The New Financial Order?

(April 16, 2006)

Dear Subscribers,

In our last mid-week commentary, I had stated that there was a high likelihood that the secular bull market of the U.S. long bond (which began in 1982) was effectively over. Please read our last mid-week commentary in details. In this commentary, we will effectively close out our arguments by attempting to quantify the effects of our prior points as well as presenting new evidence on why we believe the secular bull market in the long bond is over.

In the early part of the 21st century, many investors were "fooled" into believing that interest rates could only rise from current levels – and yet there were sorely disappointed – especially sponsors of defined benefits pension plans whose liabilities grew by leaps and bounds for every percentage point decline in the 30-year Treasury yield (the typical "duration" for a pension plan is 10 to 15 – which means that for every percentage decline in the yield curve, liabilities would rise by 10 to 15%). Over the last couple of years, however, many folks started giving up on this thesis when rates continued to remain low – even going as far as believing in the omnipotence of the Federal Reserve and other Central Banks in being able to "manage" or jawbone global long-term rates. The 64-million dollar question: Is this view justified?

It is interesting to note that as recently as late last year; many Central Bankers and Wall Street analysts alike were still very puzzled on why long-term interest rates remained so stubbornly low. Various reasons were thrown about – such as the "global savings glut," the willingness of pension funds to shift their asset allocation from equities and into bonds (in order to better match their liabilities), and the accumulation of U. S. Treasuries and Federal Agency debt by foreign Central Banks such as the Bank of Japan and the Bank of China. Interestingly, Central Bank accumulation of U.S. Treasuries has more or less been discredited as a reason – since this "low interest rate phenomenon" is literally global in nature and is not just restricted to the United States.

Sure, the Federal Reserve can jawbone interest rates lower in the short-run, but over the long-run, the Fed cannot influence the bond market any more than it could have prevented the 2000 to 2002 technology bust or the secular rise in long-term rates during the 1970s. The bond market – just like any other market – is an auction market, and unless the Fed can get itself involved as a counter-party in every single transaction of long-term bonds, it could never over the long-run maintain a fictitious market. Besides, the Fed – unlike the Bank of Japan – has never tried to directly "manipulate" the long side of the yield curve in the recent decline in rates. As I have argued before in many of our commentaries, there are many legitimate reasons out there for the low interest rate environment that we have experienced in recent years other than Fed manipulation. If anything, a better explanation could just be the fact that the secular bull market in bonds was running itself into conclusion – since at the end of every bull market, many market participants are typically confused or confounded by every single up-move – whether it is with stocks, commodities or bonds.

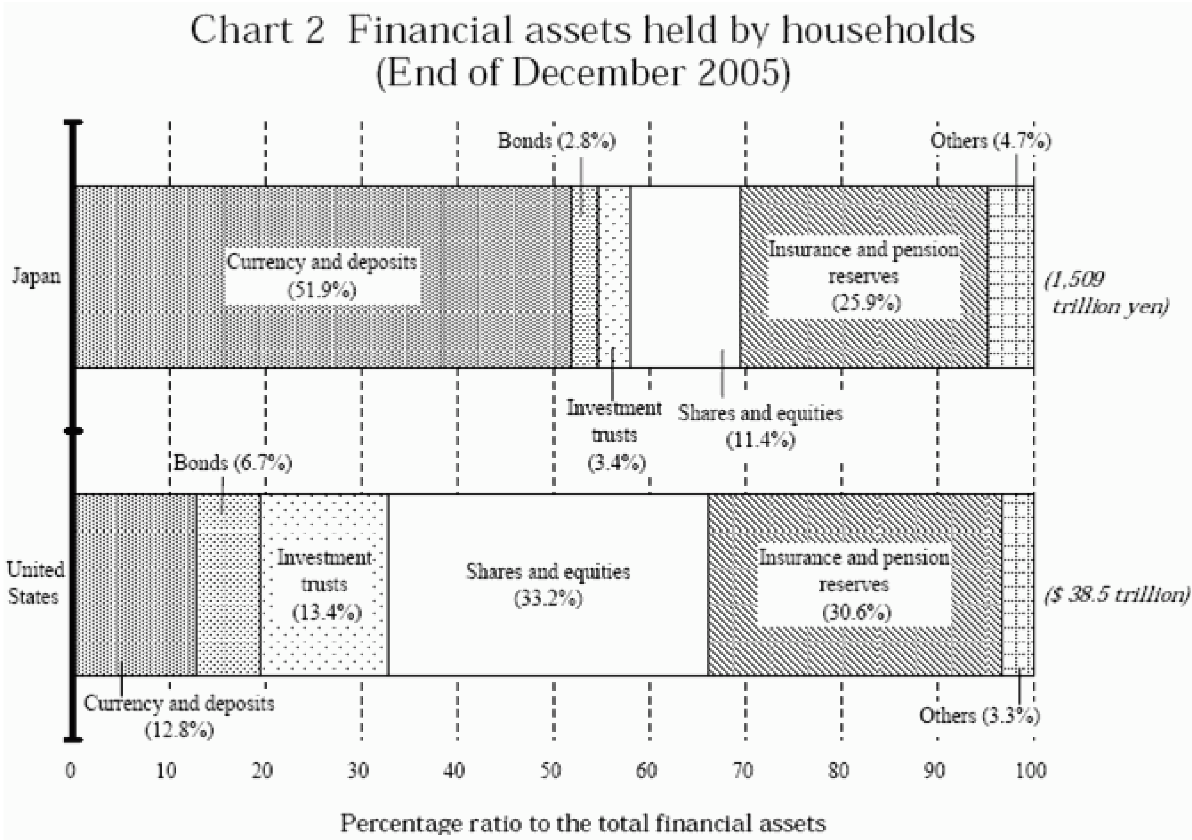
One legitimate reason I have previously discussed is the implementation of the "quantitative easing" policy by the Bank of Japan in order to get the Japanese economic and financial system back on its feet. One of its policies involved the Bank of Japan purchasing domestic government bonds all across the yield curve – thus lowering interest rates all across the board and reliquefying the financial system in the process. This has in turn forced Japanese private investors (households and pension funds, and so forth) to go on a "search for yield" game all across the globe, and since Japanese private individuals represent the largest group of savers in the world, this has had a hugely depressing effect on sovereign yields all across the world.

