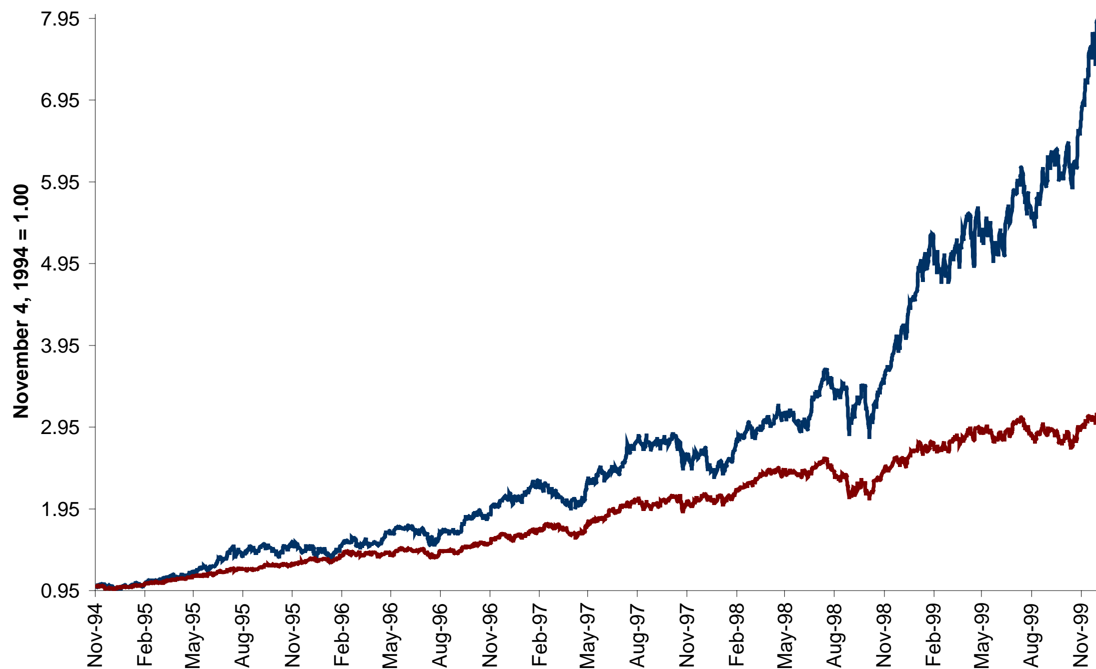
Trees Grow To The Sky, Don't They?

Even the most crazed technology bull has to be a little winded by the NASDAQ's rise since October 15, 1999. While it at times feels as if the NASDAQ has been outperforming the S&P 500 forever, the real outperformance extends backwards in time only to the market low of October 8, 1998. The extent of this outperformance is even more remarkable when we consider 34.94% of the S&P 500 (SPX) as presently constituted is subsumed by the NASDAQ 100 (NDX).

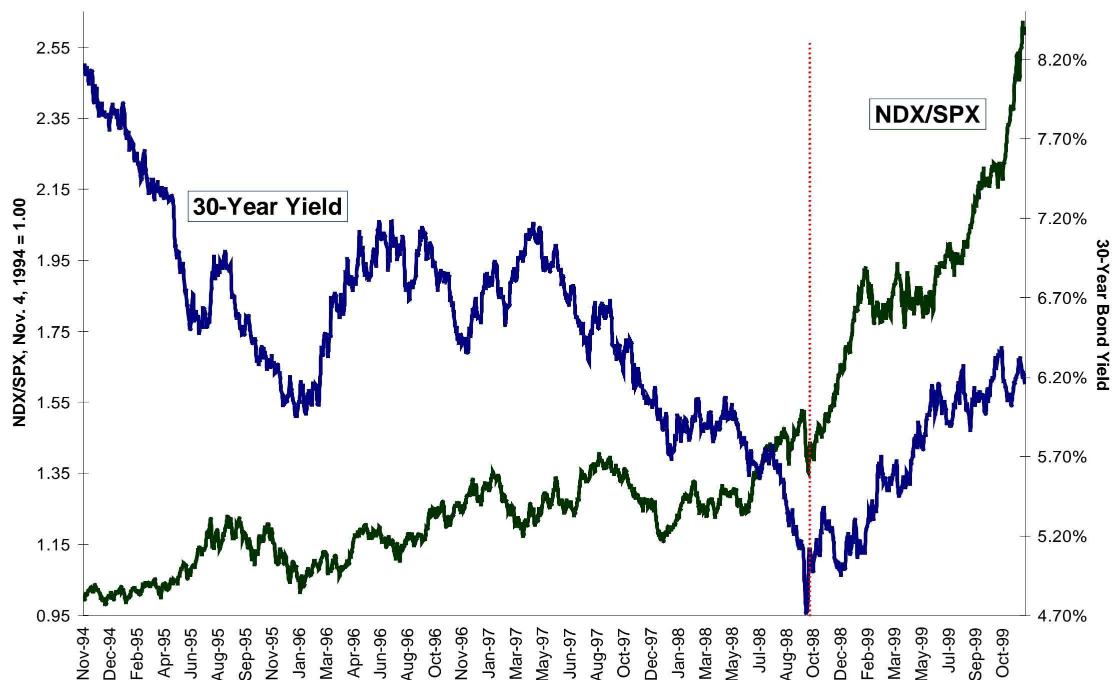
Relative Performance: NASDAQ 100 Vs. S&P 500



