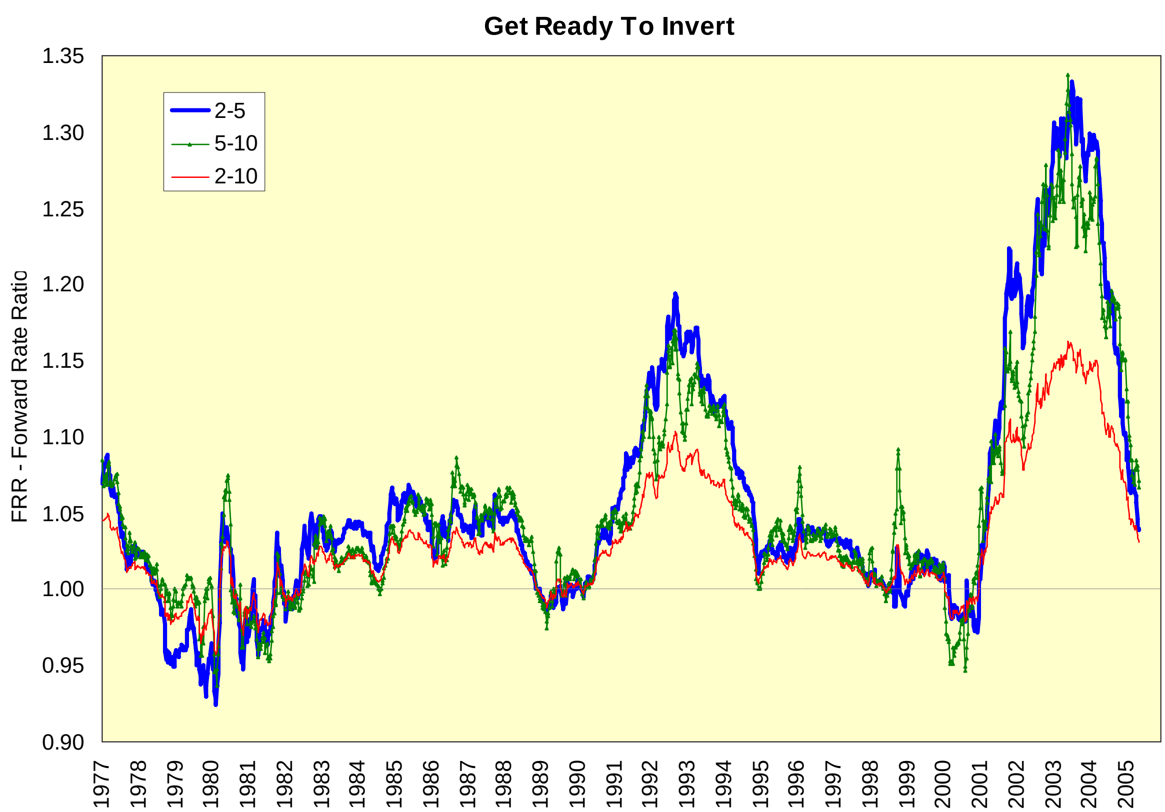
Financial Gravity And The Flattening Yield Curve

Isaac Newton sure was on to something with that whole first law of motion thing: Trends in motion tend to stay in motion. And no trend has been more enduring and powerful since early 2004 than the flattening of the yield curve, a topic last addressed here in May.

The rapidity and power of the yield curve changes over the past five years is difficult to comprehend in the historic context. The Federal Reserve conducted a great social experiment in driving short-term interest rates lower between 2001 and 2003. The yield curve steepened under this monetary onslaught; long-term rates did not tumble as much as the market began pricing inflation into the mix. Once this experiment ended, the flattening of the yield curve still underway proceeded, as Newton would have predicted, in an equal and opposite fashion.

We can illustrate this with the forward-rate ratios between various points on the yield curve. The forward rate between, say, two and ten years is the rate at which you can borrow money for eight years beginning two years from today. If the ratio between this forward rate and the ten-year rate itself exceeds 1.00, the yield curve is positively sloped. Levels less than 1.00 indicate an inverted yield curve.