But Henry, you have just stated that the Bank of Japan has effectively been able to manage the domestic yield curve. Can't the U.S. Federal Reserve use the same policy to continue to depress long-term yields?

Copyright © MarketThoughts, LLC.

My short answer to this question is "No." Why? Readers should know this: Japan's quantitative easing policy effectively began in March 2001. At the end of February 2001, the yield of the 10-year JGB stood at 1.3% (see the chart showing the action of the 10-year JGB and the 10-year U.S. Treasury note in last weekend's commentary). By May 2003, the yield of the 10-year JGB had declined to a new low of 0.53%. Over the subsequent 12 months, however, the yield of the 10-year JGB would rise significantly – hitting 1.85% by July 2004. 10-year yields subsequently reacted by hitting 1.17% by June 2005, but it would never see a level below 1.00% again. By the time the Bank of Japan made the decision to stop its quantitative easing policy, 10-year yields were back to 1.6%. In other words, the BoJ's monetary policy has already lost its effect on the yield curve by the beginning of this year – unless the Bank of Japan and the Ministry of Finance were willing to "take it one step further" by flooding the system with more bank reserves or by implementing a higher target rate for their purchase of 10-year government bonds (they had already been consistently buying 1.2 trillion Yen worth of government bonds every month).

More importantly, unlike U.S. government securities (where more than half of the amount outstanding is held by foreigners), 95% of Japanese government securities are held by domestic investors. If the Federal Reserve had wanted to implement a similar policy, it would have required the cooperation of many different kinds of investors – including countries that are not particularly friendly or has the same agenda as the U.S. As for Japan, the economy had been mired in deflation for over 15 years – and private individuals and pension funds alike were thus very risk-adverse and were very willing to invest in relatively risk-free JGBs or U.S. Treasuries. True, the amount of Japanese government debt outstanding is the highest among developed countries at 160% of GDP, but readers should note that this amount is essentially dwarfed by the balance sheets of the Japanese private sector, as shown by the following chart comparing financial assets held by Japanese and U.S. households, courtesy of the Bank of Japan:



At 160% of GDP, the amount of government debt outstanding is approximately $6 trillion – but this is more than made up by savings of domestic households, pension funds, and insurance companies. The balance sheets of individual households are also very healthy – as shown by the following table compiled by the Japanese Statistics Bureau (note that the asset side only includes financial holdings, not real estate holdings).

Table 13.3
Amount of Savings and Liabilities by Age Group of Household Head
(Workers' households) (2004)

(Million yen)

Item	Average	Under 29	30 - 39	40 - 49	50 - 59	60 - 69	70 and over
Yearly income	7.30	4.61	6.08	7.78	8.58	6.61	6.35
Saving total	12.73	3.49	7.01	11.32	16.83	22.50	20.71
Financial institutions	12.10	3.23	6.49	10.57	16.05	22.17	20.57
Demand deposits	2.06	1.39	1.72	1.58	2.42	3.35	3.73
Time deposits	5.21	1.16	2.44	4.27	7.11	10.68	9.33
Life insurance	3.78	0.55	1.89	4.08	4.96	5.62	3.92
Securities	1.06	0.12	0.44	0.64	1.56	2.52	3.60
Non-financial institutions	0.63	0.26	0.52	0.74	0.78	0.33	0.13
Liabilities total	6.55	2.96	7.42	9.23	5.47	2.15	1.10
Housing- and land-related debt	6.05	2.61	6.98	8.66	4.95	1.76	0.85
Debt related other than housing and land	0.34	0.19	0.25	0.40	0.40	0.32	0.22
Monthly and yearly installments	0.15	0.16	0.19	0.17	0.13	0.07	0.03

Source: Statistics Bureau, MIC.

