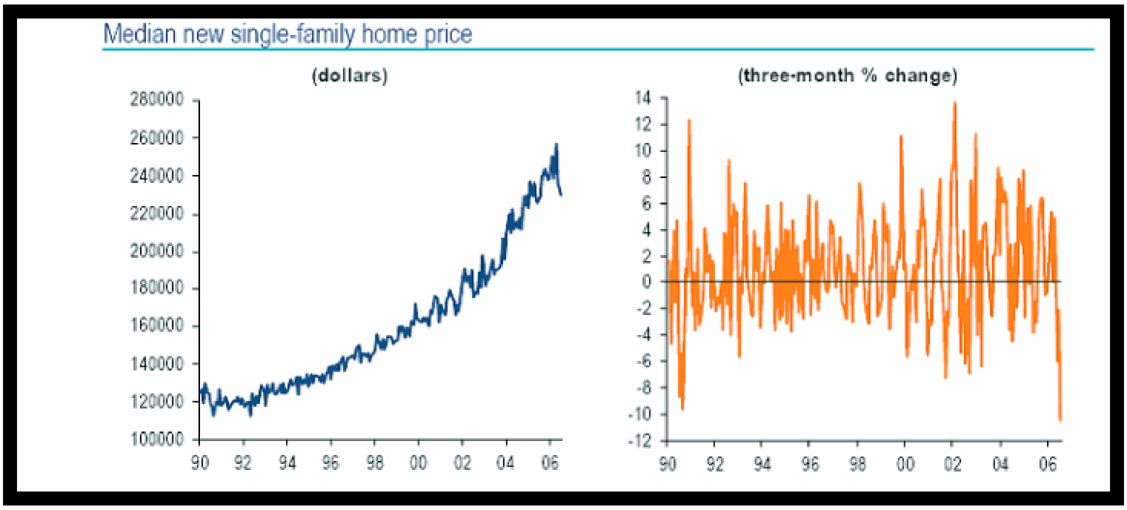
More Cautious on Bonds!

A few weeks ago, we suggested that contrarian investors should consider investing in bonds, notwithstanding our long-term negative view about the US dollar and US bonds. Our main concern about US bonds centers on our belief that the US will have no other option but to print money and that the Fed's priority will be to support asset markets and not to combat inflation. I may add that the Fed has no idea of what constitutes inflation because the common man's cost of living do certainly not only increase by "core inflation" but by headline inflation plus about 2% per annum. In time, the Fed's monetary policies, which are not only misguided but also irresponsible, will lead to far higher inflation, a weaker dollar and rising interest rates. However, two months ago, sentiment about bonds was extremely negative and, for this reason we expected a bounce in bond prices. Moreover, it was our view that weakening home prices would lead to slower consumption growth and a weaker economy.

Indeed, while median home prices in the US were in July still 1.4% higher than a year ago, they had declined by almost 10% over the last three months, which as can be seen from figure 1, is one of the steepest declines since 1990 (see figure 1).

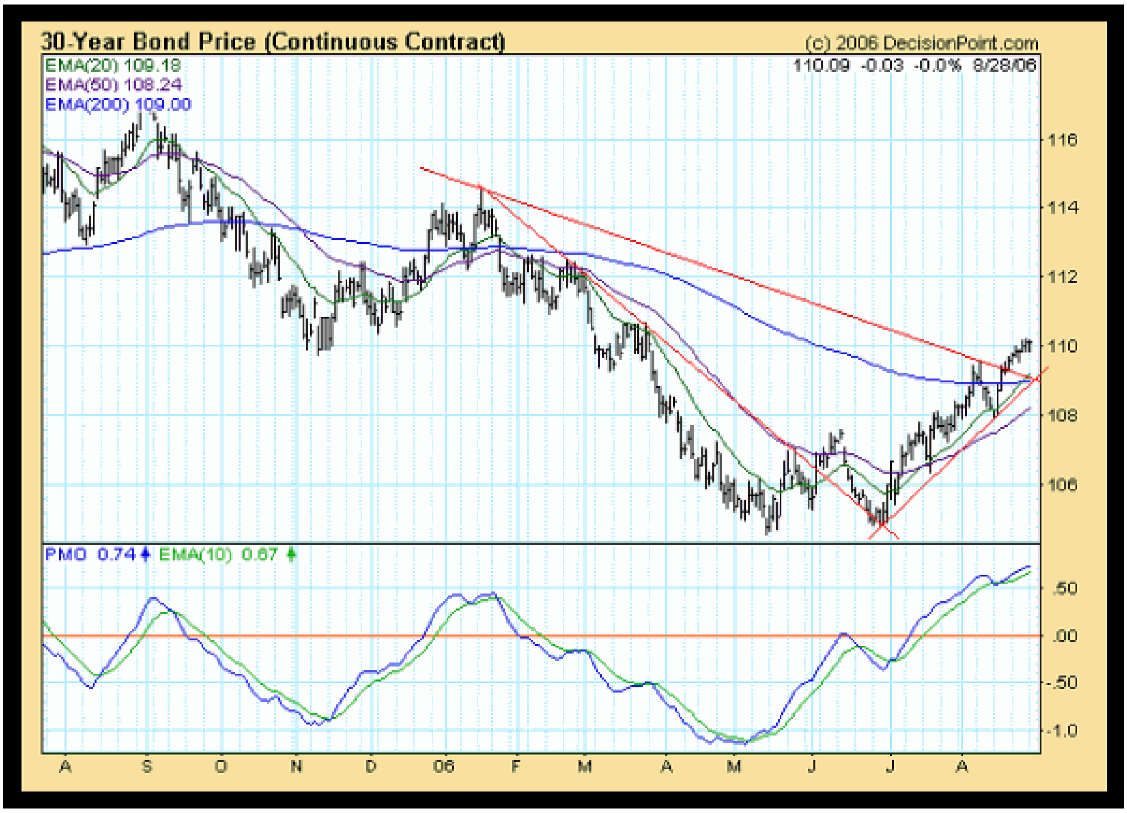
Figure 1: Median New Home Prices and 3-Month % Change, 1990 – 2006.



