When Stocks And Bonds Disconnect

The present decade has been most unkind to those who like their intermarket relationships simple and direct. If on December 31, 1999, when everyone else was concerned over Y2K, you were told that by mid-2008 crude oil would be over $125, that gold would have been over $1,000, soybeans near $15, etc, and that Treasury note yields would be approaching 4% from below, you would have thought your informant had gotten a head start on the evening's festivities.

Those low Treasury yields, part of a trading range extending back to mid-2003, were a continuation of what Alan Greenspan referred to in February 2005 as a "conundrum." The Federal Reserve was in the middle of a rate-hike campaign that would extend to seventeen consecutive FOMC meetings, inflation was on the rise, the world economy was growing, the dollar was on the run, stocks were in a bull market and yet yields refused to rise.

Part of the reason for the conundrum was the massive U.S. current account deficit. It mandated an equally massive U.S. capital surplus as foreign investors had to plow the dollars into American financial instruments. A second reason, only visible later, was how Treasuries serve as a repository of flight capital during times of financial stress. Viewed in this sense, unnaturally low Treasury yields actually are a form of insurance; the buyer receives a lower-than-deserved yield in exchange for nominal safety of principal.

The Breakdown Begins

As Treasury yields both form the basis against which corporate bonds are quoted and serve as a point of reference for stock prices, their distortions become critical for other financial markets.

Stocks prices, which are held in financial theory to represent the discounted stream of future dividends, have their own distorting forces as well. One of the lessons learned during the leveraged buyout boom of the 1980s was investors seeking corporate control are willing to pay a premium over and above what an ordinary investor is willing to pay for mere ownership.

Therefore, just as Treasury yields can be pushed too low by a flight-to-quality, stock prices can be pushed too high by increased merger and acquisition, private equity or leveraged buyout activity. The end result in this environment is a breakdown in the familiar dividend discount model, shown at a ten-year horizon as

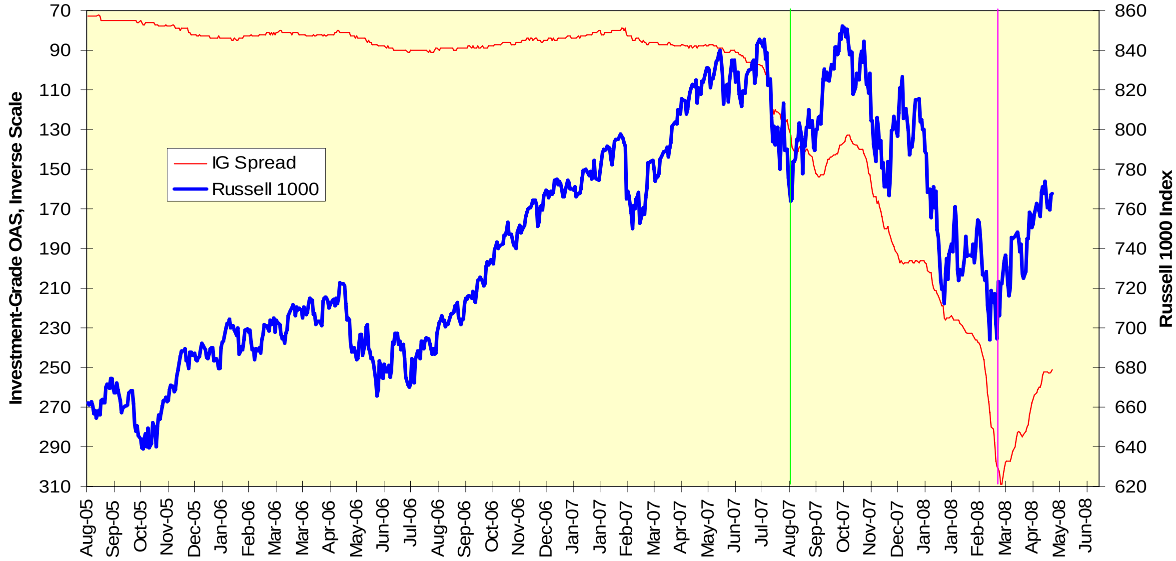
Where r is the Treasury rate and g is the growth rate. The end result is an environment wherein the normal and expected relationships between stocks, corporate bonds and Treasury bonds (see "Stocks Float On A Sea Of Bonds," December 2005) collapse.

Stocks And Corporate Bonds

The disconnections had been building going into 2007 on the back of a huge private equity boom that pushed stocks higher as their supply shrank under the weight of these buyouts, and then really accelerated with the onset of the credit crunch in July-August 2007. The August 2007 panic low is marked in all charts with a green vertical line, and the March 2008 panic low is marked on all charts with a magenta vertical line. The January 2008 panic low is omitted to avoid clutter, which is quite an editorial comment in itself.