In other words, there has been a "global savings glut" – but this "savings glut" has mostly been concentrated in Japan. This "savings glut" in Japan came into being primarily because of two factors: 1) The high savings rate of Japanese individuals, and 2) The fact that Japan has been mired in deflation over the last 15 years and the resulting lack of willingness of Japanese individuals to put their cash in instruments other than a savings account or government bonds. Neither of these two factors is currently in place in the U.S. – and so any direct manipulation of the U.S. yield curve will only be temporary at best. Readers should also keep in mind that while the amount of U.S. government debt outstanding is "only" at 80% of GDP, the amount of mortgage-backed securities and federal agency debt outstanding is three times as big as the government debt market. Even a coordinated effort among the world's major Central Banks cannot "manipulate" the bond market for long if private investors really and hedge funds alike want to sell.

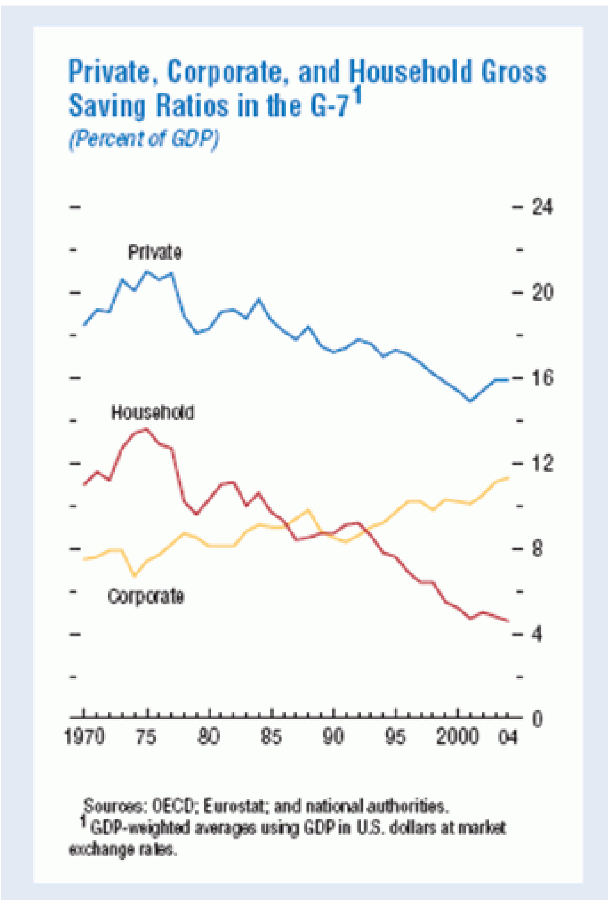
More importantly, the manipulation of the long bond in Japan combined with the "savings glut" in Japan has had the purpose of compressing yields around the world. However, with the end of the "quantitative easing" policy and with the outperformance of the Nikkei in Japan in recent months, not only will the lack of government buying put upward pressure on yields (Japanese insurers have just recently come out and stated that they will increase their domestic bond holdings relative to foreign bond holdings should the yield of the 10-year JGB rise above 2% in the days ahead), but for the first time in a long time, domestic private investors are now taking a hard look at domestic equities. I may not have mentioned this before, but over the last five years or so, the action of the Nikkei and the yield of the 10-year U.S. Treasury Note have had a 90% correlation. Yes, this correlation is even higher than the correlation between the yield of the 10-year JGB and the 10-year U.S. Treasury Note.

There is also no reason for either the U.S. Federal Reserve or the European Central Bank to "manipulate" the long-end of their yield curves unless REAL interest rates (long-term borrowing costs) start going sky-high. While this author thinks that the secular bull market in the long bond is effectively over, there is no reason to believe in an Armageddon scenario – and thus while the central banks can try to directly lower long-term interest rates by buying U.S. Treasuries or UK gilts, there is no reason to believe that they will do so at this point.

Finally, two more important reasons have served to compress yields (and most probably emerging market spreads) around the globe – those being the high corporate savings rate and the recycling of petrodollars into U.S. Treasuries (through third-party intermediaries which makes it very harder to verify) and other sovereign bonds. In the latest "World Economic Outlook" that is due to be officially released by the IMF this coming week, the IMF states that: "*Since the 1980s, the corporate sector of the G-7 economies has swung*

Copyright © MarketThoughts, LLC.