Source: David Rosenberg, Merrill Lynch

Since early July, the situation has, however, changed. There is now a widespread belief that the US housing market is dead and that the economy will slow down, and that therefore, bonds will continue to rally because the Fed will shortly begin to cut interest rates. I may add that the media is also full of negative stories about the housing industry. Therefore, with presently so much bearish consensus about the economy, as a contrarian, I think that the upside for long term bonds is now extremely limited (see figure 2).

Figure 2: No Longer Great Value!



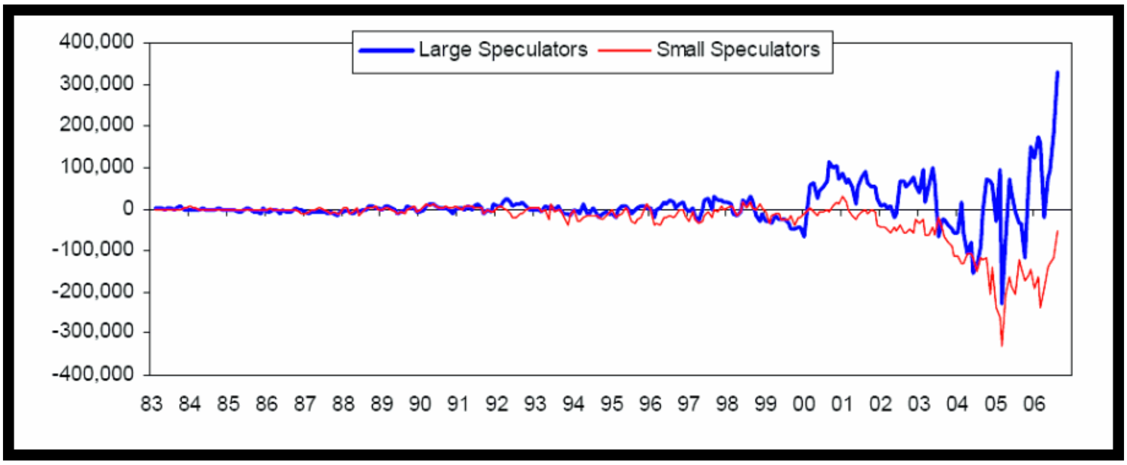
Source: www.decisionpoint.com

But if the economy is weakening why should bonds not rally further? Several reasons: It is far from certain that the US economy will slow down right away. Consumers, whose sentiment has recently weakened considerably, could still continue to live above their means for a while by selling equities or simply borrowing even more, because lending standards are still extremely loose - this certainly among the sub-prime lender desperados. Moreover, wage growth and capital spending has recently seen some upside acceleration, which could - at least partially - offset a slump in housing.

Finally, as energy prices have begun to decline and as interest rates have recently come off, the consumer's endless energy to "shop until you drop" may once again be revitalized.

Then, there is also a technical reason for my renewed caution about holding longer dated Treasury securities. At the end of August, Large Speculators held record net long positions of Ten-year Treasury Future Contracts – indicating too much bullishness among these market participants (see figure 3).

