Non-Musical Notes Are Worth Listening To

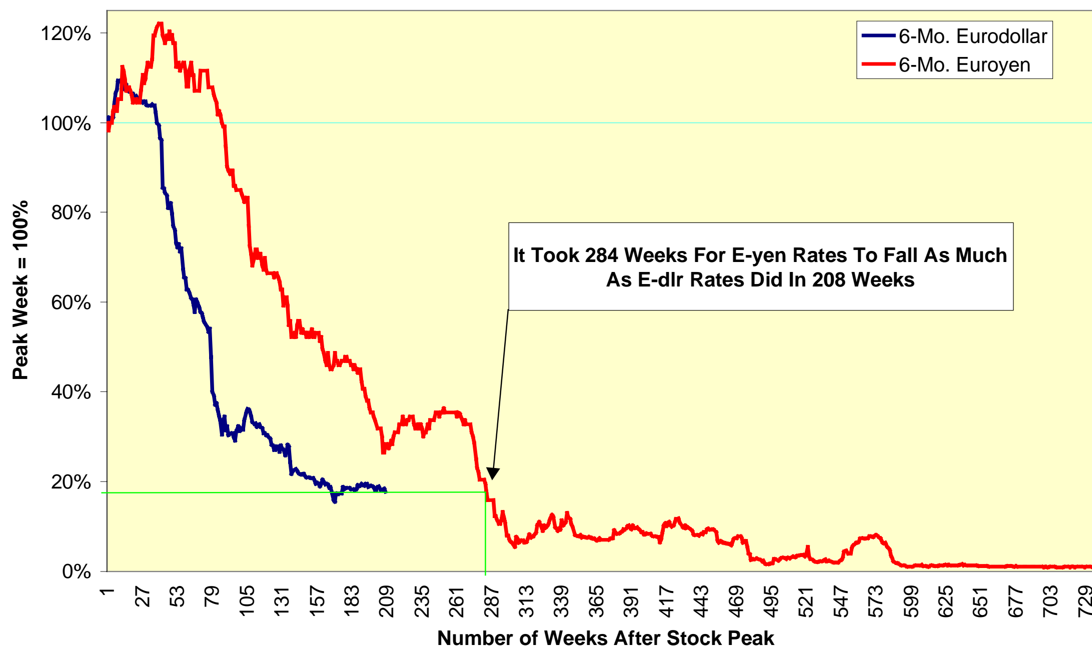
In this business, when someone asks whether you believe them or your lying eyes, the best course of action is to go with your lying eyes. The renewed downturn in interest rates, especially at the longer end of the yield curve, is forcing us to decide between our own judgments or those of the market. You may fill in your own ragged Wall Street cliche at this point.

An Incomparable Analogy

The Japanese experience with their 1980s bubble and its subsequent collapse holds an eerie and even morbid fascination for American analysts; witness the numerous discussions as to whether the Nasdaq has remained on a course parallel to the Nikkei following its bubble peak. Often ignored in these stock market comparisons is an equally compelling analogy, one I made back in October 2002, between Japanese and U.S. interest rates.

While the federal funds rate and the discount rate get all of the ink, these rates are only of importance to banks. Businesses and individuals would be hard pressed to borrow and lend at these rates. A six-month LIBOR rate for both the dollar and the yen is a better instrument of comparison; the six-month horizon is more reflective of both market expectations and actual cash management decisions and is far less noisy than the three-month rate.