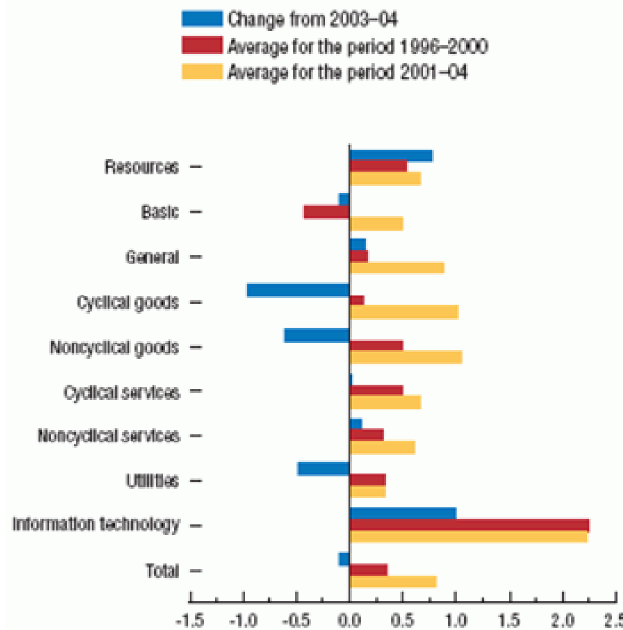
from being a large net borrower of funds from other sectors of the economy to a net lender of funds. Indeed, on average over 2002–04, the excess saving (or "net lending") of the corporate sector—defined as the difference between undistributed profits (gross saving) and capital spending—was at a historic high of 2 1/2 percent of GDP in the G-7 countries (Figure 4.1). This behavior has been widespread, taking place in economies that have experienced strong economic growth (Canada, the United Kingdom, and the United States) and in those where growth has been relatively weak (Europe and, until recently, Japan)." Indeed, while the decline of the savings rate has been very well-publicized in the U.S., what has not been that well-publicized is the resultant (which may actually have been one of the causes of the decline in household savings rate) increase in the corporate savings rate. Following is a chart from the latest IMF World Economic Outlook comparing the private (sum of corporate and households), corporate, and household gross savings ratios in the G-7 countries:



As an aside, the decline in the household savings rate is not only a U.S. phenomenon, but a G-7 one as well. That being said, this author believes that the U.S. is stronger than it appears, given the "entrepreneurial spirit" of this country relative to other G-7 countries. For example, both Larry Page and Sergey Brin of Google have historically been treated as having a negative impact of the U.S. household savings rate in our (traditional) national accounting methodology – even though both the founders of Google has been genuinely "saving" by investing in their business since the mid 1990s. Such "investing" across the U.S. by entrepreneurs (including yours truly on the MarketThoughts.com website, even though we are light years away from accumulating a nest egg that can match even 1% of Larry and Sergey's net worth) is totally ignored on the income statement. As a matter of fact, both Larry and Sergey has continued to add to the expense side of the U.S. income statement, given that taxes are treated as a household expense when corporate insiders choose to sell their holdings and diversify into other investments.

Anyway, we digress. The strong savings mentality of corporate management has resulted in a sizeable cash hoard in the G-7 countries – and especially in the IT and resources sectors, as exemplified by the chart from the IMF below:

Copyright © MarketThoughts, LLC.



The secular decline in borrowing by G-7 corporations since the 1980s has no doubt contributed to the decline in yields (borrowing costs) all across the world – particularly in U.S. Treasuries. Going forward, however, both the IMF and this author will argue that the current cash accumulation by G-7 corporations will be difficult to match and perhaps even reverse, given the following:

1. Most of the cash accumulation in recent years has been due to a huge increase in corporate profits as well as a lack of growth in capital spending – especially among IT and resources corporations. Given that corporate profits in the U.S. (and in many other G-7 countries) as a percentage of GDP are now at 40-year highs, it is difficult to see how corporations can grow their profits as significantly as they have relative to the last few years, especially given the tight labor market here in the U.S. Also, many G-7 countries have significantly used up their excess capacity in the last couple of years, suggesting that capital investment (and subsequently, borrowing) should increase in the corporate sector just up ahead.

2. The IMF is also arguing that the process of deleveraging among G-7 corporations may be coming to an end. Quoting from the IMF's World Economic Outlook: *"Substantial progress has been made in reducing corporate debt in some countries, and an international survey by Merrill Lynch Global Fund Managers shows that investors have become much less worried about companies leverage ratios. Indeed, only 18 percent of the investors questioned in the most recent survey wanted companies to improve their balance sheets, compared to 31 percent at the end of 2003 and 55 percent at the end of 2002."*

3. The huge underfunding of corporate DB pension and health care plans – which should continue to put a strain on both household and corporate savings going forward.