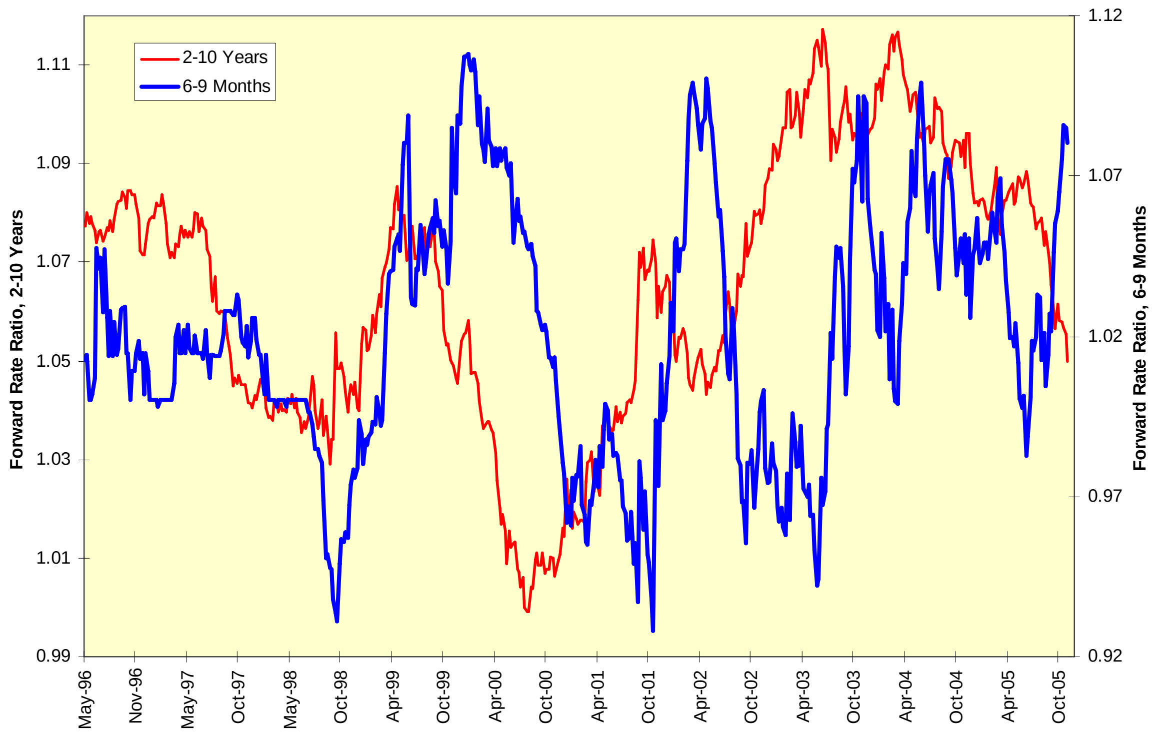
Incredibly, there are people who can look at the chart below and debate when we are headed for an inversion. Here's some free advice: When you fall out of a window, skip the debate on whether you will hit the ground or not. Newton had that gravity thing down, too.



Europe Joins The Party
Jean-Claude Trichet of the European Central Bank, possibly motivated by my merciless taunting two week ago – I'm certain he had to answer for that "*les poulets* at the ECB" jibe – made it clear this past Friday that short-term interest rates were going to rise in the Eurozone. Interestingly, the bond market in Europe began pricing in a flatter yield curve at the end of March 2004; the forward rate ratio for European sovereigns over the 2-10 year segment has been flattening and flattening at an accelerating rate since that time.

We can make no parallel statement for the 6-9 month segment of the yield curve, the money market segment related most directly to the currency market. This has been moving both in a steepening and flattening fashion regardless of official ECB policy and in a manner unrelated to longer segments of the yield curve. It should be safe to assume the European money market curve will flatten as ECB policy tightens, but you would be amazed to learn what Isaac Newton had to say about "assume."

Euro Yield Curve Has Been Flattening At Long End



Flat Curve Winners And Losers

Let's return to an analytic technique first introduced here in February and used several times since of measuring the relative impact of a market factor on industry groups. Negative numbers in the table below indicate groups benefiting from or at least not hurt by the flatter yield curve, while positive numbers indicate groups hurt by the flatter curve. The groups with statistically significant relationships (90% confidence interval) against the large-cap S&P 500, the mid-cap S&P 400 and the small-cap S&P 600 are displayed.