We can compare the course of the large-capitalization Russell 1000 index against the Merrill Lynch investment-grade bond index' option-adjusted spread (OAS) to Treasuries; this index is plotted inversely in Chart 1. The higher the OAS, the greater the risk premium of the bonds is believed to be.

Chart 1: Large-Capitalization Stocks Still High Relative To Credit Spreads

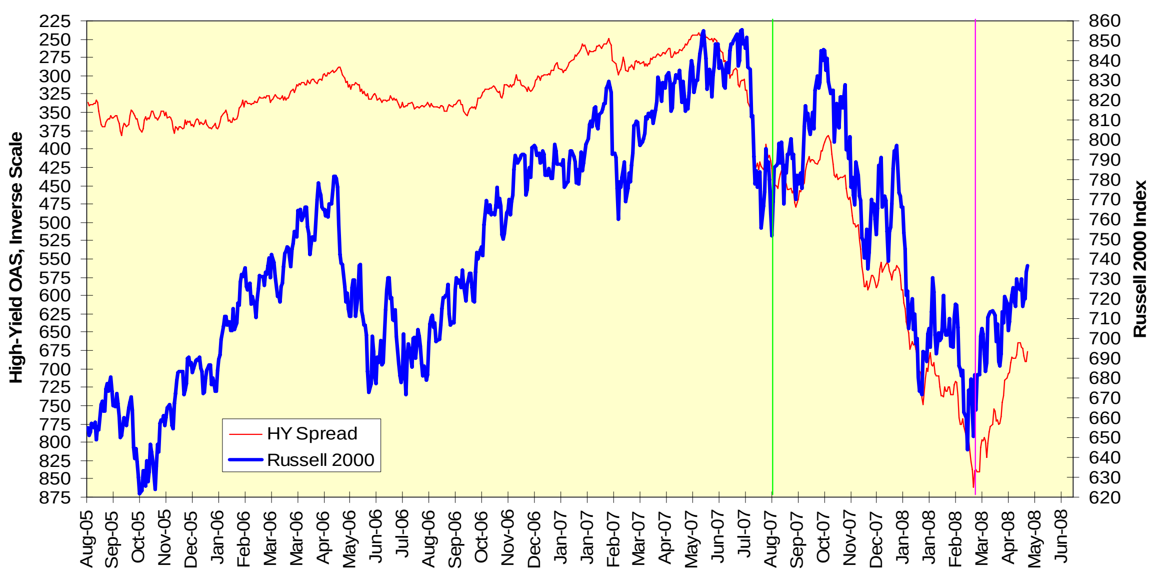


Note how the rise in OAS levels preceded the July-August selloff in stocks and never really topped out until the March 2008 panic. Stocks made several furtive rally attempts between August 2007 and March 2008, all of which failed, but the corporate bond market never took the rally bait.

This is logical. Corporate bonds stand ahead of stocks in a company's capital structure; in the event of bankruptcy, the bondholders get paid first. Why would anyone want to own a company's stock but demand a higher risk premium for lending that very same company money? The answer alluded to above and revisited below, lies in the control premium investors are willing to pay for stock.

The same relationship seen in Chart 1 for investment-grade issues and large-capitalization stocks extends to high-yield bonds and small-capitalization stocks. These are represented by the Merrill Lynch high-yield bond index' OAS and the Russell 2000 index, respectively. That the relationship is consistent for both investment-grade and high-yield bonds says something about how artificial – useless? – these ratings can be.

Chart 2: Small-Capitalization Stocks Still High Relative To Credit Spreads



In both bond classifications stocks remained historically rich relative to corporate bonds. As investors in both markets had access to the same information, we have no reason to believe the bond investors had it right by selling off their allegedly safer investments, nor do we have any reason to believe stock investors had it right by buying stocks in the face of a slowing economy and visibly deteriorating credit conditions. If, however, stocks were being priced for control as opposed to ownership, the two levels of valuation can be reconciled.

