Stocks In 1974 or Japanese Bonds In 1996?

Stood alone on a mountain top,
starin' out at the Great Divide
I could go east, I could go west,
it was all up to me to decide
Just then I saw a young hawk flyin'
and my soul began to rise
And pretty soon
My heart was singin'

Roll, roll me away,
I'm gonna roll me away tonight
Gotta keep rollin, gotta keep ridin',
keep searchin' till I find what's right
And as the sunset faded
I spoke to the faintest first starlight
And I said next time
Next time
We'll get it right

-- Bob Seger, "Roll Me Away"

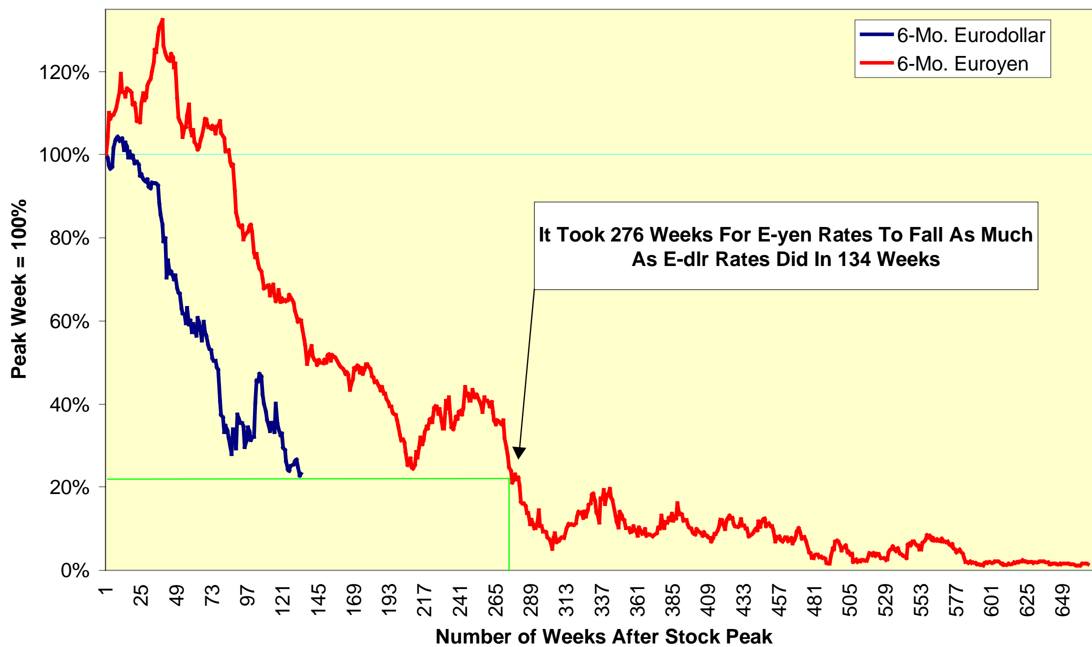
Can anything compare to a good analogy? Not in stocks anymore: If I see one more chart from the bulls comparing this market to 1973-1974, I'm going to unleash the atom bomb response. The year 1975 witnessed the rise of both disco and the leisure suit, and I hereby submit to the jury that we should not permit any similar developments peaceably.

We are at the point in financial markets where as bad as stocks look, bonds may be just as risky. With ten-year notes yielding a scant 3.665% and thirty-years at 4.714%, the future total return of fixed income instruments is getting pretty skinny. Even a 50 basis point increase in Treasury yields will knock the price of the 8.125% bond due August 15, 2021, presently the cheapest-to-deliver issue against the Treasury bond future, down to 134.68 from its present 142.31. A 100 basis point backup, hardly inconceivable given the experiences of 1994 and 1999, sends the price down to 127.61. Not a very good risk/reward picture for coupon yield involved, is it?

Ain't No Cure For The Bubbletime Blues

But just because rates are low does not mean they cannot go lower. The post-bubble markets of the U.S. in the 1930s and Japan in the 1990s, not the event-driven bear market of 1973-1974, remain our best guideposts, but even these are not very good ones. The 1930s were a far worse period economically, and the Japanese experience has been characterized by runaway stupidity to the extent that the Bank of Japan is now trying to save member banks by buying their stock holdings. Despite the depressions that have hit our technology, telecommunications and merchant energy sectors, and despite the massive losses in our stockholdings, our general macroeconomic picture is still better than these two episodes. And, most importantly, we can debate whether we are in any sort of deflation; those episodes clearly were deflationary.

Let's take a look at the Japanese interest rate experience of the 1990s and overlay our present situation to see whether a reasonable analogy is developing in the interest rate market. First, let's take a look at the yields on 6-month eurodollar and euroyen markets; these interbank rates at the six-month horizon are most reflective of the market's expectations for short-term monetary policy.