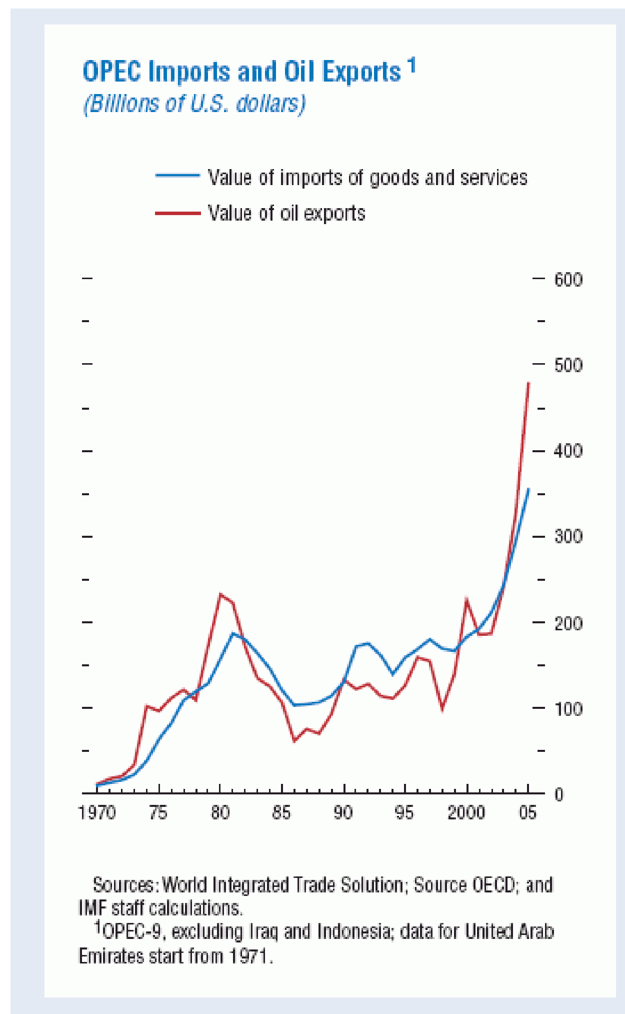
In a nutshell, it is very difficult to see how the secular trend of cash accumulation by G-7 corporations will continue to hold – especially given that the favorable factors that have popped up in recent years (such as

Copyright © MarketThoughts, LLC.

the lack of capital spending and 40-year high corporate profits) can only be sensibly viewed as temporary in nature. The subsequent "forced" re-entry of corporations into the debt markets will put significant upward pressure on both absolute yields and corporate bond spreads going forward. The IMF report concludes by stating:

The corporate sector in the G-7 countries has moved from being a net borrower to a substantial net saver in recent years. This has followed the earlier move by emerging market countries to a net saver status following the financial crises of the late 1990s. Taken together, these developments have substantially altered the financial landscape of the global economy—two sectors that have traditionally been sources of demand for financing are now lending to other countries/sectors. These changes in behavior are one factor behind the relatively low level of global long-term interest rates at present … [H]igh corporate saving should not be relied on to keep longer-term interest rates low in the future. Indeed, without some increase in household and government saving in the coming years, changing corporate behavior will likely start to put upward pressure on interest rates, and could exacerbate the current pattern of global imbalances if it lowered total private saving in deficit countries.

The final reason on why yields have remained low in recent years is the recycling of petrodollars into both U. S. Treasuries and other government bonds – which is very difficult to gauge given that most of these "recycling" is done through third-party intermediaries (or even third-party countries). While the IMF has not found any direct correlation between the recycling of petrodollars and the relatively low yields in the U.S., it should be noted that the OPEC countries have not exactly been squandering most of their revenues, as highlighted by the following showing the value of oil exports by OPEC countries vs. the value of imports of goods and services from 1970 to 2005:



Except for a brief spike in 2000, the value of oil exports from OPEC countries has been consistently lower than imports from the early 1980s until 2003. For the year 2005, however, the OPEC countries as a whole ran a good sized surplus of over US$150 billion – with much of the evidence (hard as well as anecdotal) suggesting that approximately 60% of that money is still with dollar-denominated assets such as U.S. Treasuries, U.S. Agency debt, or investments in U.S. assets through hedge funds or private equity funds.

In other words, there has also been a "savings glut" in the OPEC countries – and a significant part of this surplus has been used to purchase U.S. Treasuries and U.S. Agency debt during 2004 to 2005 – thus further compressing yields in the U.S. and most probably emerging market spreads. But with crude oil currently at $70 a barrel and with an increase in production not likely in the next 12 months, how much further can the trade surplus in the OPEC countries increase in 2006? Readers should also note forget that many OPEC countries (such as Saudi Arabia and Kuwait) are also running gigantic welfare states, and even $70 oil won't solve their long-term social problems. The dependency of Saudi and Kuwaiti citizens on welfare and retirement benefits going forward will mean that many OPEC countries will ultimately end up tapping the bond markets again for funding – and this current savings glut in the OPEC countries is also most probably temporary in nature.

