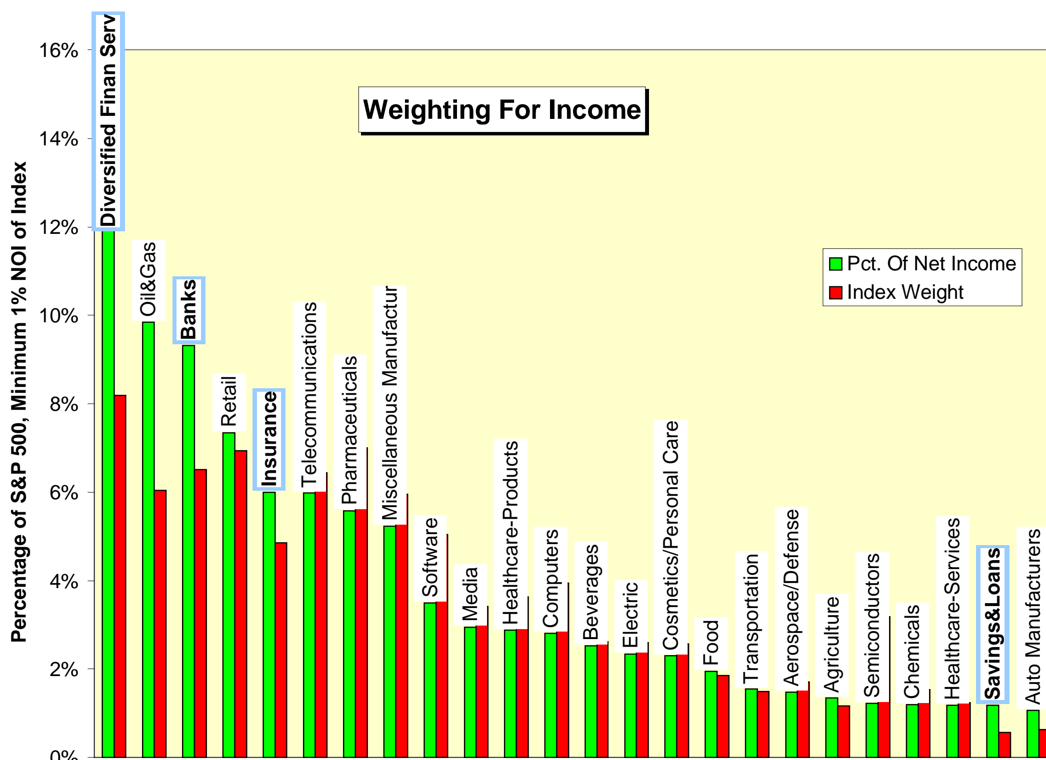
Carry Outweighs Kerry

The nation's Democrats gather on the banks of the River Charles this week to offer their solutions to the world's problems (let me guess - elect them?). They may wish to contemplate a remark I made to a friend back in the summer of 2000, well before that year's votes were cast: "The next guy in should keep a picture of Herbert Hoover on his desk." Regardless of one's politics, the cruel and simple reality is President Bush's economic policy had to react to the bursting bubble and his foreign policy had to react to September 11.

The next guy in should keep a picture of Alan Greenspan and then his successor handy and a real-time chart of the yield curve would not hurt, either.

Three out of the top five industry groups in the S&P 500 in terms of total net operating income - diversified financial services, banks and insurance - are in the financial sector. That number would be even higher if General Electric were classified as a financial firm instead of "miscellaneous manufacturing." If we add the savings and loan group into this classification, only four financial groups account for 30.5% of the S&P's net operating income and 20.1% of its market capitalization.



Linked To The Curve

Much has been made, and rightfully so, of the financial sector's ability to dodge certain bullets so far. Our good friends at Fannie Mae and Freddie Mac, to whom we all owe the roofs over our heads to hear them tell the story, have been able to ride out huge waves of refinancing and a couple of violent bond market selloffs over the past three years. Hopefully the occasional executive dismissals and accounting scandals only bother the squeamish. But, as noted here in September 2002, the mortgage giants are nothing more than big bets on a continued steep yield curve at lower rates.

They are not alone. Just as cattle process corn into beef plus a few by-products, (watch where you step) financial firms process short-term savings into long-term investments plus a few by-products (read the Chairman's Letter in an annual report). The lower the price of either corn or money, the greater the profitability of the processing operation. It really is that simple.