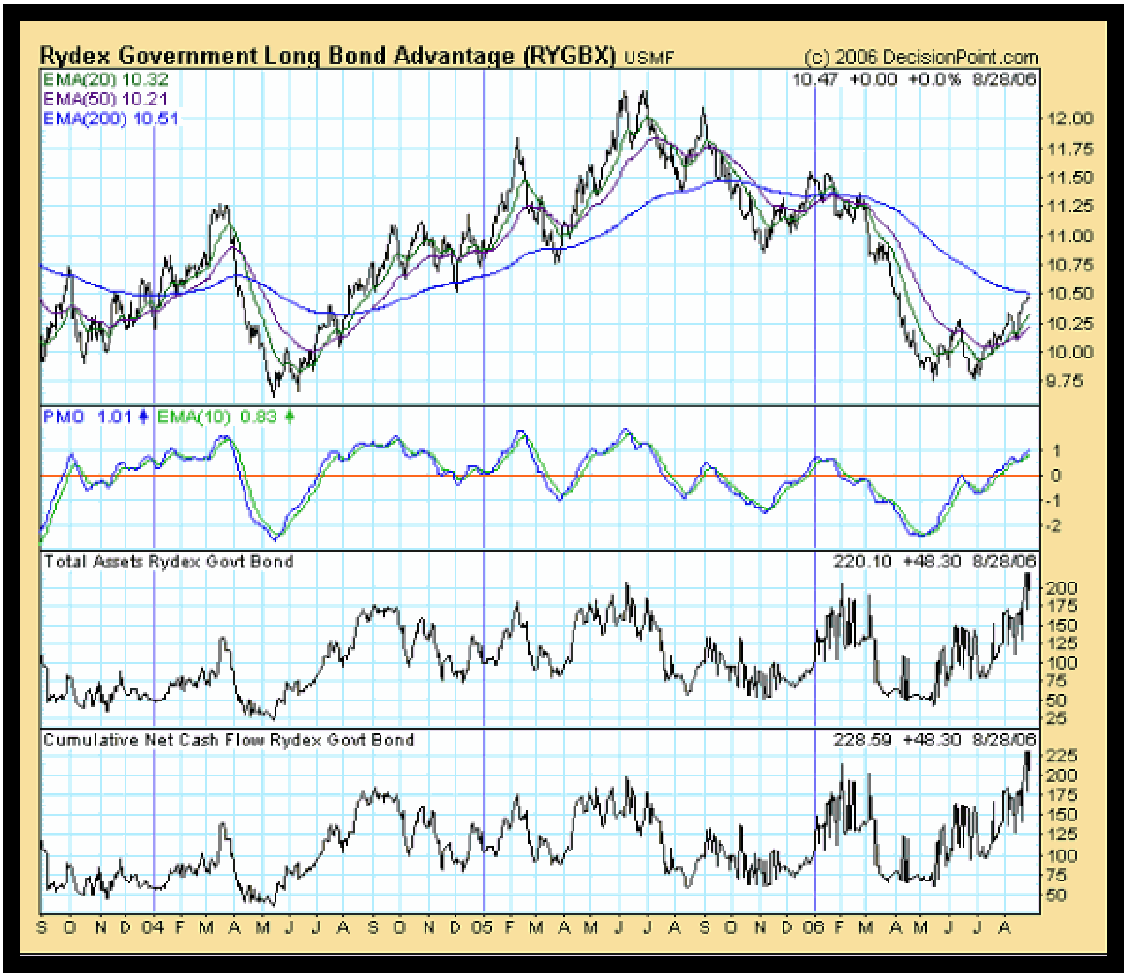
Figure 3: Net Long Positions in Ten-Year Treasury Futures Contracts, 1983 -2006



Source: Bridgewater Associates

High optimism among market participants about the prospects of the bond market is also evident from studying net fund inflows into the Rydex Government Long Bond Advantage Fund. Let me explain the following figure. When total assets in this fund have tended to be low and when net cumulative inflows were also depressed, as was the case in May 2004, November 2005, and in May of this year, the Rydex Government Bond Fund (which moves with bond prices) subsequently rallied (see figure 4).