A Tale of Two Rates



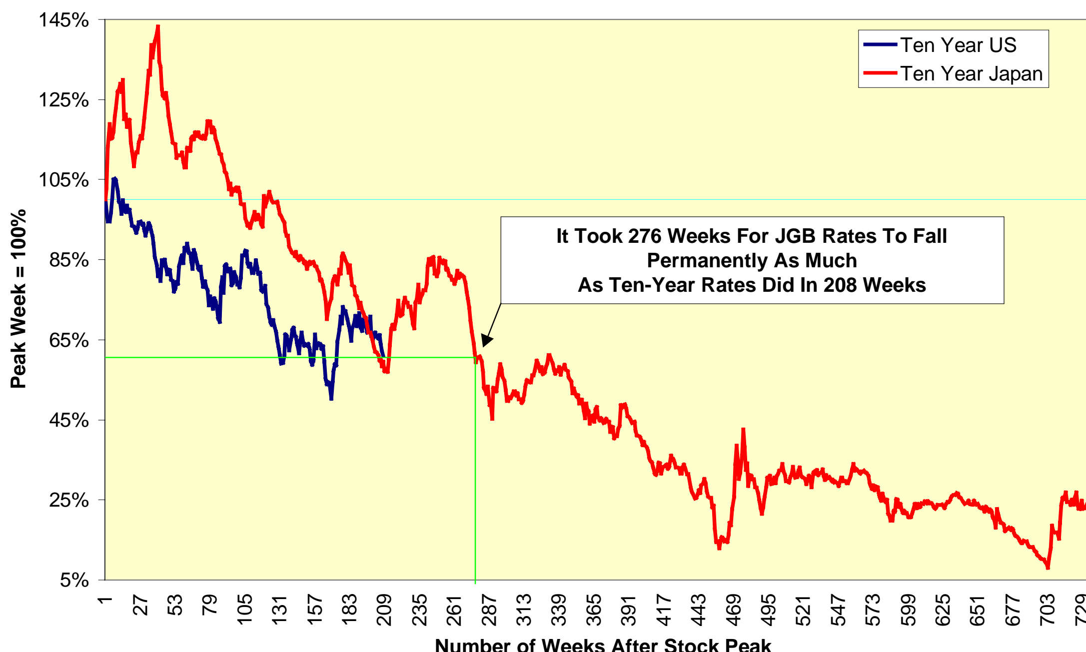
Six-month euroyen rates to rise for a year after the December 1989 peak of the Nikkei. In contrast, six-month eurodollar rates started falling by September 2000, and taken as a percentage of the stock market peak levels, fell further and faster than did euroyen rates. At this point in time, eurodollar rates have leveled off, as euroyen rates appeared to have done in 1995. A casual glance at the course of euroyen rates after that point belies the argument that eurodollar rates cannot go lower from here.

The longer end of the curve tells a somewhat similar story. Once again, rates on U.S. ten-year notes rose less after the respective stock market peaks and fell both further and faster as a percentage of the peak levels.

While the paths were not as parallel up until three years after the stock market peaks, it is interesting to note that last June's nadir in yields occurred in the 169th week after the stock market peak. Japanese ten-year yields hit a similar nadir in February 1993, 166 weeks after the Nikkei's peak. The present bond rally is occurring right on schedule; this is December 1993 based on the Japanese analog.

If we follow the Japanese path - and I am by no means offering this as a forecast - we could see a spectacular selloff in bonds in the near future followed by a long and enduring descent to yields now unimaginable.

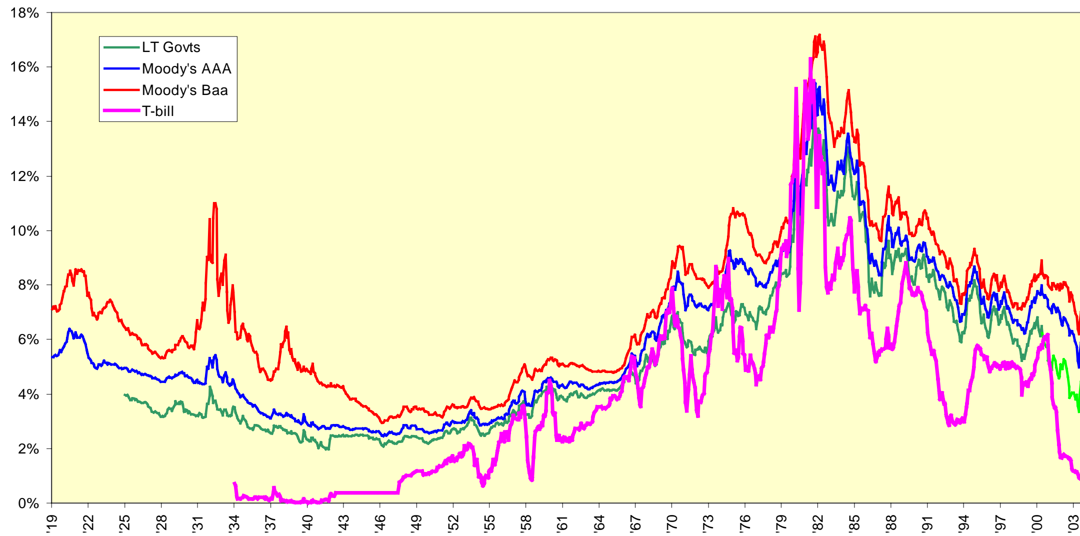
Markets can make the unimaginable real: A convention of those who forecast in March 2000 that we would now be in our ninth month of a 1% federal funds rate with no end in sight could be held in a very small room. Neither I nor anyone I know would need to attend.