As I am writing this on Sunday night, I see that oil is now trading at the $70 level once again while gasoline prices are once again making seven-month highs. And given the continued ramping up of ethanol production in the next few weeks (just in time for the May 5th deadline), gasoline prices could rise even further even as crude oil prices stay stagnant. Finally, gold is up another $7 an ounce, while copper rose another 8 cents – up a whopping 40% since the end of 2005 and over 45% higher than its 200-day moving average. At some point, one has to wonder: How much further will China, India, the airlines, GM, Ford, and U.S. blue-collar labor absorb all this before it gets passed onto core inflation? Are we really in a new era or is just a huge lag? If it is the latter, then this will put further upward pressure on long-term yields across the developed world.

For folks who believe that we were in a "new era" or a "new financial order" (stealing a page from Robert Shiller), I believe the events of the last years represented a confluence of unprecedented events which all acted together to compress long-term yields across the world – and such a benign environment for yields should most likely cease to exist over the coming few years.

Speaking of "The New Financial Order," I highly recommend readers at least taking a peak a book of the same name written by Robert Shiller (author of the famous work "Irrational Exuberance") and published in 2003. In his book, Shiller argues that the U.S. financial system is still in its infancy since even though the U. S. has the largest capital and the transparent market in the world, and yet with the exception of corporations, we as individuals have relatively few ways of hedging our risk - such as the risks of losing one's job, being hit by a life-changing disability, or being unsuccessful in one's chosen career. If Robert Shiller has his way, however, most of these risks that we suffer as individuals will be hedgeable in the not-too-distant future. Shiller envisions a somewhat utopian world where finance (the age-old issue of risk management) is "democratized," i.e. a world where everyday individuals will gain access to a futures market that will allow them to diversify away every risk imaginable. Shiller presents the following six incredible ideas:

1. The concept of livelihood insurance, where contracts will protect individuals from long-term economic risks such as the loss of a paycheck or the depreciation of one's home value.

2. The concept of what he terms "macro markets" - where individuals, corporations, and governments alike can trade or hedge risks associated with the fluctuations in GDP or national incomes.

3. The concept of income-linked loans - where lenders will make loans to governments, corporations or individuals whose repayment terms are tied to the incomes of these entities. Such repayment terms could be a certain percentage of one's income, which would cause the outstanding balance to decline if income levels decline. This would reduce the change of bankruptcies but will also alleviate our fears of taking more risks (such as changing careers). Shiller also addresses the potential "moral hazard" problem of this approach in his book.

4. The idea of inequality insurance - which is designed to address the income inequality problem within a particular nation.

5. Intergenerational Social Security - which will allow "genuine and complete intergenerational risk

Copyright © MarketThoughts, LLC.

sharing" - as opposed to today's Social Security program (which is basically a pyramid scheme) in the United States today.

6. International Agreements - which will allow sovereign governments to manage the risks of their own national economies - by sharing their risks with other sovereign governments.

Any one of the above ideas is controversial in itself, but as Shiller points out, many such insurance or futures contracts were controversial before their widespread adoption. The most controversial of all proposals could very well be the massive database that Shiller suggests will be capable of handling all this (public as well as private) information - a database which is necessary if we were to implement any one of the above ideas. Most recently, Robert Shiller has been working with the Chicago Mercantile Exchange to implement a derivative market for housing prices, which would *"provide homeowners with tools to help them protect the value of their largest asset."*