Figure 4: Rydex Government Bond Fund, 2003 – 2006



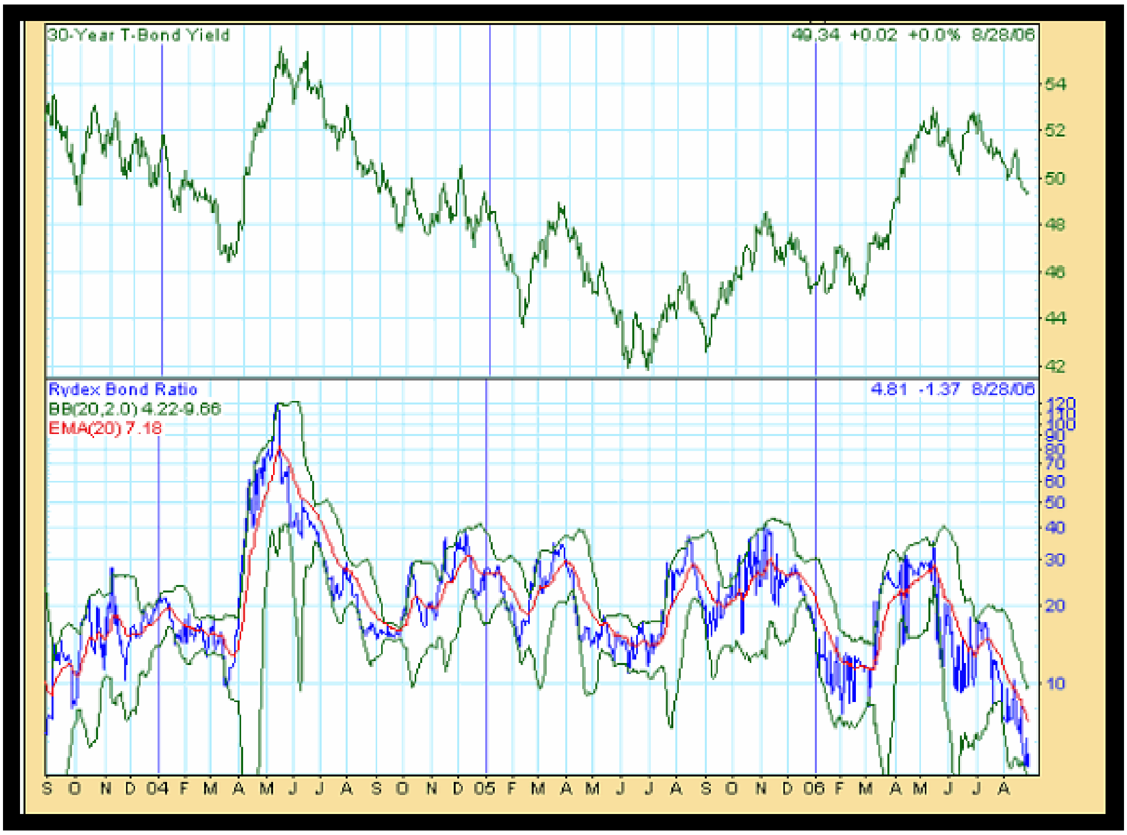
Source: www.decisionpoint.com

Conversely, when both total assets and the cumulative net cash flow were high, such as was the case in March 2004, September 2004, July 2005, February 2006, and now, the bond market had a tendency to at best move sideward, but more often, to decline rather abruptly.

There is another technical indicator which is flashing a warning signal. The Rydex Bond Ratio. The Rydex Bond Ratio is calculated by dividing the total assets in the Rydey JUNO Fund (a fund that increases in value when bond prices decline and interest rates rise) by the total assets in the Rydex

Government Bond Fund (see above). From figure 5, we can see that when investors are very bearish about bonds and, therefore buy the JUNO Fund (bearish on bonds) interest rates subsequently dive and bond prices rally. This was the case in May 2004, November 2005, and May 2006 (see figure 5)

