Open Ended Questions For Closed-Minded People

Take it on faith, you take it to the heart
Waiting is the hardest part -- Tom Petty

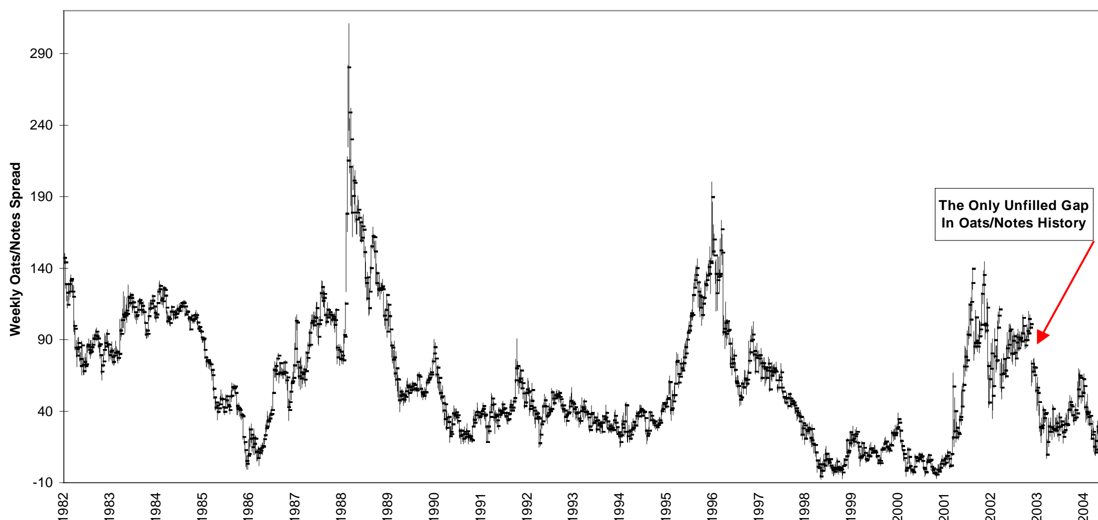
The sun is the same in the relative way, but you're older
And shorter of breath and one day closer to death -- Pink Floyd

In homage to the Vietnam-era poster, suppose they gave a market and nobody traded? We cannot say that universally about all markets in the year just departed; the energy market in particular decided to poke around the stratosphere, but the returns on conventional investments all hovered around the unchanged line for interminable periods.

What is the best explanation for this flatlining, this languid torpor, this beat-your-head-against-the-wall inaction? Waiting, that's what. We kept waiting: Waiting for the Fed, waiting for the political conventions, for the Olympics, for the election, for something. It got so bad that Godot himself could have strolled by and no one would have noticed.

What, if anything, could have alerted us to the possibility that our thumbs would have been safe and in a warm place for the better part of a calendar year? This being January, there can be only one answer to that question, and that is the oats/notes spread, the very real difference between the front month contracts for oats and ten-year notes. The logic is impeccable: The lower interest rates go, the higher note prices go, and thus the lower the oats/notes spread. It has done nothing but provide us with clues to the inner workings of the market for the past decade, but like the dearly departed Rodney Dangerfield, it gets no respect.

Its breakaway gap to the downside in April 2003 alerted us to the arrival of a huge rally until the end of the year. But, then a funny thing happened: Despite the Federal Reserve's series of rate hikes commencing in June 2004, note yields refused to go higher. No, they were reacting to the depressive effects of higher energy prices. The end result, and one there for all to see, was the one and only unfilled gap in the history of the oats/notes spread. Until this gap is filled, either by a huge rally in oats or a major selloff in notes, financial markets will not move.



