Bonds Turning Bearish

If the international language of physics is broken English, perhaps it is for the best. Every now and then someone struggling in a second language can say something quite enduring. I recall an Italian speaker many years ago who when asked to give his rules of trading responded in part with, “Don’t get velocitated.”

Good advice, we all assumed, even though we had to request clarification on what getting “velocitated” was to better avoid it. He explained it well: Notice how much faster you drive on city streets after you pull off an expressway. You became acclimated to the higher speed, therefore, you were velocitated. In trading, this happens frequently after a prolonged period of either high or low volatility.

Long-term traders of long-term bonds may recall having to get used to the sharp moves and wide ranges bonds started putting in during the 1970s and 1980s. Bond futures used to trade in “two-handle” days with regularity during this period. Over the past decade, trading has compressed into much narrower ranges. This may change, and soon, if bond yields break out to the upside.

Let’s go back three years to the April 2004 employment report that determined the Federal Reserve would have to start raising interest rates. A weekly candlestick chart of ten-year note yields plotted inversely with red candles indicating rising yields during the week and green candles lower yields, tells an interesting story. In a rare foray into technical analysis, we see something of a head-and-shoulders bottom in yields, marked with magenta arcs, and a swing high in yields just over 4.90% marked with a blue arc; we settled after last Friday’s abbreviated trading session at 4.75%. A break over that swing point takes us to 5.05%, followed by 5.25%. After that, resistance on a monthly chart does not appear until 5.80%. Feeling velocitated?

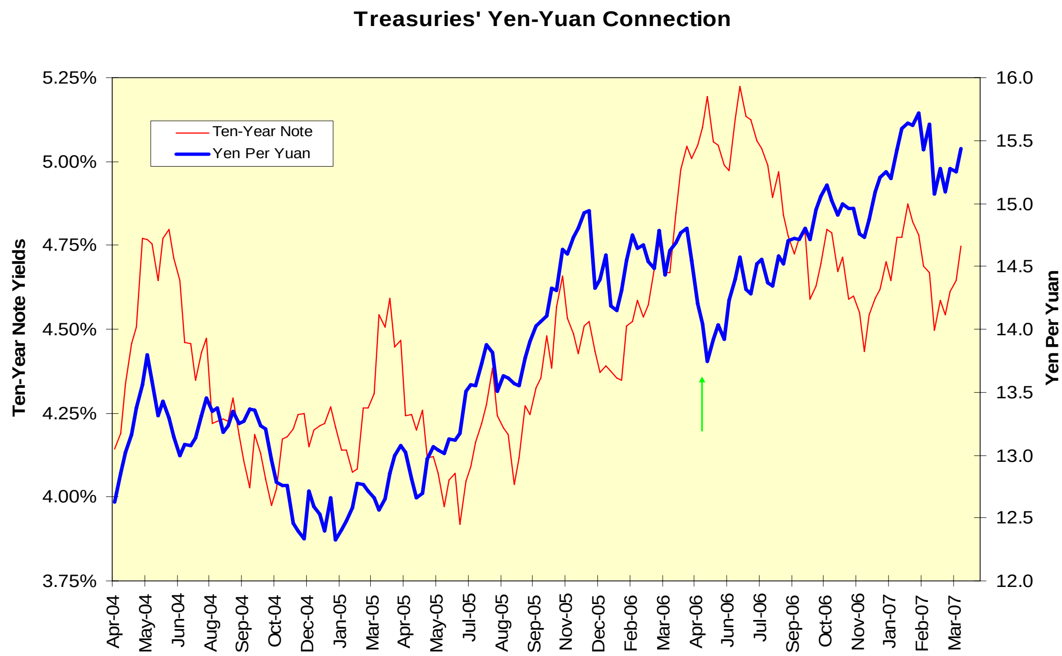
Long-Term Yields Set To Rise

Made In Japan

Connections between markets can exist where least expected. While we focus on the exchange rates of the Japanese yen and Chinese yuan, referenced here from last October and last week, we tend to forget the cross-rate between the two countries is of vital importance to both of them. Japan is an extraordinarily expensive place to do business compared to China, and the Japanese are not shy about keeping the yen from rising too swiftly vis-à-vis the yuan. One way to do this is for the Bank of Japan to engage in the yen carry trade itself by printing yen and selling them for U.S. Treasuries. Japanese investors, official and otherwise, bought $18.24 billion of U.S. Treasuries in the year ended January 31. That number pales to the $244.16 billion bought in the year ended August 31, 2004.