Figure 5: Rydex Bond Ratio, 2003 - 2006

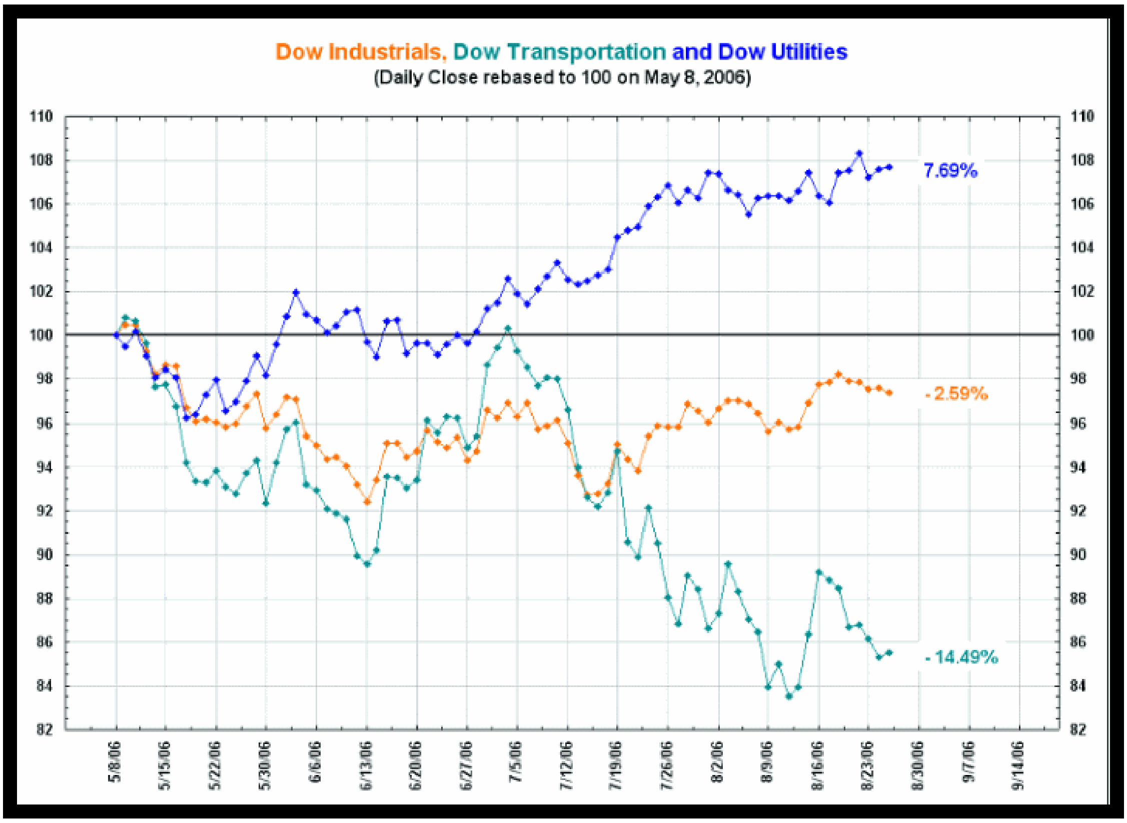


Source: www.decisionpoint.com

But when the Rydex Bond Ratio reaches historical lows, as is now the case, and investors shun the JUNO Fund but pile into the Rydex Government Bond Fund (bullish on bonds), bond yields tended to subsequently increase! Incidentally, I think both the net flow of funds into the Rydex Bond Fund and the Rydex Bond Ratio are very interesting contrary indicators. Based on these indicators investors should, now, not be falling in love with bonds based on a recessionary scenario but they should actually be selling bonds aggressively….

Turning to equities and commodities, our readers will remember that in the spring of 2006, we expected a correction in asset markets to unfold. Subsequently, asset markets corrected, but have rallied again since the end of June. However, the rebound took place amidst enormously diverging trends. As can be seen from figure 6, courtesy of the indefatigable Ron Griess who runs the www.thechartstore.com website and publishes an excellent weekly blog with all kinds of useful figures, we can see that whereas the Dow Utilities Average rose from its May high another 7% (in the last week of August it reached a new high), the Transportation Average has sunk by almost 15% since its May peak.

Figure 6: Strongly Diverging Performance since May 2006 High!

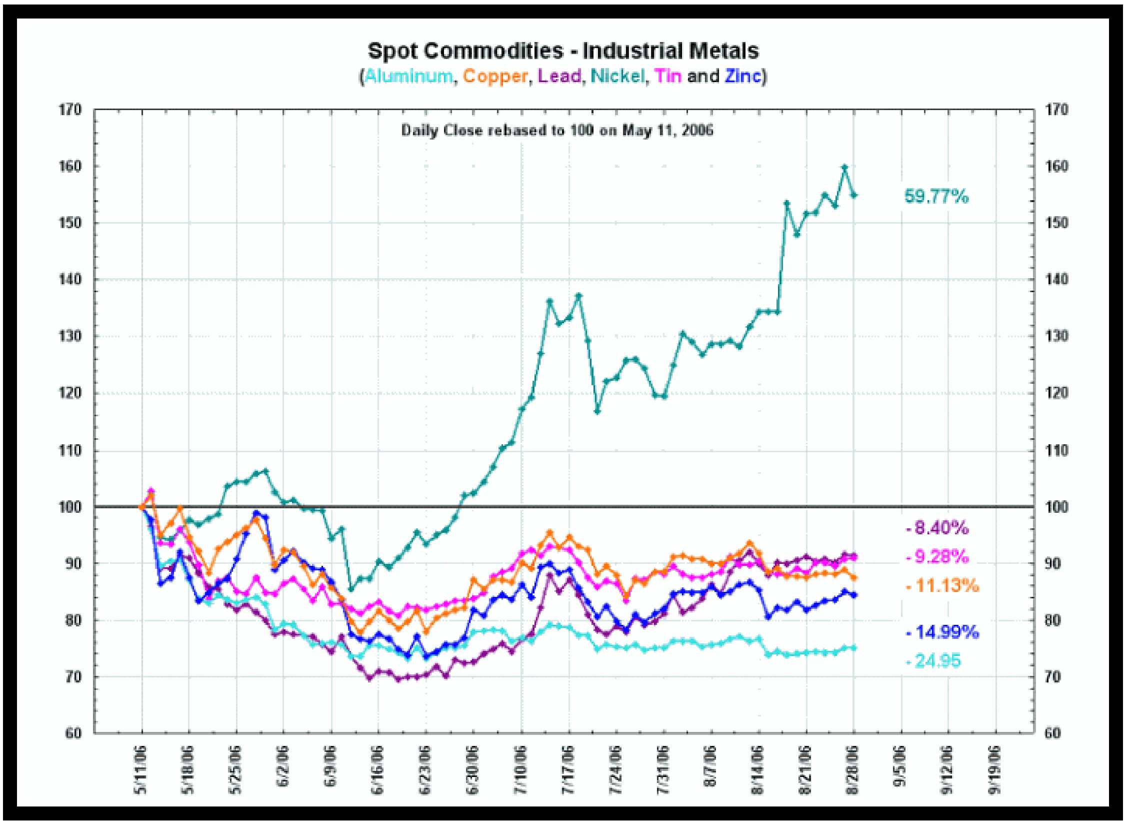


Source: Ron Griess, www.Thechartstore.com

I may add that the Dow Transportation Average is far more sensitive to the economy than the Dow Industrial or the S&P 500. Also, the diverging trend in the stock market is not only evident from the performance of the various market indices but also from the movement of individual shares. Since the May high, among Dow Jones stocks, Alcoa and MMM are down 20% whereas pharmaceutical and healthcare companies like Pfizer and Johnson & Johnson are up respectively 21% and 11%.