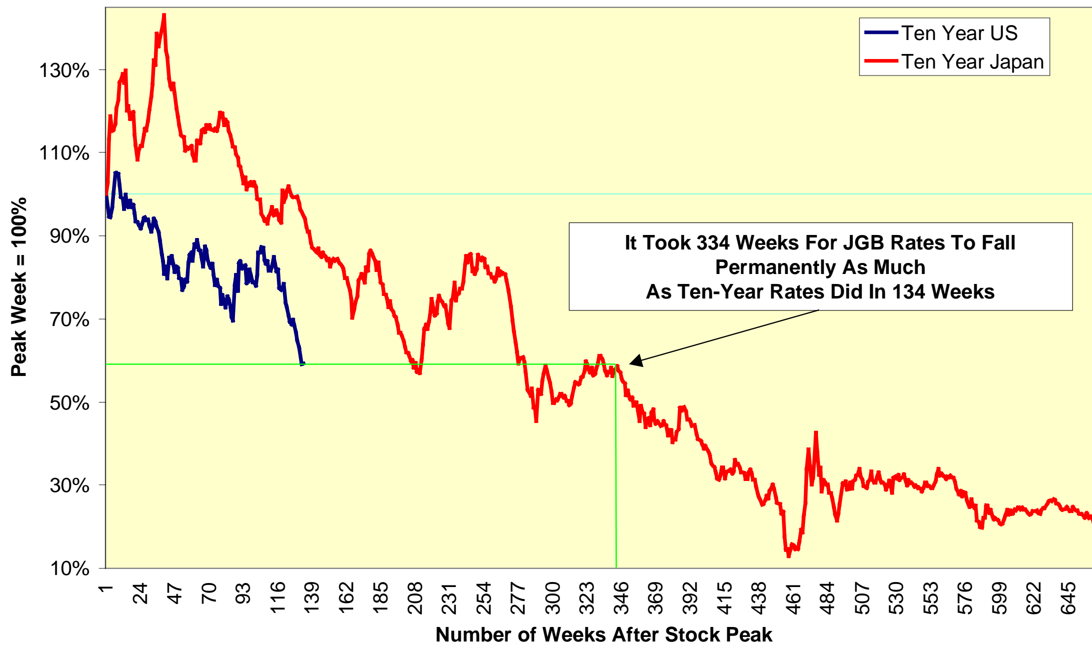
We can compare how these rates fell relative to where they were at the respective equity market peaks, December 29, 1989 for the Nikkei and March 24, 2000 for the Wilshire 5000. This provides strong confirmation that the Fed has been far more aggressive in cutting rates than was the BOJ. In fact, it took 276 weeks, or more than five years, for euroyen rates to fall by the same percentage as eurodollars have in 134 weeks, or two and one-half years.

On one level, this must count for something in the small consolation department. However, low rates by themselves did nothing to help the Japanese economy or the Nikkei. If we are to place our faith in market analogies, we would have to note how once euroyen rates retreated 77% from their bubble peak, they kept on heading lower: By June 2002, were a full 98.88% lower than they were in December 1989.

On The Investment Horizon

One of the many impediments to monetary policy's effectiveness is its operation on only the shortest maturities, not on the capital market maturities at which real investment decisions are made. Accordingly, we must examine the respective ten-year government rates for Japan and the U.S. on the same basis as above.

Ten Years After



The picture here is somewhat similar to that of the money market rates. Despite the relative stickiness of note rates in 2001, stickiness borne largely of the belief that a strong recovery was just around the corner, U.S. long rates fell much faster than did Japanese note rates. These rates got sticky at 60% of their bubble peak, the present level of the U.S. retreat, and did not move decisively and permanently below that level until 334 weeks after the Nikkei came unglued.

For those of you keeping score, the Nikkei settled at 20,700 on the date of this crossing, a full 129% higher than its present level.

At The Great Divide

Will the swifter response of U.S. interest rates, both at the short and at the long ends, presage a divergence from the Japanese experience or, worse, simply bring about a similar equity collapse at an earlier date? That will be answered both by fiscal policy and by events lying outside of market control. We know that the Great Depression was prolonged and deepened by the disastrous protectionism of the Smoot-Hawley tariff, by Hoover's tax increases and by the Fed's inability to prevent a massive contraction in the money supply.

The Japanese Lost Decade (now in its twelfth year) has been prolonged by an increase in the consumption tax, by runaway deficit spending and by the Bank of Japan's inability to forestall deflation. The strong Japanese yen, created by their permanent trade surplus and deflationary tendencies, has priced Japanese labor out of line with other Asian exporters.

Our present policy mix is that of expanding deficit spending, too-high taxes, and various ill-conceived forays into protectionism. The dollar has been quite strong, as U.S. assets still remain attractive to global investors. The big uncertainty at the moment is the military situation. While wars are uniformly disastrous economically, something the merchants of death crowd ignores, they do have a way of breaking deflation simply by destroying existing goods and services and inducing vast government borrowings later financed via inflationary monetary policies.

So, in Bob Seger's words, is it up to us to decide? If we continue on our present befuddled course, each well-intentioned action will contribute to a worsening of the overall situation, and we very well might mimic the Japanese experience. The economy is not the government's toy to make better or worse, and the notion they can "do something" is a dangerous and childlike fantasy. Take the collapse of interest rates, please: It has done nothing to stimulate capital spending - what, Cisco's going to build more routers? - and it has done much to finance over-

investment in housing. Low interest rates penalize savers and investors, and the flattening of the yield curve from the long end is stressing mortgage lenders and banks who depend on a positive carry.

Between war and muddling through, I prefer muddling through (as a personal aside, most people describe me as hawkish, and I am a devoted student of military history). If we continue the present inane and unproductive saber rattling, the uncertainty will suppress credit demand and risk-taking, and staying in bonds, even at their present risk/reward, is likely to be the best alternative.

Next time, next time we'll get it right.