Relative Valuation To Treasuries

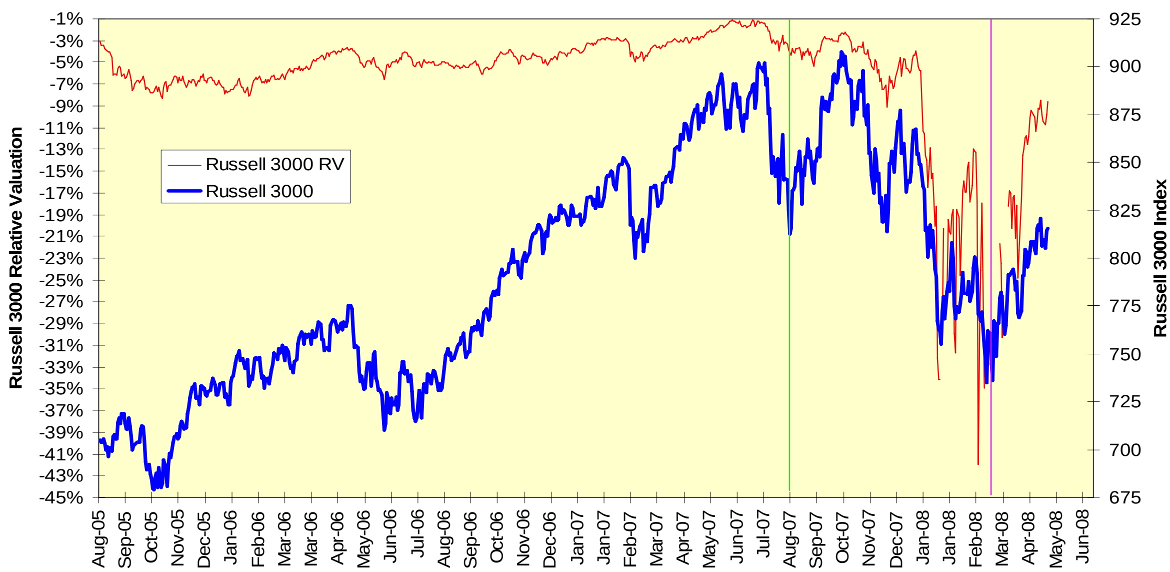
Let's reconstruct the dividend discount model at the ten-year horizon by using consensus top-down expected price-to-earnings ratios as reported by *Bloomberg* for the broad-based Russell 3000 index and the Russell 3000 growth and value indices instead of for an individual stock.

The results can be compared to Treasury yields as if none of the factors discussed above existed to distort either Treasury yields or stock prices. As interest rates plunged in late 2007 and remained low through early 2008, stocks looked increasingly attractive by virtue of money fleeing from risky assets to Treasuries. While this may seem preposterous, it makes perfect sense economically; the more one asset is sold in favor of another, the more undervalued it becomes on a relative basis.

The relative valuation levels in Charts 3-5 can be interpreted as the more negative the relative valuation number, the more undervalued the stock index is relative to the ten-year Treasury.

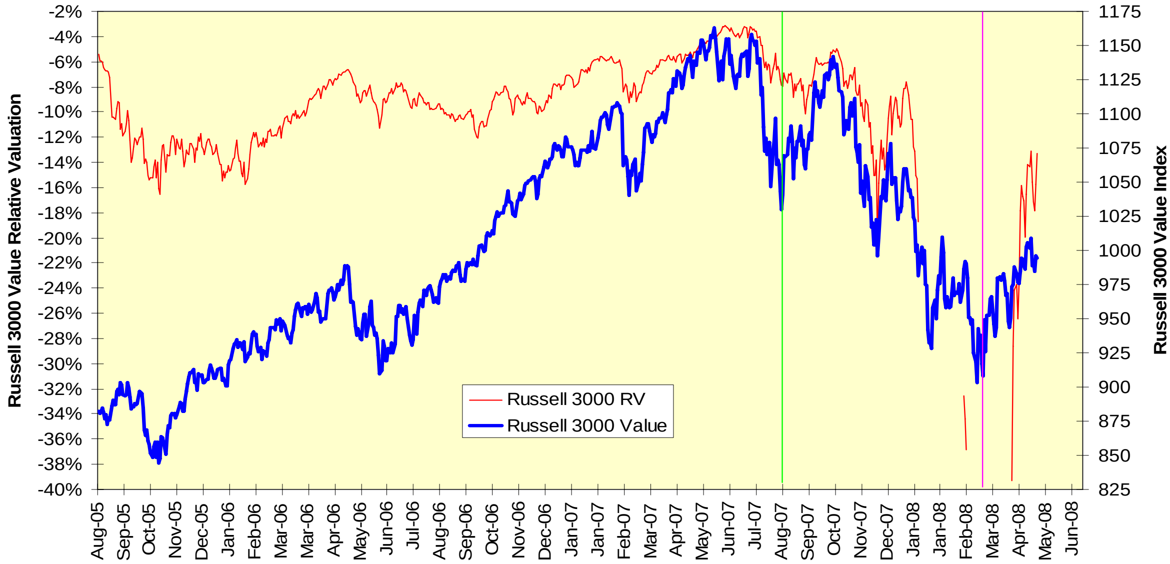
The Russell 3000, seen in Chart 3, has been undervalued continuously since *Bloomberg* began reporting the consensus estimates in August 2005. We can attribute this to the persistent over-pricing of Treasuries via the conundrum effects discussed above. It would take either a rise in long-term interest rates or a fall in earnings expectations to reverse this pattern.