Similarly, diverging performance is also evident in the commodity markets. Since the May high in the CRB Index, Nickel is up 60%, whereas all other industrial commodities and precious metals are down between about 8% and 25% (see figure 7).

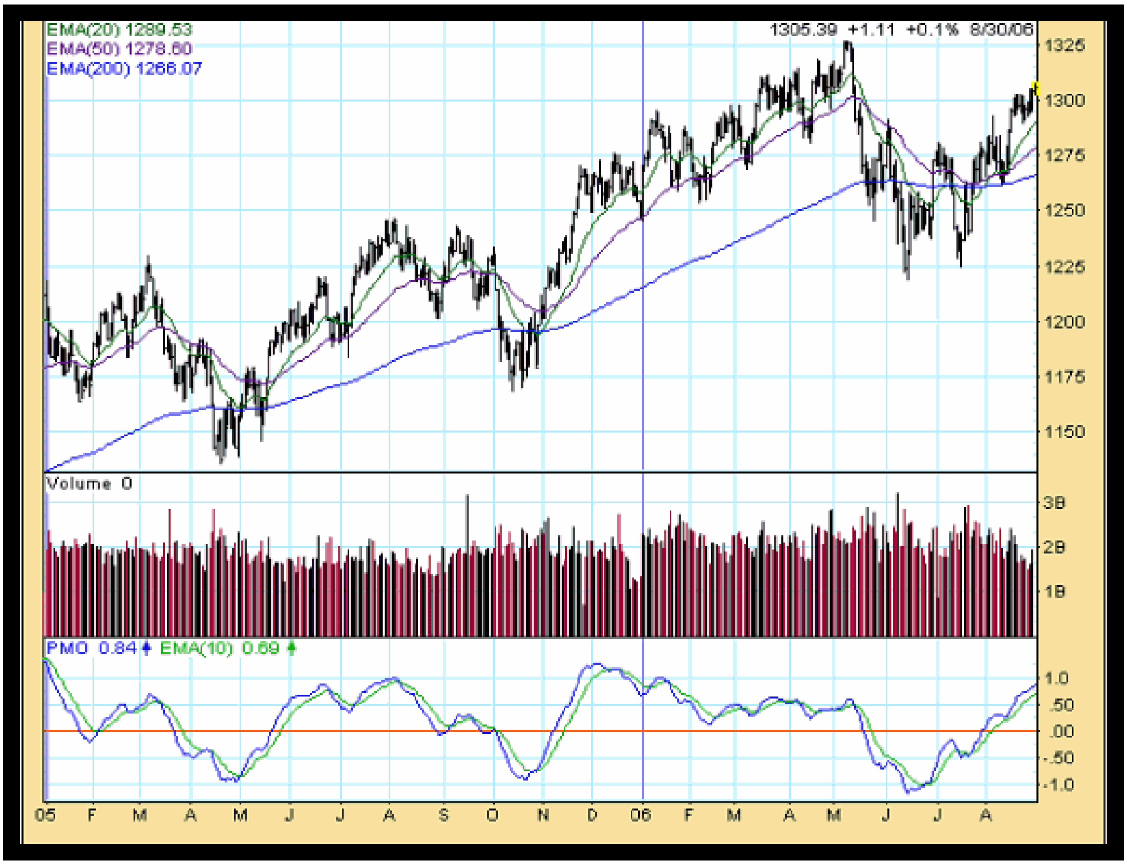
Figure 7: Performance of Spot Commodities since May 11, 2006



Source : Ron Griess, www.thechartstore.com

So, what should an investor do considering these diverging trends? I have to admit that, at present, I cannot get excited about much. As indicated above, there was a trading opportunity in bonds in late June early July (see report of July 6, 2006, entitled “Should You Buy Bonds?”) but now, the upside seems rather limited. Equities do not look particularly appealing either. The S&P 500 is - following its rally from 1220 to above 1300 - overbought and is running into heavy resistance between 1290 and 1320 (see figure 8).