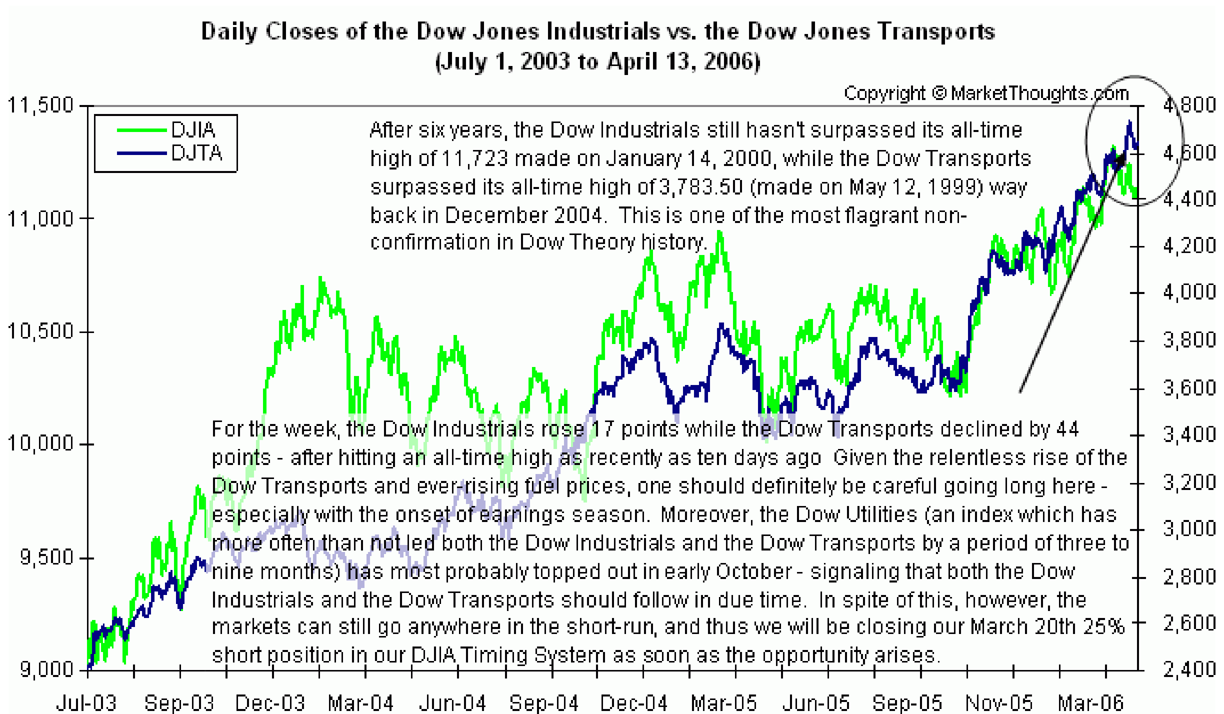
I know for a fact that many of our subscribers are fed up with discussions of trading derivatives and/or options – especially the further creation of leveraged vehicles which could be used for speculation purposes by hedge funds and individuals alike. Enron clearly stepped out of bounds when it strived to create a market in trading bandwidth, and even wine futures. At the core, however, the futures and options markets are used to hedge risks and to gain pricing transparency – and while Shiller definitely has a very utopian view of things – I think he is somewhat on the right track. Whatever the case may be, this author believes the explosive growth enjoyed by many derivative and options exchanges will continue for the foreseeable future – with many more standardized contracts to be introduced over the next few years (such as standardized contracts based on rainfall in a particular geographic area or a further development of ETF and single stock futures). For readers who are genuinely interested, you can read a somewhat amusing post on the Hollywood Stock Exchange in our MarketThoughts discussion forum.

While some of our ultra short-term indicators are getting moderately oversold, this author believes that we are still at least mired in a short-term downtrend – especially in light of the recent relentless rise in long-term interest rates around the world. Like I said in our last weekend commentary, we should continue to keep an eye on indicators such as the equity put/call ratio, the NYSE ARMS Index, and the VIX besides our most popular sentiment indicators such as the Investors Intelligence and American Association of Individual Investors (AAII) surveys. For now, these are not a concern yet. As a matter of fact, our most popular sentiment indicators actually rose in the latest week – which is bearish from a contrarian standpoint.

Before I go on, I would like to refresh our readers' memory on the Barnes Index – which I first discussed in our March 30, 2006 commentary. In a nutshell, the Barnes Index is an indicator that is meant to be a measurement of the "relative value" of equities (the S&P 500) vs. bonds. Unlike other "tactical allocation models," it also tries to take short-term interest rates and dividend yields into account. Since our March 30th commentary, the Barnes Index has risen further from a level of 54.8 to 57.2 as of last Thursday at the close, as shown by the following chart courtesy of Decisionpoint.com:

