Fright To Quality

Nothing is more reliable than a failed signal. The stock market collapse of Friday, April 14, 2000, was significant not only for its magnitude, but for what did not happen. The Hound of the Baskervilles, fresh from treating your portfolio like a fire hydrant, neither barked nor induced a bond market rally.

Since markets are motivated by fear and greed, and since we are programmed biologically to run away from scary things, it is only natural for us to flee market calamities and seek the solace of a safe haven. The term "flight to quality" came into common financial parlance in the aftermath of the October 1987 crash. That day's festivities lopped close to 23% off the value of the S&P 500. Since the crash followed months of disturbing economic talk about how there would be hell to pay for our twin deficits -- budget and trade -- it was only natural to assume there would be at least some macroeconomic consequences from this crash. In fact, the Brady Commission report ordered by President Reagan and released in January 1988 was fixated on comparisons between 1987 and 1929.

Several factors made 1987's flight to quality intense. First, the 1987 bond market was terrible; yields had been rising steadily since March, and the yawning gap between bond yields and stock valuations received much of the subsequent blame for the crash. The high point for bond yields in 1987 occurred on the morning of October 19, and this provided a huge impetus for short covering over the next three days. Second, the Fed under the skillful leadership of a promising rookie named Alan Greenspan was determined to provide sufficient liquidity to prevent a catastrophic implosion of credit, something that very nearly occurred anyway on the morning of October 20. Short-term interest rates fell by almost 250 basis points from October 19 to October 20. Third, the dollar had been weakening throughout 1987, and it didn't take much of a push to make foreign holders of U.S. assets sell. Finally, the connection between the stock market crash and a looming recession or worse seemed plausible.

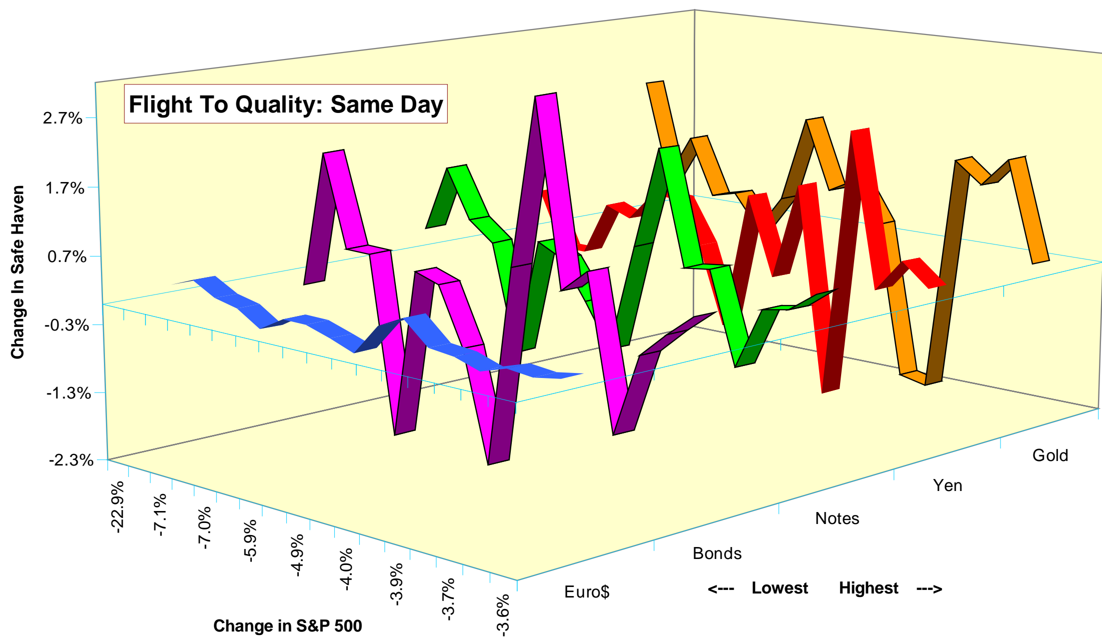
In retrospect, the lack of macroeconomic fallout from 1987 was nothing short of a defining moment in our culture. Investors have internalized the timeless investment advice of Alfred E. Newman: What, me worry? Not only do we buy the dips, we have sworn off fleeing stocks for various havens.