Oats/Notes Traders For Truth

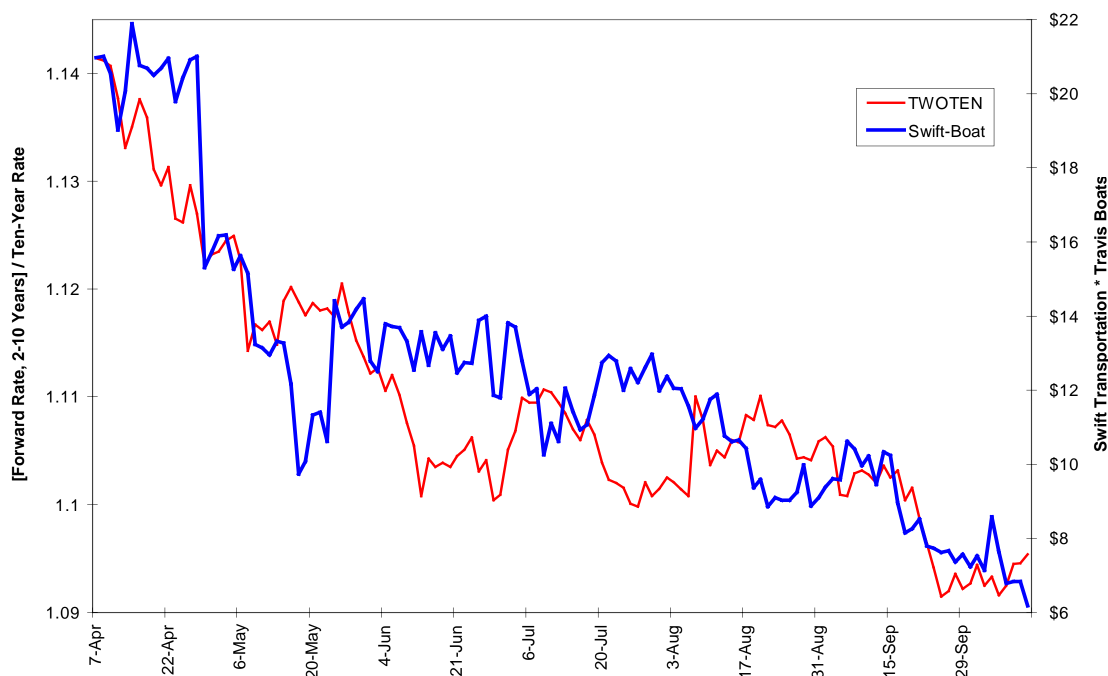
Of course, as effective as the oats/notes spread has been, it is unfair to ask it to shoulder the entire forecasting burden itself. It needs help. In previous years, we have offered measures as disparate as the HU/NG spread between gasoline and natural gas, the brass/ball spread between a synthetic London Metals Exchange brass forward and the stock of the Ball Corporation, and the DXY/CHX spread between the dollar index and Pilgrim's Pride stock.

But, as many of you noticed, 2004 was an election year, and an unnecessarily long one at that. President Bush was unchallenged for the Republican nomination, and John Kerry wrapped up the Democratic nod by early March. The two major parties then spent eight months and hundreds of millions of dollars to change what could have been a few thousand votes, although the actual tally might run into the hundreds.

The only real excitement came in late August when the last battle of the aforementioned Vietnam War was fought over the American airwaves. When the oddly named Swift Boat Veterans For Truth emerged at the same time the extraordinarily steep yield curve, one that defines the cost of **carry** in financial markets, began to flatten, the whole thing came together in a Eureka moment. The Swifties were driving the yield curve, its carry, and by extension the political fortunes of John Kerry.

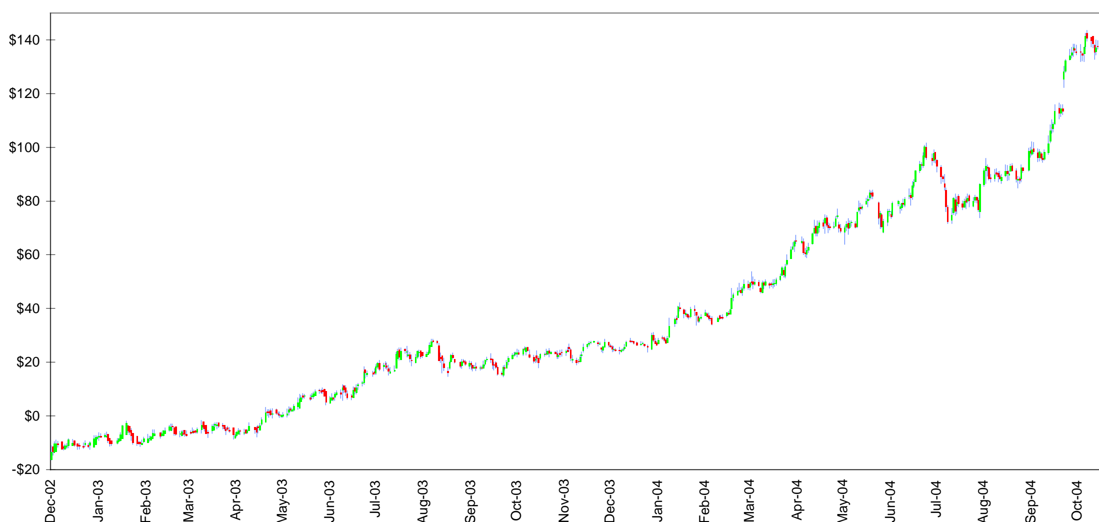
How so, you ask? We can measure the steepness of the yield curve by taking the ratio of forward rate between two and ten years, the rate at which we could lock in borrowing for eight years starting two years from now, to the ten-year rate itself. The lower the number, the flatter the yield curve; a number less than 1.00 indicates an inverted yield curve, one wherein short-term rates are greater than long-term rates. By the end of the Federal Reserve's series of rate cuts between 2001 and 2003, this ratio was the highest it ever had been.

The next part of our spread is the Swift-Boat indicator, which we can derive by multiplying the respective stock prices of Swift Transportation (ticker: SWFT) and Travis Boats (ticker: TRVS). Is the cost of carry related to swift boats? We report and you decide.