If we keep this motivation in mind, we can understand readily why Treasury yields have risen parallel as the yen weakened against the yuan over the past two years. The one exception was the immediate aftermath of the Bank of

Japan's contraction of liquidity in 2006, discussed here in July 2006 and noted on the chart with a green arrow. This coincided with the U.S. bond market pricing in lower expected inflation in the aftermath of the liquidity contraction.



What should we expect from the yen-yuan cross-rate in coming months? As discussed here last week, the Chinese appear reconciled to an acceleration of yuan strength; one can almost sense shoulders shrugging in Beijing as they say, "Well, you asked for it." And for all of the concerns about the yen carry trade unwinding catastrophically, the yen is still the world's cheapest country in which to borrow and by an order of magnitude. So long as the yen continues its downward path against the yuan, why should the Bank of Japan knock itself silly by buying Treasuries with freshly created yen?

Equity Market Consequences

Higher long-term interest rates need not be an absolute negative for U.S. stocks if those higher rates are accompanied by both higher expected profit growth and contained inflation. But they are a headwind for equity valuation; for any level of earnings, stock valuations should be higher as interest rates are lower. This is still operative when stocks rise in the face of higher interest rates; it is just that the higher rates are being overwhelmed by other factors.

What is the net industry group impact of higher ten-year note rates? Let's return to an analysis first introduced in February 2005 on assessing the impact of factor prices on S&P industry groups, and add the twist introduced in November 2006 on weighting these factors by the groups' representation in the index, we can construct a table of groups both helped and hurt by rising long-term interest rates at a 90% confidence interval.

There are 14 industry groups in the S&P 500 accounting for 10.72% of the index' capitalization with a statistically significant negative beta to long-term interest rates. If we multiply them by their betas to yields, we get a weighted beta of -1.41%. There are 16 groups with a statistically significant positive relationship to yields, accounting for 11.31% of the index' capitalization. Their betas are lower, however, giving this set of industries a 0.83% weighted beta for a net weighted beta of -0.58%.

Ten-Year Yield Beta-Weighted Impact On S&P 500							
	SPX Weight	TY Beta	Weighted Beta		SPX Weight	TY Beta	Weighted Beta
Electric Utilities	2.47%	0.162	-0.40%	Systems Software	2.76%	0.057	0.16%
Multiline Utilities	2.76%	0.144	-0.40%	Aerospace & Defense	2.47%	0.048	0.12%
Gold	1.01%	0.197	-0.20%	Department Stores	0.76%	0.104	0.08%
Gas Utilities	0.86%	0.097	-0.08%	Railroads	0.74%	0.103	0.08%
Thrifts & Mortgages	0.77%	0.090	-0.07%	Diversified Chemicals	0.86%	0.076	0.07%
Managed Health	0.74%	0.078	-0.06%	Steel	0.34%	0.189	0.06%
Regional Banks	0.76%	0.071	-0.05%	Drug Retailers	0.77%	0.078	0.06%
Homebuilding	0.12%	0.340	-0.04%	Automobile Manufacturers	0.26%	0.172	0.04%
Construction Materials	0.41%	0.092	-0.04%	Data Processing & Outsourcing	1.01%	0.044	0.04%
Home Furnishings	0.30%	0.085	-0.03%	Application Software	0.41%	0.078	0.03%
Specialized Finance	0.18%	0.108	-0.02%	Specialty Stores	0.30%	0.083	0.03%
Diversified Banks	0.12%	0.080	-0.01%	IT Consulting & Services	0.12%	0.124	0.01%
Consumer Finance	0.12%	0.054	-0.01%	Employment Services	0.09%	0.169	0.01%
Other Diversified Financial Services	0.09%	0.038	0.00%	Motorcycle Manufacturers	0.12%	0.103	0.01%
				Advertising	0.18%	0.060	0.01%
				Office Services & Supplies	0.12%	0.042	0.01%
				Subtotal:	11.31%		0.83%
Subtotal:	10.72%		-1.41%	**Total:**	**22.03%**		**-0.58%**

The list of industries immune to rising long-term rates is an eclectic mix of Industrials and Basic Materials stocks whose profit margins can expand along with economic growth. The victims list is dominated by utilities, housing-related issues and financial firms.

At its most basic, the shift toward higher long-term interest rates should favor growth over value until and unless there is emerging evidence of an economic downturn.