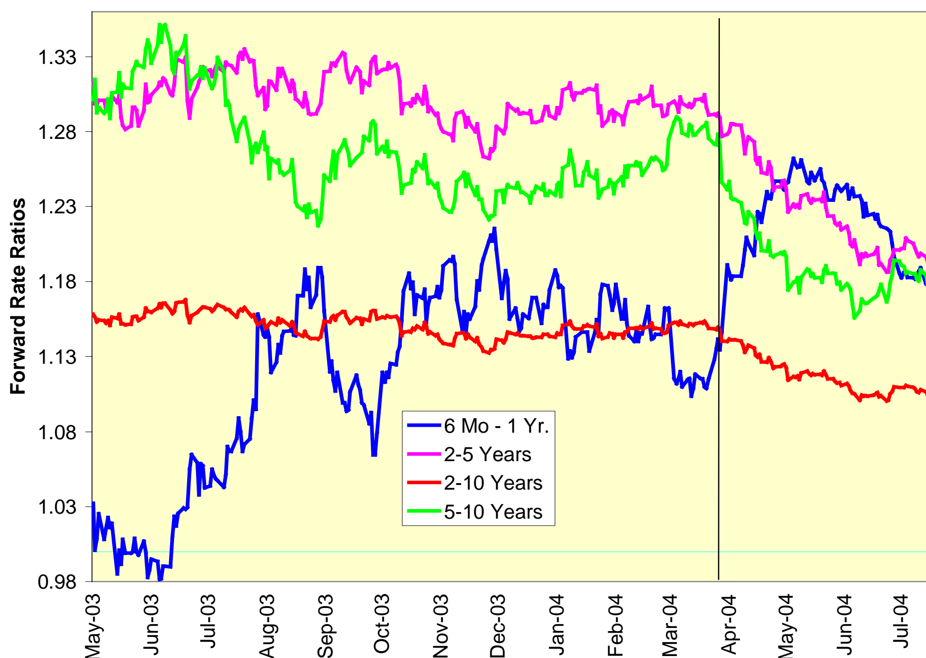
So even if, as suggested here last week, the Federal Reserve may be both loath and correct to raise short-term interest rates at much more than a measured pace, we may owe the absence of disaster in the financial sector more to the continued steepness of the yield curve than to adroit risk management. Translation: The banks, insurers, brokerages and hedge funds dotting the landscape, including a few in downtown Boston, may be more lucky than good. If and when the curve starts to flatten, the reckoning will begin.

The simple reality is yield curves are and continue to remain steep, which continues to perpetuate the so-called carry trades of borrowing cheap short-term money to lend at longer-term horizons. The source of the funds borrowed is immaterial; the global financial asset boom of the late 1990s was financed in large part by the cheap yen. The incentives for lending long are immaterial as well; much of the bond rally of January-February 2004 was financed by Asian central banks frantic efforts to weaken their own currencies relative to the dollar.

Still Steep

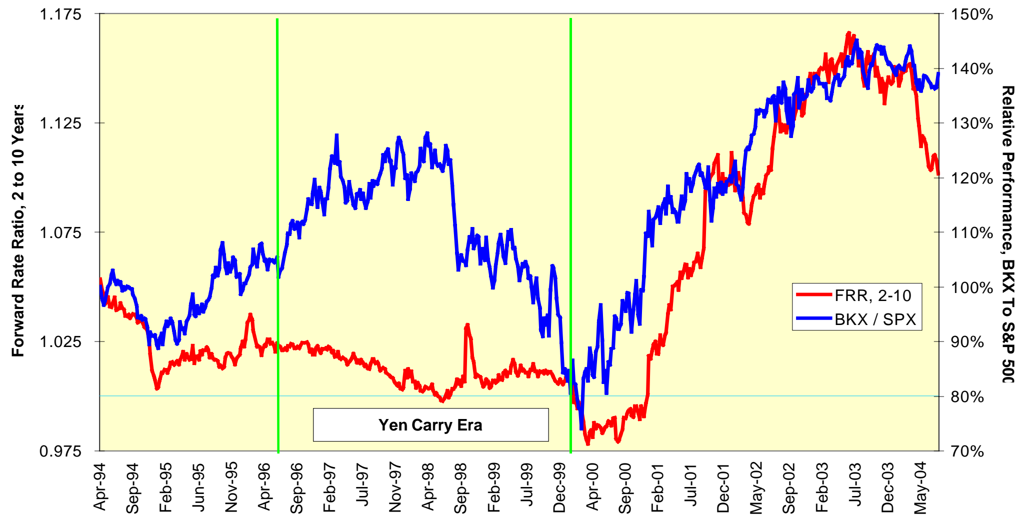
We can measure the steepness of the yield curve by taking the ratio of a forward rate between any two maturities to the rate of the longer maturity itself. A forward rate between one and five years, for example, is the rate at which you can lock in borrowing for four years starting one year from now. The more this ratio exceeds 1.00, the steeper the yield curve is. An inverted yield curve has a forward rate ratio less than 1.00.

How much have various segments of the curve flattened since the FOMC warned about the dangers of deflation in May 2003? Overall, not very much. While the segments between two and five years and between five and ten years started to flatten considerably after the release of the March employment report in early April, that flattening has stopped. Paradoxically, the money market segment between six months and a year actually got steeper as one-year rates rose but the six-month rate stayed stable in anticipation of a kinder, gentler Federal Reserve.



Good News And Bad News

Over time, bank stocks have done a good job of anticipating changes in the yield curve; the one exception over the past decade occurred during the yen carry trade era of 1996-1999. Banks got fat then by borrowing cheap yen, swapping them into dollars and doing who knows what therewith. The relative performance of the Philadelphia Bank Stock index to the S&P 500 led the steepening of the yield curve between the two and ten year maturities following the bursting of the equity bubble in 2000. The same relative performance also led the flattening of the yield curve in the in 2003.



Interestingly enough, while the yield curve has flattened over the past year, the relative performance of the bank stocks is still rich. Based on past relationships, one of these indicators is out of line: Either the yield curve will once again steepen as the Federal Reserve reacts to weakening economic conditions, or bank stocks will follow the flatter yield curve lower.

Either one of these convergence engines carries significant negatives; the former reflects a weaker economy, the latter a sharp drop in the profitability of a major segment of the stock market. Neither development should be welcome.

Barring a recession or worse, the carry trade will be over before any Kerry trades, if and when, ever begin.