This Is Your Exchange On Drugs

Stock markets, like elections, are supposed to reward winners and punish losers, and they do this after a fashion. Let's revisit a spread introduced last year, the Merc/Merck spread between the Chicago Mercantile Exchange and the homonymous pharmaceutical giant. The Merc has rocketed forwarded since its December 2002 initial public offering, stepping on (or perhaps "in" would be a more appropriate preposition) its competition. By the end of October 2004, its stock had risen 86.75% since Euronext.liffe began offering a virtually identical Eurodollar contract in March 2004. Merck did not have a similarly good year; not only did all pharmaceutical stocks retreat under the threat of a Kerry presidency, but the firm had to withdraw Vioxx from the market. The Merc/Merck spread has been a one-way street.



The Abby

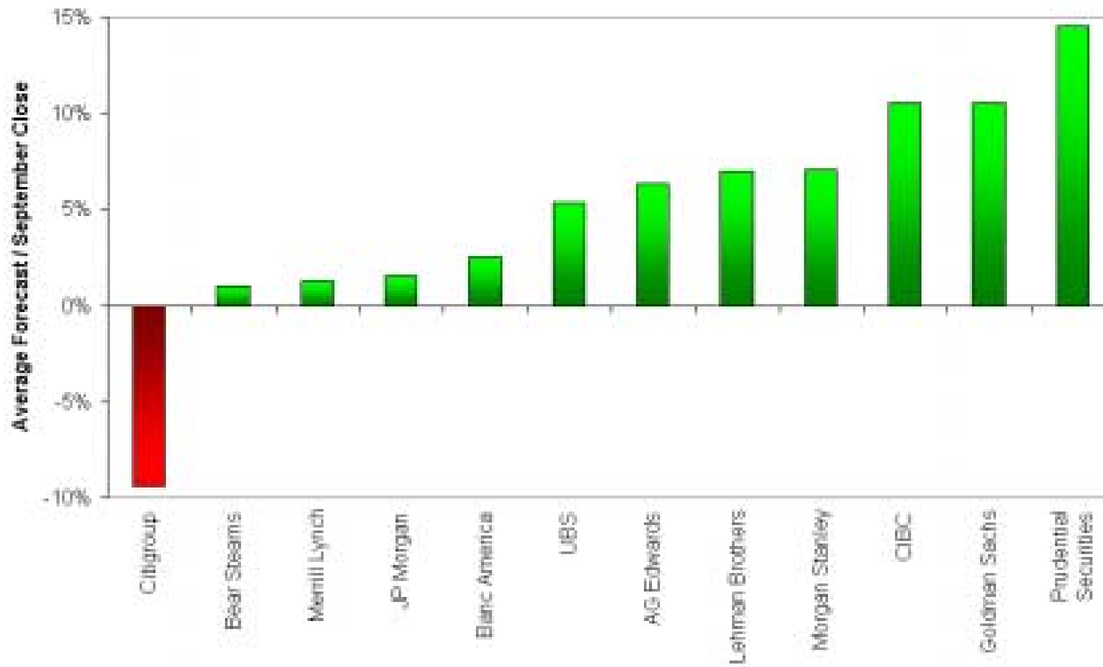
CNN closed its financial network. CNBC started running talk shows with old tennis players. The VIX hit new lows with regularity. Has money lost its sexiness? What happened to the stars of the 1990s, the ones who managed to stay on the outside of Camp Cupcake? Fear not, for we keep the flame burning bright next to that $2.50 gasoline you have been buying.

Yes, it is time once again to bestow this year's Abby Award, the most prestigious non-existent prize in existence. If you want to win an Abby inscribed with Druid incantations and festooned with a symbolic broken clock for your skills at fearless forecasting and peerless prognostication, you actually have to do something right, which apparently is the highest hurdle in the business. It is on the order of the Boston Red Sox finally winning the World Series. Perhaps next year's award should simply be the broadside of a barn with the words "hit this" painted on the sides.

The contest is simple. Each week Bloomberg tracks the forecasts and asset allocation recommendations of Wall Street's leading strategists. We track the tracking. The weekly forecast for the year-end of 2004 was averaged and compared to the S&P 500's actual value at the end of September. The closest ratio to 100% takes the Abby, no questions answered, especially if they are about mistakes.

The winner for this year is Francois Trahan of Bear Stearns. He joins this author, Ron McEwan, Chris Costakos, Beth Loeb & Darlene Demor, Douglas Cliggott and Abhijit Chakrabortti in the select company of Abby Award winners.

What was Mr. Trahan's secret? Not sticking to his guns and not changing his position frantically. Several strategists did not bother updating their forecasts at all during the course of the year; these included Thomas McManus of Banc of America, Subodh Kumar of CIBC and Abby Joseph Cohen of Goldman Sachs. Others adopted the weather vane approach. Trahan went from January through June with a forecast of 1160, dropped it to 1100 and then lowered it to 1050 for the last week of the contest. The net result was an average forecast error of 1.00%.



The Abby Goes Sideways

There is a poetic justice to this outcome. Many of the most famous market gurus earned their bones by simply staying long during a bull market, or more rarely by staying short in a bear market and never varying their opinion. No matter how devoid of content their work was, the market bailed them out. This was the year when doing little and doing it quietly paid off in the markets. Do not expect this to continue.