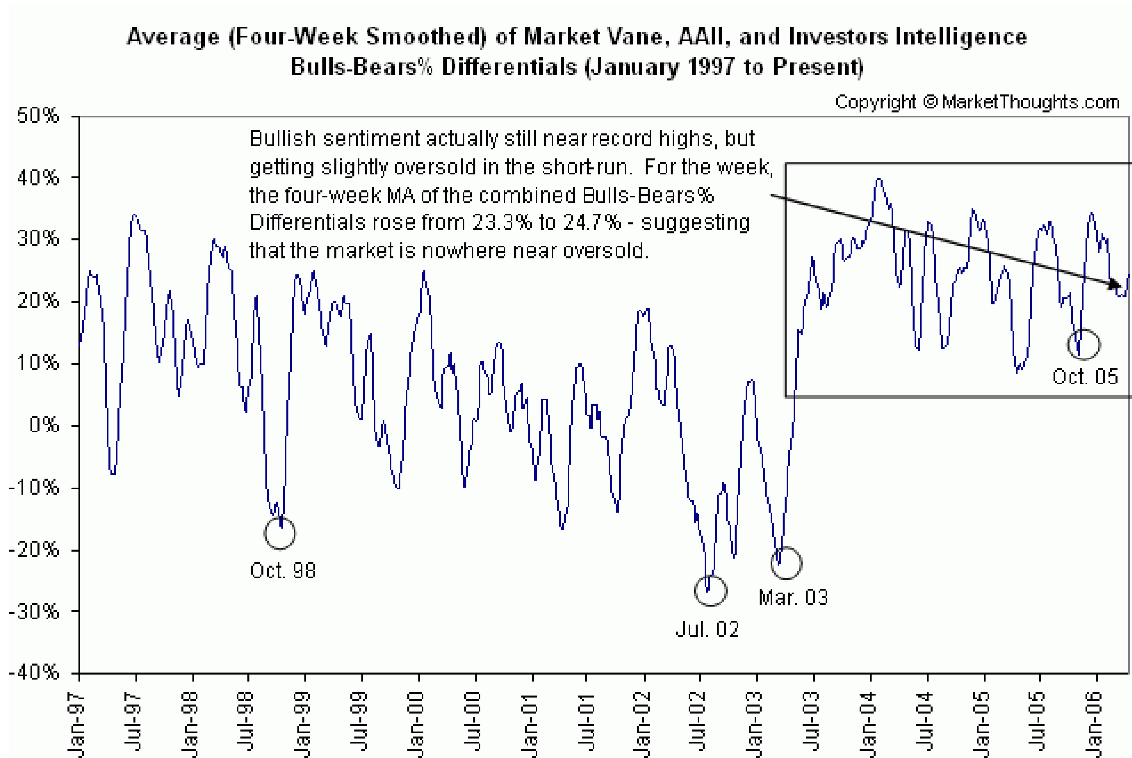
In our March 30th commentary, I stated: *"While the current value of 54.8 isn't overly high relative to the readings of the last 25 years, readers should note that the Barnes Index now represents the highest reading since this cyclical bull market began and since early 2002. More importantly, readers should also note that the S&P 500 topped out in January 1973 with the Barnes Index at around current levels. While we won't officially enter the "danger zone" until the Barnes Index hit the 65 to 70 level (which would be comparable to a Fed Funds rate of 5.0% and a long bond yield of approximately 5.5%), this author believes (as I have mentioned before) that the pillar of support provided by a secular decline of interest rates since the early 1980s is now officially over. Given an increasing rate environment, there is nowhere to go for the Barnes Index except for the up direction."* As of the Sunday evening, I still stand by this statement – and given that the futures market is now pricing in a 58% chance of a 5.25% Fed Funds rate by June 28th, I believe a Barnes Index level of 65 or over is now inevitable in the next ten weeks.

Let's now discuss the most recent action in the stock market. It was mostly a quiet week last week – with the Dow Industrials rising by 17 points while the Dow Transports declined by 44 points. A very interest development occurred last week when both the NYSE A/D line and the NYSE new highs vs. new highs weakened considerably (although as Lowry's pointed out, the NYSE operating companies' A/D line did not weaken to a considerable extent). Some of this is due to declining bond prices – but it is interesting to note that the number of new highs vs. new lows on the NASDAQ Composite is also starting to weaken. Once the number of new lows starts surpassing the number of new highs on the NASDAQ, readers should be careful and start taking on a very defensive position. Following is our daily chart showing the action of the Dow Industrials vs. the Dow Transports from July 1, 2003 to the present:



In the meantime, the Dow Utilities continues to weaken – closing at a low not seen since October 20, 2005. I will now end this commentary with a quick discussion of our popular sentiment indicators – those being the bulls-bears percentages of the American Association of Individual Investors (AAII), the Investors Intelligence, and the Market Vane's Bullish Consensus Surveys. Readers who want us to periodically show you the individual weekly charts should let me know – but in the meantime, I will only report to you a condensed format of our three popular sentiment indicators. While the short-term readings of these indicators may be more on the neutral side (relative to the readings we have gotten over the last couple of years), readers should note that these readings are still pretty overbought relative to the readings since January 1997.

During the latest week, the four-week moving average of the bulls-bears% differentials of these three popular sentiment indicators again rose a little bit further – from 23.3% to 24.7%. Following is a weekly chart showing the four-week moving average of the Market Vane, AAII, and the Investors Intelligence Survey Bulls-Bears% Differentials from January 1997 to the present week (note that I have redid the scales and shortened the time period by changing the starting month from July 1987 to January 1997):



In light of the mediocre performance in the market during the last week, this increase should thus be bearish from a contrarian standpoint. Moreover, readers should note that these surveys do not take into account the really great things that Mark Hulbert at Marketwatch.com is doing – such as the compilation of stock newsletter sentiment via the HSNSI. For informational purposes, the latest HSNSI readings are still in very bullish territory (and thus bearish from a contrarian standpoint).

In the short-run, this author is still looking for a more oversold reading before we will pare down our 75% short position in our DJIA Timing System. Should this indicator get to more oversold levels (such as those we witnessed during October 2005), then we may even pare down our short position back to 25% or even to a completely neutral position – and re-enter our short position from a high level in the Dow Industrials. Like I said before, we will continue to update our readers in the days ahead – but things are about to get interesting. For now, stock selection (both on the long and the short side) continues to be the key.

At some point, there should at least be a trade on the long side – but as I detailed in our commentary in the above paragraphs, the risk-reward ratio is still not there yet at this point. We will continue to keep an eye on bonds, but for now, readers should just know this: The secular bull market in bonds is most likely over, and any trade here should only be short to intermediate term in nature.

Signing off,

Henry K. To, CFA