Figure 8: S&P 500, 2005 - 2006



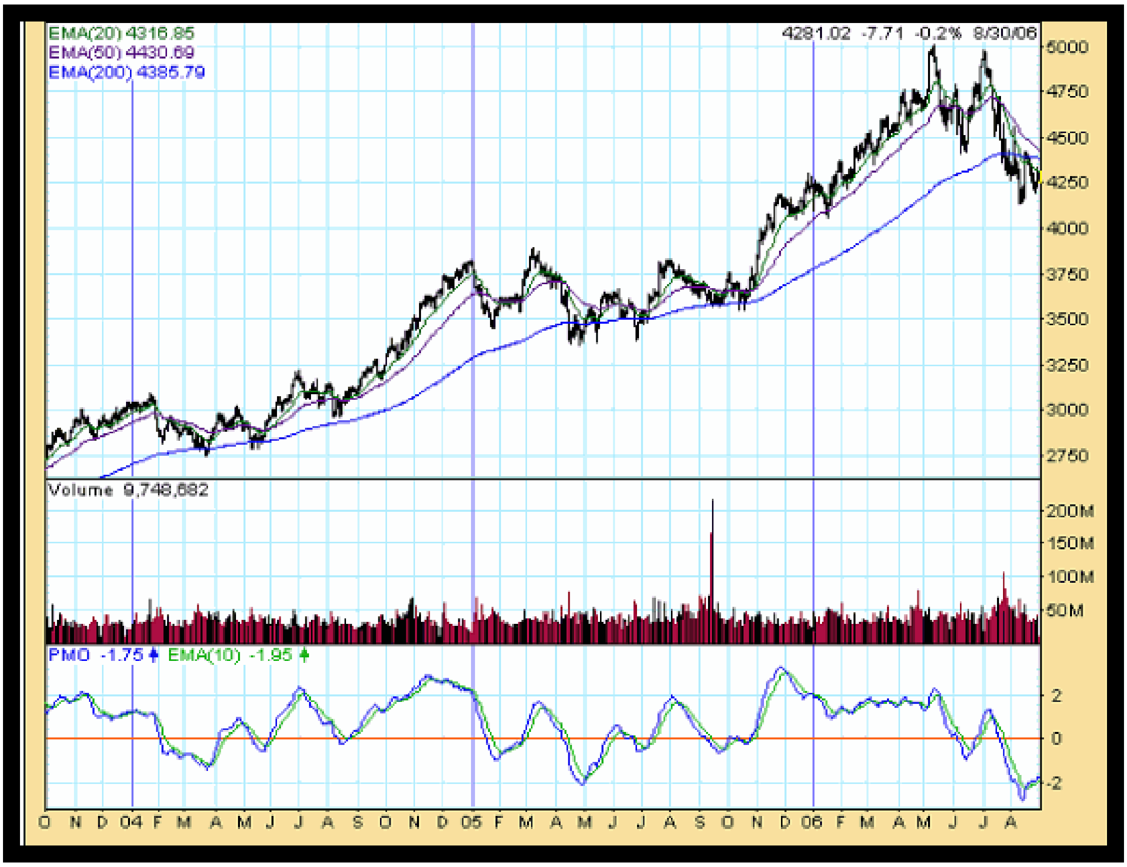
Source: www.decisionpoint.com

Please note that so far volume has been declining as the market recovered. In addition, as indicated in last month’s report the brokerage stocks have been performing miserably compared to the overall market. Unless the brokerage stocks can regain their leadership right away, a new high by the Dow Jones

Industrial or the S&P 500, if not confirmed by brokerage stocks, would be technically a very negative sign!

Another negative for the overall stock market, as indicated above, is the weakness in the Dow Transportation Average, which was one of the leaders in the 2003 – 2006 bull market (see figure 9).

Figure 9: Dow Jones Transportation Average, 2003 - 2006

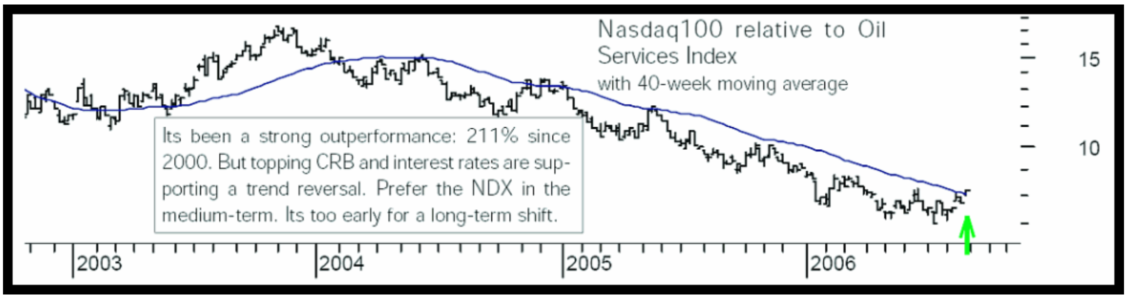


Source: www.decisionpoint.com

So, I would look at selling some stock sectors, which appear to be weakening including retailers, sub-prime lenders, brokers, and cyclical stocks including resource stocks (even oil) rather than to buy aggressively the stock market in expectations of interest rate cuts, in the near future. I

concede, however, that despite poor fundamentals, the high tech and telecom sector looks technically strong, offering possibly a short term trading opportunity.
My friends at Credit Suisse who run the bank's market technical department provided a figure showing that the high tech and telecom heavily weighted NASDAQ 100 Index had for the first time since 2003 the potential to reverse its downtrend relative to the oil service sector (see figure 10). I referred above to the potential of a change in leadership within the stock market.