Chart 3: Price And Relative Valuation of Russell 3000



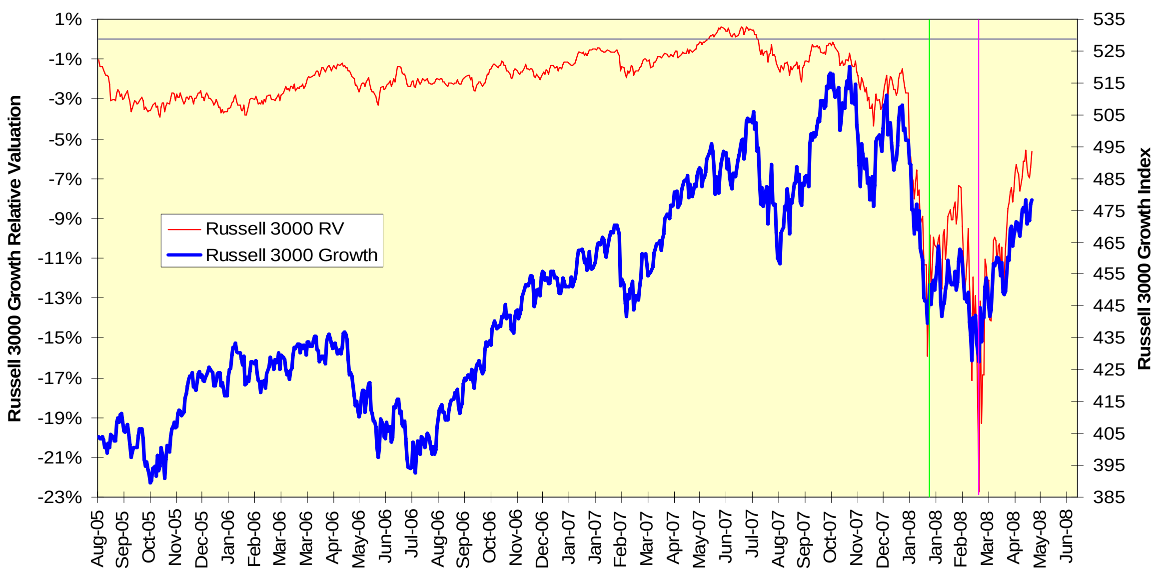
Now let's look at the value and growth indices, respectively. The Russell 3000 value index, depicted in Chart 4, has followed its relative valuation measure rather closely, but at a significantly undervalued level. Even as long-term interest rates fell, value stocks' valuation remained under pressure.

Chart 4: Price And Relative Valuation of Russell 3000 Value Index



The pattern for the Russell 3000 growth index is different. They became more attractive in late 2007, but were nowhere near as undervalued as their value stock counterparts. This is one of the few things we can point to as being in conformance with financial theory: As a proportionately greater share of growth stocks' earnings occur at a later horizon, they should benefit more from lower long-term interest rates as a discount factor.

Chart 5: Price And Relative Valuation of Russell 3000 Growth Index



Who Is Buying?

We see a strong performance of stocks relative to corporate bonds and a strong performance of growth relative to value. We have to ask who is doing the buying of stocks to account for these relationships.

The answer, as became apparent in late 2007, was sovereign wealth funds, those vast pools of capital controlled by states around the world with large trade surpluses vis-à-vis the U.S. These funds took ever-larger stakes in the financial sector; by the first quarter of 2008, firms such as Merrill Lynch, UBS and Citigroup all had announced infusions from these investors. The sovereign wealth funds moved from pushing Treasury bond yields lower to pushing stock prices higher, and to acquiring increasing ownership stakes in U.S. companies along the way.

Is that a negative for the U.S.? Not really; we financed much of the rest of the world in the 1950s and 1960s to everyone's benefit, and we bailed out various Third World debtors in the 1970s, 1980s and 1990s. We are now on the receiving end of the process. In fact, by mid-2008, the financial sector had the lowest weighted average cost of capital of all ten economic sectors in the U.S. That is how a market is supposed to work, and all we need do is see how many success stories American investment created globally, we should welcome the process.