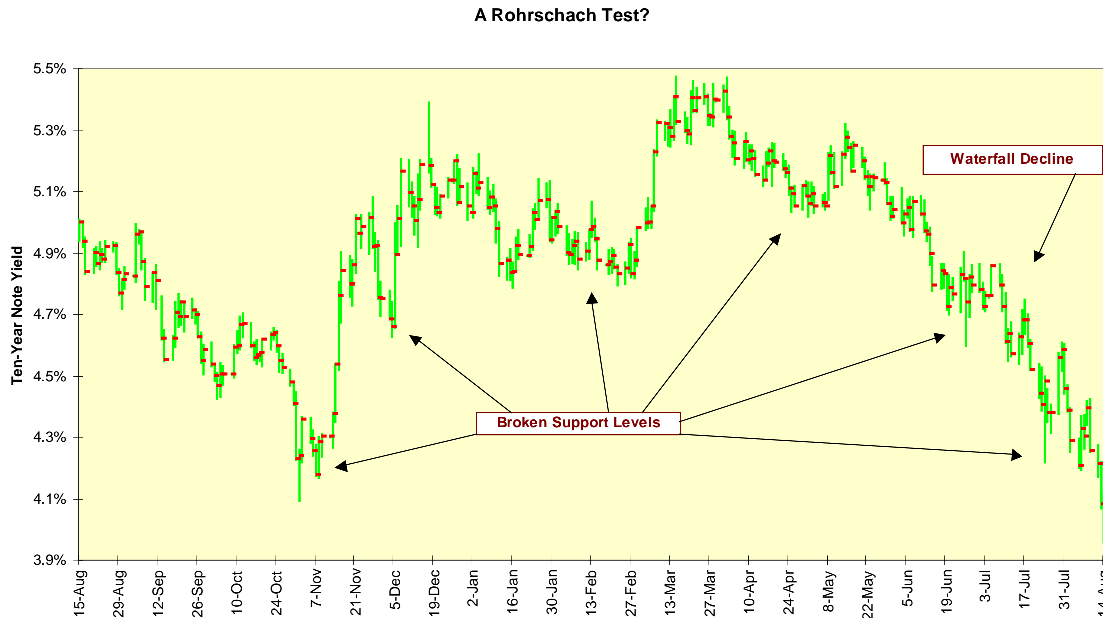
Not Your Father's Intermarket Analysis

"Say not, 'I have found the truth,' but rather 'I have found a truth.'" - Khalil Gibran

A passerby the old quote screen took a glance at a chart and exclaimed in a loosely translated manner for all to hear, "That looks like Shinola!" Well, the joke was on him: The eyesore was not a stock, it was the yield on ten-year notes over the past year, and it certainly does look like the familiar look-out-below pattern characteristic of too many stocks.



The Bull In Bull Market
The twentieth anniversary of the Great Bull Market arrived this past Monday, August 12th. Lost in the spectacular stock rally of 1982-2000 is the fact that it started out as a bond rally that carried stocks along for the ride well into 1986. After all, bond yields were in excess of 16% in the early 1980s, and I still love to see the looks on students' faces when I tell them about 14.5% money market rates. The daily trading pattern of stocks frequently depended on how bonds closed; most of the last-hour rallies in stocks occurred only after a strong close in bond futures.

More important than ancient history, however, is the consistency of all this with standard financial theory. The fundamental value of a stock is alleged to be the discounted stream of future dividends, and the presence of interest rates in the denominator of this fraction argues strongly for lower interest rates being an unalloyed benefit to equities.

However, we have been training a generation of traders to believe that stocks and bonds move inversely to one another, that bonds only catch a bid in price and a drop in the above-charted yield when stocks are being taken out and shot. To say this would surprise traders of only fifteen years ago would be a mild understatement.