Relative Industry Group Betas To Forward Rate Ratio

S&P 500		**S&P 400**		**S&P 600**	
Group	Beta	Group	Beta	Group	Beta
IT CONS&SERV	(1.278)	COMP&PERPH	(1.091)	MARINE	(1.208)
ELEC MANU SRVC	(0.938)	AIRLINES	(1.077)	SYS SFW	(1.144)
DEPT STORES	(0.834)	SEMICONDUCTORS	(1.021)	ENVR SRVCS	(0.893)
MCYCL MANF	(0.819)	IT CNSLTNG	(0.937)	TRDNG COMP	(0.761)
COMP&ELECT	(0.723)	DIV COM SV	(0.909)	DATA PRCS & OTS	(0.749)
APPLIC SFTW	(0.697)	TRUCKING	(0.871)	SEMICONDUCTORS	(0.694)
SEMICONDUCTORS	(0.691)	OFFCE SERV	(0.832)	ADVERTISING	(0.654)
COMMERCIAL P	(0.572)	HLTHCR FAC	(0.620)	LEISURE PROD	(0.644)
RAILROADS	(0.559)	TECH DIST	(0.570)	TRUCKING	(0.579)
DIV COMM SER	(0.527)	ELE CMP&EQ	(0.503)	SPEC STRS	(0.482)
DRUG RETAIL	(0.513)			APPRL & ACCESS	(0.478)
INDUST GASES	(0.469)			COMP & EQUIP	(0.395)
SYSTEMS SFTW	(0.430)			APPL SFW	(0.372)
DATA PRCS & OTS	(0.428)				
ELEC COM&EQU	(0.362)				
PHARM	0.356	MLTIUTIL	0.345	GAS UTIL	0.350
DIV BANKS	0.433	ELEC UTIL	0.393	ELEC UTIL	0.378
GAS UTIL	0.461	TRFT/MRTG FINCE	0.400	REITS	0.507
REAL EST INV	0.598	PRP&CAS INS	0.404	THFT & MRTG FIN	0.635
THFTS & MRTGE	0.721	PAPER PRDCT	0.608	HOMEBUILDING	0.693
FOREST PROD	0.728	LEISURE FC	0.649	INSUR BRKG	0.811
OIL & GAS EQU	0.782	REITS	0.678	OIL&GAS EXPL	0.821
SPECIALIZED FIN	0.856	PHARMCTCLS	0.820	OIL&GAS	0.919
OIL&GAS EXPX	0.949	OIL&G STR&TRD	0.849	PAPER	0.942
OIL&GAS DRIL	1.375	OIL&G EQUI	0.853	MOV & ENTR	1.022
GOLD	2.947	MLTISECTOR	0.899	HSHLD PROD	1.091
		SOFTDRNKS	0.912	OIL&GAS REF	1.102
		OIL&G EXPL	1.062	OIL&GAS PROD	1.252