Figure 10: NASDAQ 100 relative to Oil Service Index

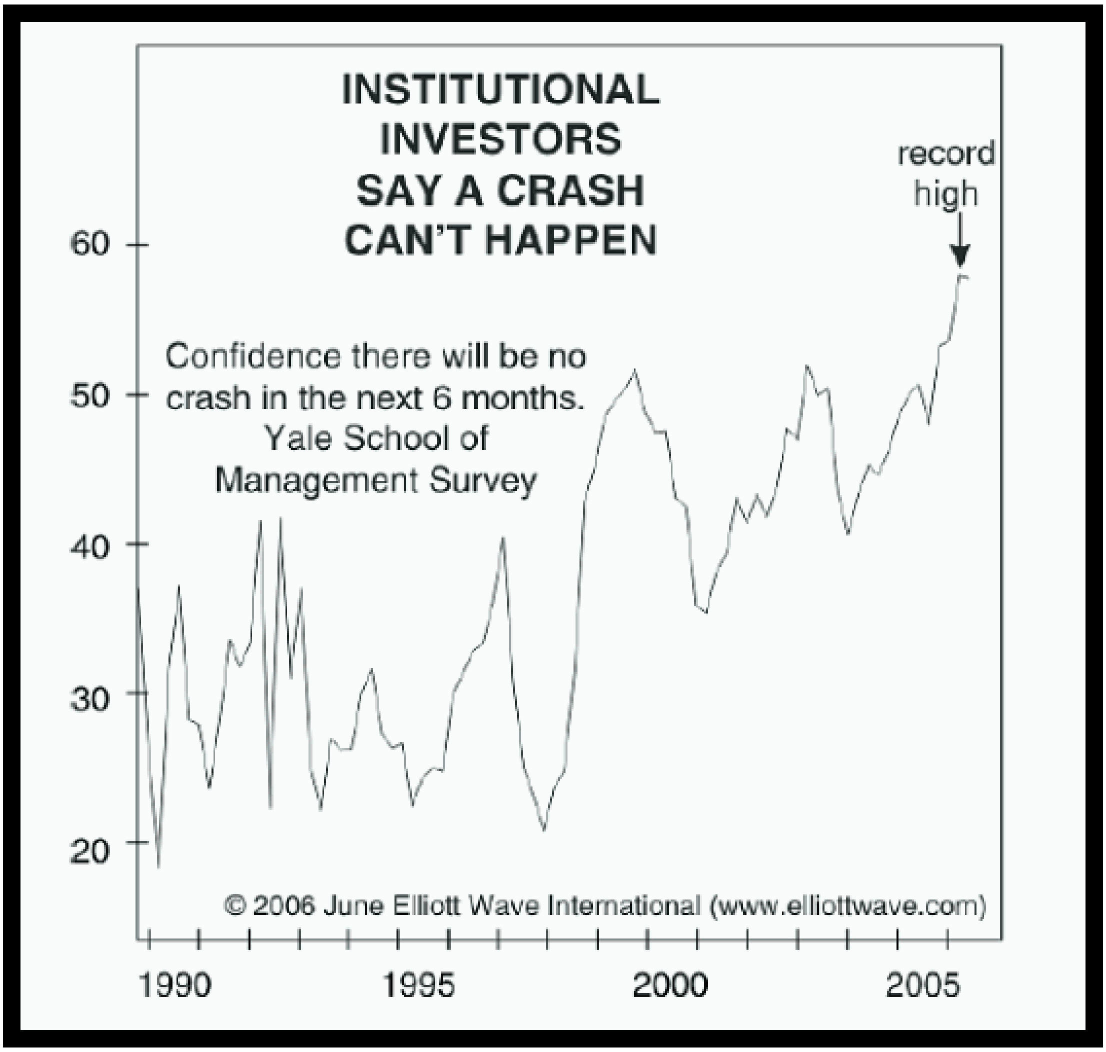


Its been a strong outperformance: 211% since 2000. But topping CRB and interest rates are supporting a trend reversal. Prefer the NDX in the medium-term. Its too early for a long-term shift.

Source: www.credit-suisse.com/techresearch

Still, my concern for the entire market is that when the Fed announces its first interest rate cut, the stock and bond market and the dollar will tank – unless they did so already in anticipation of such an inflationary monetary policy move.
Lastly, with so much complacency around and with such a high propensity to speculate in just about everything among all classes of investors, a nice crash should not entirely be ruled out (see figure 11)

Figure 11: High Confidence among Institutional Investors!



Source: www.elliottwave.com

Finally, with respect to commodities, I feel we are still in the midst of a correction period. I like gold and silver for the longer term, but further near term weakness should not be ruled out. I suppose that when the Fed will cut interest rates, precious metals will resume their bull market and surprise investors by its up-side potential while industrial commodities are likely to under-perform.