Murphy's Laws
The estimable John Murphy noted the following relationships, among others, in his 1991 *Intermarket Technical Analysis* (page 9, original italics):

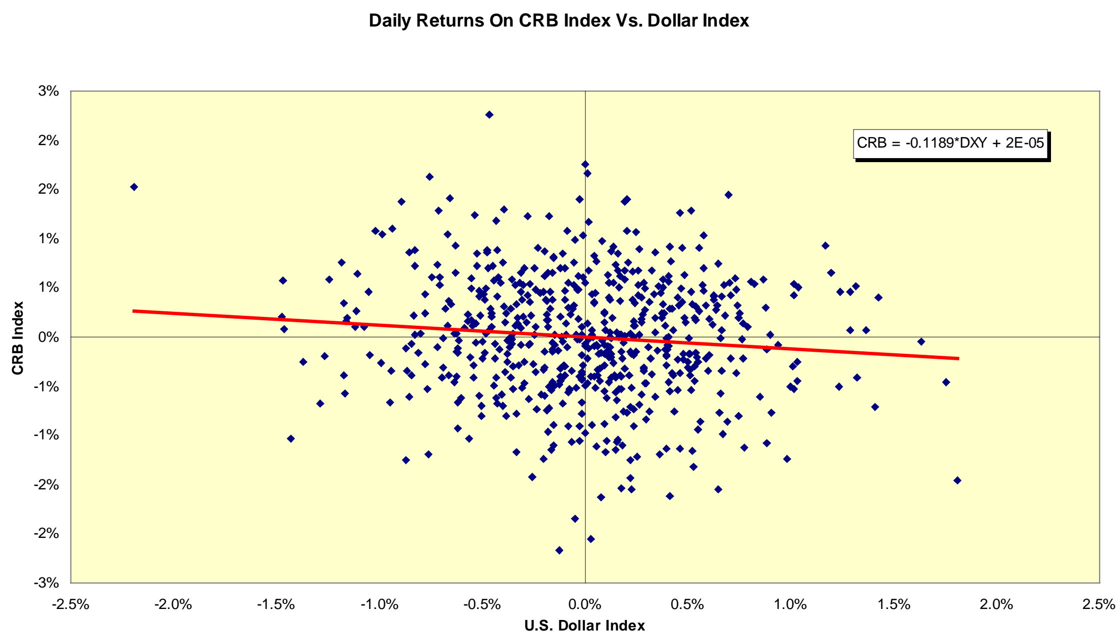
1. The *inverse* relationship between commodities and bonds;
2. The *positive* relationship between bonds and the stock market; and
3. The *inverse* relationship between the U.S. dollar and the various commodity markets, in particular the gold market

By extension, or even the transitive property of equality long lost in your distant memory, the third relationship implies an inverse relationship between the dollar and bonds: If the dollar weakens, commodities rise, and that should push both bond prices and then stock prices lower.

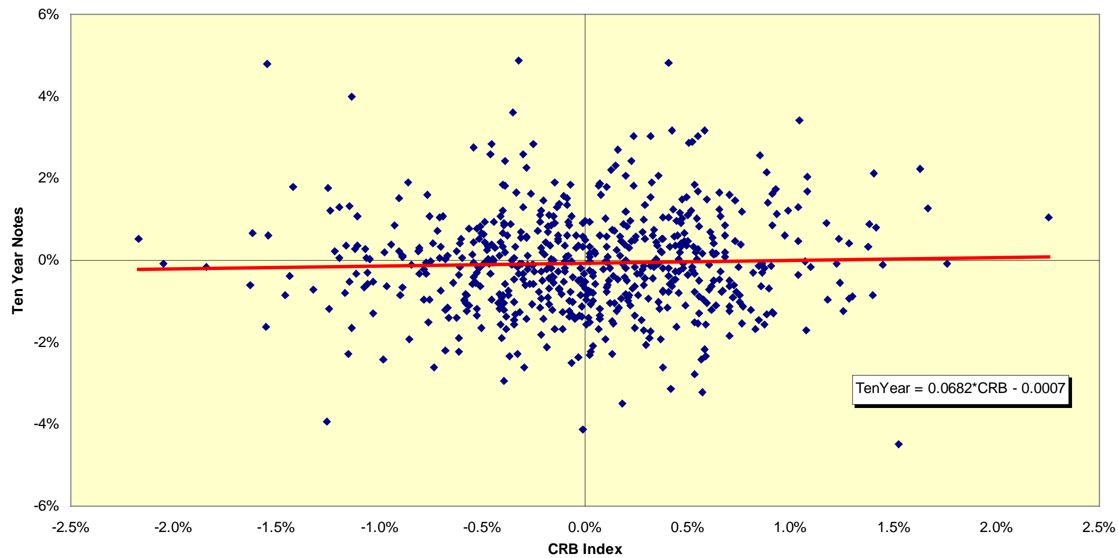
While all of this seemed perfectly reasonable given the experiences of the 1980s and the information available to Murphy at the time, it is in need of updating today. My own research, published in three articles here earlier in the year, showed no long-term inverse relationship between the dollar and either stocks or bonds; the relationship between the dollar and commodity prices, especially gold, remains stated as above, however.