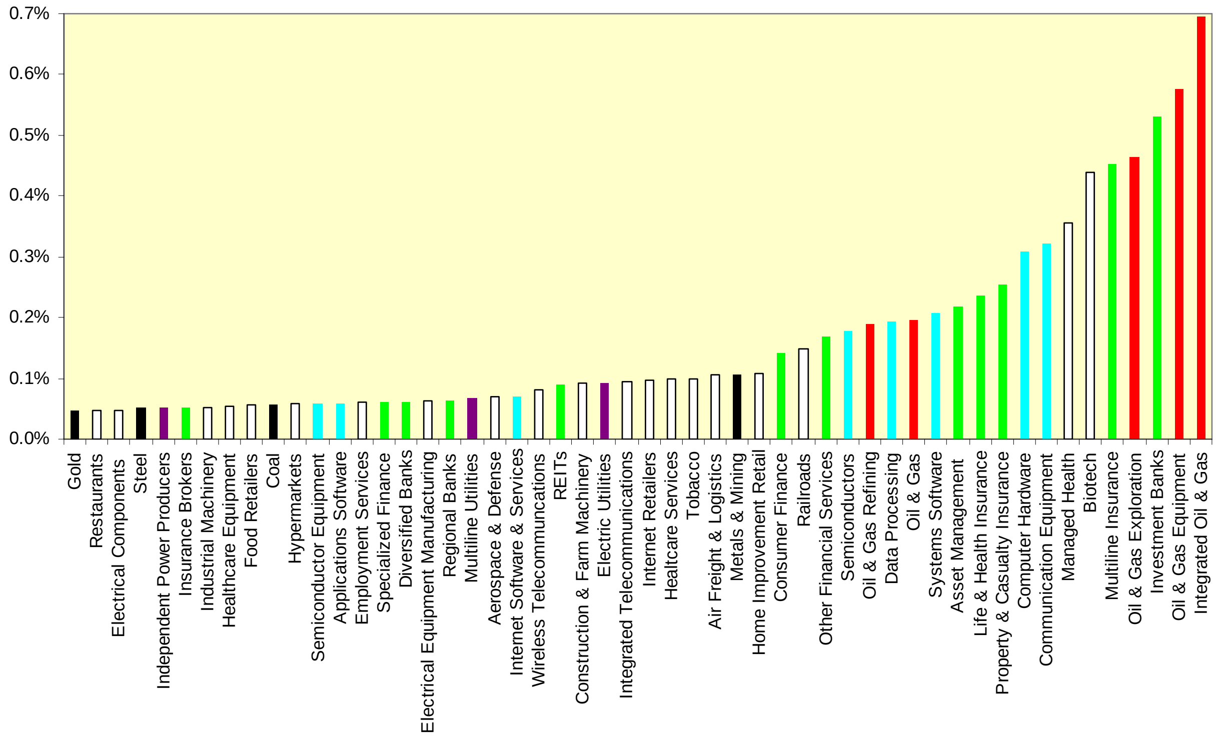
The list of victims is pretty clear across market capitalization levels. Utilities, REITs, oil-related groups, pharmaceuticals and financial firms, particularly thrifts & mortgages should underperform by virtue of the flattening curve. Relative winners are in the technology sector, especially semiconductors and software, and in electrical goods manufacturing.

This list of winners and losers relative to the forward rate ratio is not significantly different from the one posted last May. As the forward rate ratio between two and ten years has declined from 1.02818 to 1.00578 during the interim, let's see how effective the relative performance signals were.

For this exercise, we will combine all of the S&P indices into the S&P 1500 Supercomposite. The total return of each industry group over the six months since May will be multiplied by the group's weight in the Supercomposite. Only a handful of groups had capitalization-adjusted returns of less than a -.05% contribution to the index' total return of 6.86% over this period. Three of these underperformers, Pharmaceuticals, Packaged Foods and Thrifts & Mortgages were expected to be affected negatively by the flatter yield curve, and they were. Pharmaceuticals in fact had the worst total return x capitalization product of any group, -.59%.

If we move outside of the zone of underperformance, the picture starts to change. The chart below depicts the groups' whose capitalization-weighted total returns exceeded 0.05%. They are color-coded as black for Basic Materials, violet for Utilities, turquoise for Information Technology, green for Financials and red for Energy. All others are colored white.

Capitalization-Weighted Six-Month Total Return



We expected the technology groups to slough off higher interest rates, a stronger dollar and a flatter yield curve, and this certainly was true for Computer Hardware, Communications Equipment, System Software, Data Processing & Outsourcing and Semiconductors.

But what about the oil-related groups? These were expected to be affected negatively by the above-named factors, and yet their performance topped the charts. Here the answer is obvious: The financial factors affecting the oil-related issues negatively simply were overwhelmed by the unprecedented gains in crude oil, natural gas and refinery margins. Other executives might kill to have profits gaudy enough to be dragged up to Capitol Hill for a tongue-lashing.

The performance of the financial issues is fascinating. It was taken as gospel for years that this sector was one giant "carry trade" whose profits were generated from borrowing at the short-end of the curve and ending at the long-end of the curve. But these are not your father's financials; they make money more on trading, fees, prime brokerage and other services unrelated to the yield curve. Who knows how strong their performance would have been in the absence of the recent flattening of the curve?

Newton had one last relationship figured out: Force equals mass times acceleration. The large mass of the combined financial and energy sectors is being affected by an accelerating flattening trend both in the U.S. and in the Eurozone. That force is being resisted and indeed pushed back by profit growth elsewhere and by increased risk acceptance. But it is there, pushing toward us. Just because it has not ruined anything yet does not mean it is incapable of doing so.