Some of this outperformance, to be sure, is to be expected. Roughly half of the NDX can be classified as computer, Internet, or other technology-related stocks, and there is no question these sectors have been rewarded generous multiples; as of the close of business December 10, 1999, the P/E of the NDX was 99.60, as compared to 31.54 for the SPX. Well, you say, Yahoo! deserves a market capitalization twice that of General Motors since it has higher margins than the automotive giant and, indisputably, can grow at a much higher rate.

Growth And Interest

The question of whether the Internet stocks deserve their present valuations will be left to others. What we will question here is why the strong divergence between the NDX and the SPX coincided with a period of rising interest rates. Logic dictates value stocks, those trading at low P/E multiples but who have steady earnings profiles, should do better than growth stocks, whose distant earnings are now discounted by the higher rates. Even more puzzling, when taken in this regard, is the stall in the largest multinationals' stock prices during a period of resurgent growth in the global economy.



Did the surge in relative NDX performance occur in spite of higher rates, as the above theory would suggest, or did the steady climb in bond rates occur in response to the very same resurgence in global growth fueling demand for technology? We will have to lean toward the latter; higher interest rates must hurt the future earnings of these technology stocks more than those of the value stocks, but this effect is being overwhelmed by the sheer demand for technology.

Since we are discussing the relative performance of the NDX and the SPX, we must note the SPX has a large representation of financial stocks -- banking, insurance, brokerage -- whose earnings have been affected negatively by higher interest rates, while the NDX has been spared this burden.

Buy Hope

Traditional futures market bets on continued economic growth have centered on such industrial commodities as copper, nickel, lumber, and the energy complex. Nickel, which trades on the London Metals Exchange, has doubled in price during 1999. Its current price of $7,980 per tonne is approaching its historic high of $10,500 per tonne set in late 1994. Copper and lumber both have been stagnant this year, and the energy complex is showing signs of topping out as Iraqi production moves into the market. Indeed, most physical commodity markets still are facing oversupply situations and soft prices.

We could bet on a continuation of monetary tightening in response to strong growth, but the world's central bankers are not likely to step up their anti-inflation efforts until they see some real evidence of inflation -- and higher stock prices don't count.

A glance at the above chart reveals a connection between NDX outperformance and higher bond rates, but the opposite is not quite true: The massive decline in bond rates from November 1994 through October 1998 coincided with the NDX still outperforming the SPX, albeit at a much slower rate. A trade of buying the NDX and selling the SPX amounts to be bet on continued higher interest rates and on continued strong demand. The opposite trade would be particularly inefficient as a bet on lower interest rates, however. Futures on both indices trade on the Chicago Mercantile Exchange, and European-exercise index options trade on the Chicago Board Options Exchange. Tracking stocks exist for both indices on the AMEX; ticker

QQQ represents 1/20th of the NASDAQ 100, while ticker SPY represents 1/10th of the S&P 500. Patience and a strong stomach are required, especially for the NDX wing: At-the-money call option volatility on the NDX frequently trades near 40%, while that for the SPX ranges generally between 20-25%.

If you want to bet on a continuation of what we've seen this year, buy the NDX and sell the SPX; you can even throw in a few long bond positions as a hedge. If you think we've gone too far, too fast, and that the central banks are going to take away that famous punch bowl, buy the SPX and sell the NDX, but don't sell bonds as a hedge. We'll know soon enough into the new year which way we're going to go.