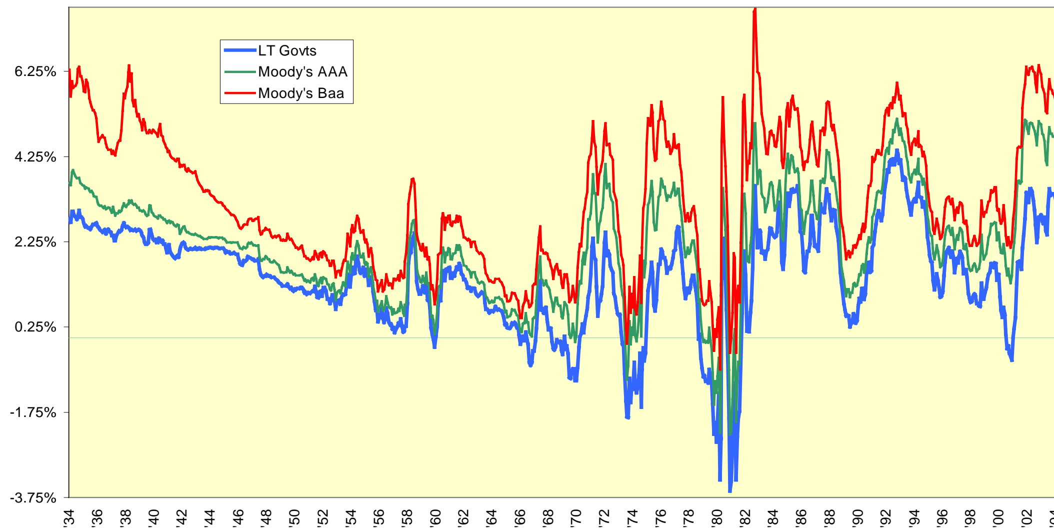
Analogies are not deterministic, and it is important to note the very major differences between the U.S. and Japan, not the least of which has been the solvent U.S. banking system and an American reliance on capital markets, not banks, for corporate financing. The U.S. has skirted deflation for now and the American economy has been growing, two other conditions absent for extended periods in post-bubble Japan. Japanese policy makers erred by raising taxes in 1997, while marginal U.S. rates have been reduced before any application of the Alternative Minimum Tax. And yet for all of these key differences, the parallel courses of post-bubble interest rates demand examination.

A Walk Down Memory Lane

We not only can compare U.S. rates to Japanese rates, we can look at U.S. history as well. The Federal Reserve's long-term histories of selected interest rates for corporate bonds, long-dated Treasuries (ten-year only after June 2000) and Treasury bills provide no indication that we are at a natural floor in interest rates. The last time three-month bills were at present levels, November 1954, long-dated notes were yielding 2.57%, and high-grade corporates were yielding 2.89%.



Even more instructive than ordinal levels are the spreads between corporates, long-dated Treasuries and bills. Each time the spreads widened out to recent levels and contracted - a phase we have been in over the past year - bond yields have fallen.



Event Risk

An interesting question, one involving the role of free will in macroeconomic decisions, is whether the recent course of interest rate movements creates conditions in which future events, accidents if you will, will produce a foreordained outcome. We have seen how a monetary policy designed to prevent deflation has succeeded in this task, but as a natural consequence has led to a weaker dollar and a reflation of assets such as real estate and bonds that respond predictably to lower costs of carry. In addition, a fiscal policy designed to stimulate the economy and to engage, rightly or wrongly, in global military activities has exacerbated a national debt load prior to the impending retirement of the Baby Boom generation.

How hard is it at this point to envision a scenario in which trigger events, such as a banking crisis in China, further terrorism and responses thereto, or even a mistimed tax increase in the next administration, Bush or Kerry, will lead to a recessionary or deflationary shock? If any of these events play out, the interest rate analogy to Japan may very well continue.