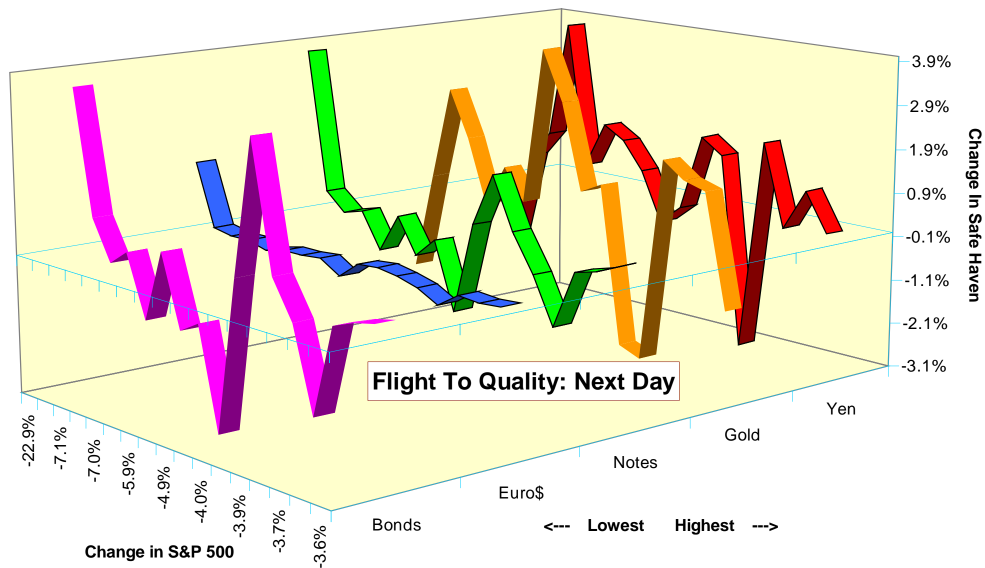
Flight To Quality: An Urban Legend

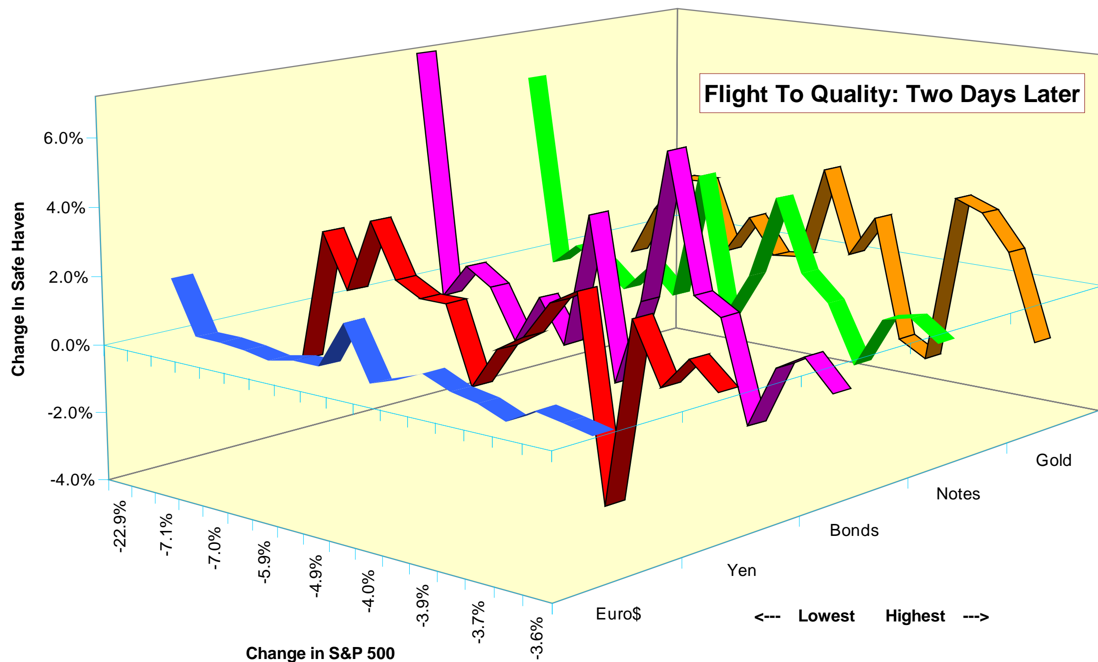
Since the 1987 crash, there have been 17 daily declines of 3.5% or more in the S&P 500, even though it feels as if there have been many more. If we examine the behavior of five potential safe haven markets on the day of each of these downturns, and on the two subsequent days, we are left with one and only one important conclusion: There has only been one flight to quality response, and that was 1987's.

A second conclusion emerges. Of the five safe havens examined -- eurodollars, Ten-year notes, Treasury bonds, Japanese yen, and gold -- the market with the highest average gain following a downturn in the S&P 500 is gold. Gold has been in a bear market since the waning days of the Carter administration. It has failed to rally during times of international distress, central banks and mining companies have driven the price down so far that they've had to publicly renounce further sales, and yet the yellow metal still manages to shine during stock market selloffs. Go figure.

The charts below depict the percentage moves of these following markets during and immediately after the stock market downturns.


Flight To Quality: Same Day
Change In Safe Haven
2.7%
1.7%
0.7%
-0.3%
-1.3%
-2.3%
-22.9%
-7.1%
-7.0%
-5.9%
-4.9%
-4.0%
-3.9%
-3.7%
-3.6%
Change in S&P 500
Euro$
Bonds
Notes
Yen
Gold
<--- Lowest Highest --->


Flight To Quality: Next Day
Change In Safe Haven
3.9%
2.9%
1.9%
0.9%
-0.1%
-1.1%
-2.1%
-3.1%
-22.9%
-7.1%
-7.0%
-5.9%
-4.9%
-4.0%
-3.9%
-3.7%
-3.6%
Change in S&P 500
Bonds
Euro$
Notes
Gold
Yen
<--- Lowest Highest --->



Alarmed By The Lack Of Fear?
The failure of a flight to quality to materialize during the week of April 10-14, 2000 may in fact underscore a deeper problem with the market as a whole. The proximate cause of Friday's debacle was a high CPI number, one that raised concerns of still more interest rate increases to come. If you believe higher interest rates are on the way, courtesy of a stronger economy and an unleashing of price pressures suppressed for two and one-half years by various international crises, then a move into fixed income instruments is irrational. You would have to believe that lower interest rates, a slowing or contracting economy, and a sudden disappearance of inflationary pressures are imminent.

This page has held inflation to be in check (see "Put the Pedal to the Metals in Inflation Hunt," November 3, 1999, "Inflation Isn't Lurking in the Fields," December 8, 1999, or "Metals Still Carry Weight and May Even Point to Bond Rally, February 16, 2000). However, the essence of great trading and investing is knowing when you are wrong. Should the CPI number be confirmed, then neither stocks nor bonds will be very rewarding for a prolonged period. After all, the stock market remained in a trading range between 1966 and 1982 during our last inflationary cycle, and that's an ugly thought to contemplate.