While there are elaborate statistical procedures such as the Chow test to ascertain the stability of coefficients over time, let's take a simpler quick-and-dirty approach to these intermarket relationships since the peak of the bull market in March 2000.

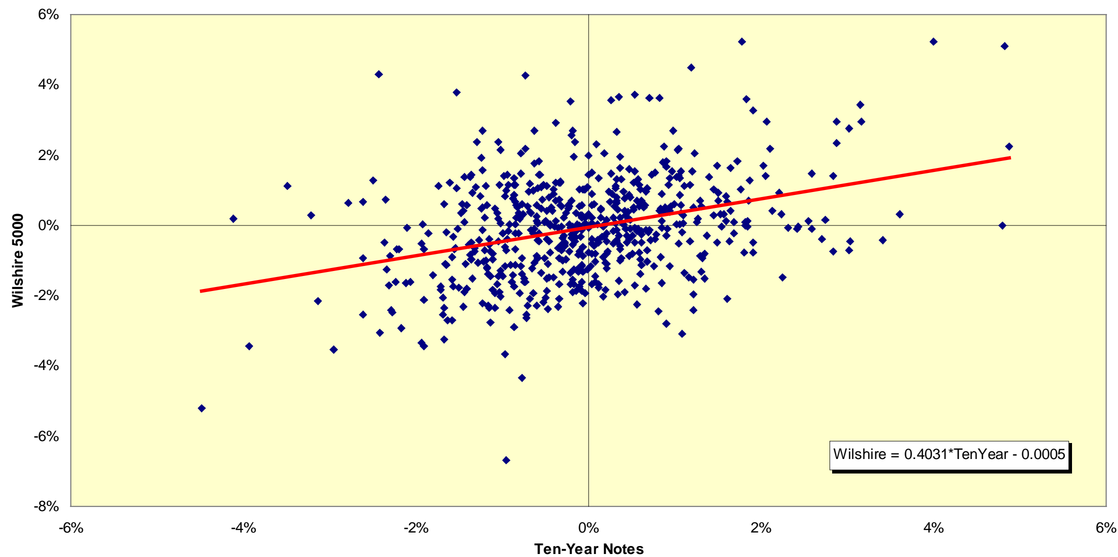
First, let's take a look at the relationship between daily returns on the CRB index as a function of daily returns on the trade-weighted dollar index. It has held, but weakly, over this period. Much of this anemic relationship is due to the erratic trading of the euro over this period of time.



Next, let's see whether yields on ten-year notes rise as expected when commodity prices rise. Not really: The relationship over this period is pretty close to zero, and we have seen bond yields fall even as commodities have risen throughout 2002.



Finally, let's add the relationship between bond yields and the Wilshire 5000. The relationship displayed is exactly the opposite of the 1980s experience, stocks rising with rising interest rates.



It's Different This Time

The last time we all heard phrases like "new metrics" we all should have run for the hills. The lesson isn't that fundamental laws of finance are born and die with each passing market cycle, but that each passing market cycle leads us to a different window and a different vantage point from which to view these laws in operation.

Lower interest rates are still good for stocks; it's just that that other aspect of equity valuation, earnings, is overwhelming them. Higher inflation is still bad for bonds, but the safety premium for bonds in a bear market is overwhelming it. For that matter, low inflation is good for all financial assets, but low inflation or even deflation caused by imploding demand isn't going to do wonders for stocks, is it?

The key to successful market analysis is remaining flexible: Would a stock analyst who only said "buy" ever be able to keep a job on Wall Street?