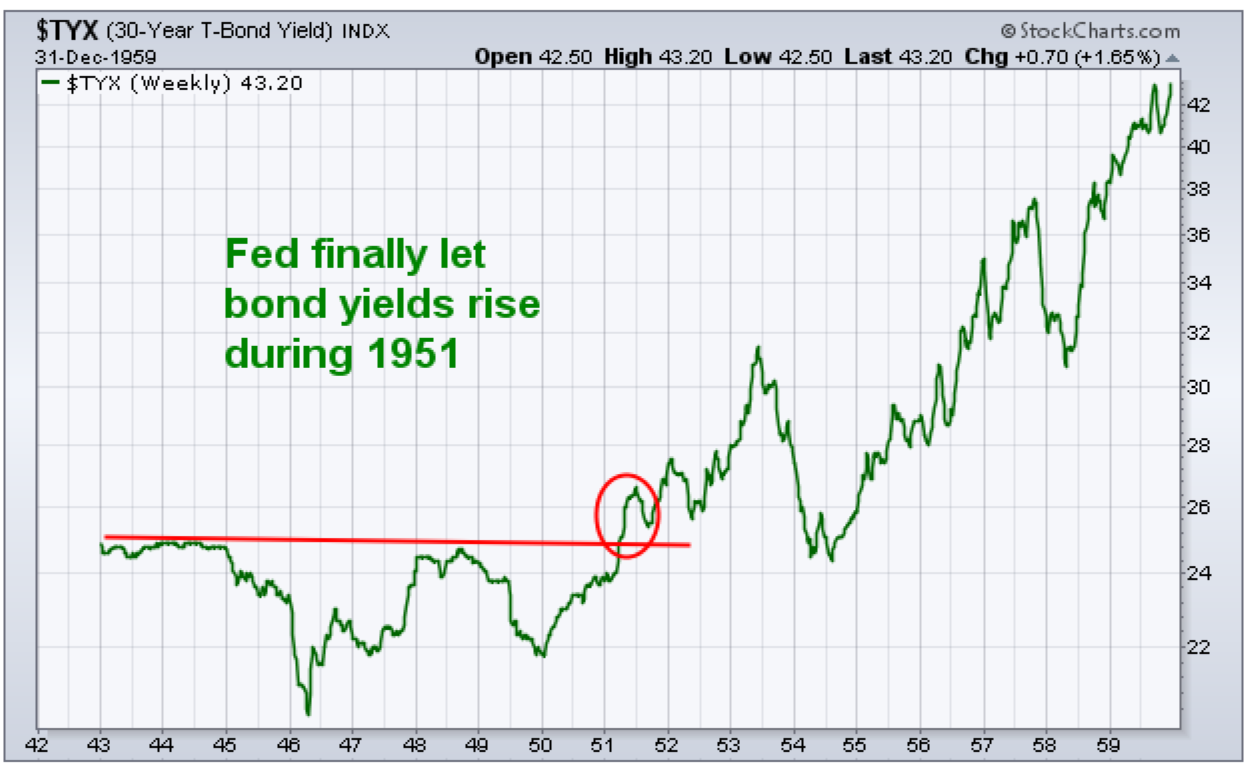
STOCKS TOOK OFF IN 1951 AFTER THE FED LET BOND YIELDS RISE -- THEY MAY HAVE TO DO THE SAME AGAIN -- THIRTY YEAR BULL MARKET IN BONDS MAY BE COMING TO AN END -- THAT SHOULD HELP STOCKS -- NASDAQ/BOND RATIO MAY BE BOTTOMING -- BANK AND HOMEBUILDING ETFS ARE CHALLENGING THEIR 2010 HIGHS AND SHOW NEW MARKET LEADERSHIP

By John Murphy

FED BOND INTERVENTION DURING 1940S CAPPED STOCK PRICES... I wrote last Thursday why the Fed's current policy of buying longer-dated maturities to keep bond yields from rising may actually be putting a cap on stock prices. I explained that the last time the Fed did that was between 1942 and 1951 in order to keep wartime inflation from pushing bond yields higher and to help pay wartime debt with lower rates. I also mentioned that it wasn't until 1951 that the Fed finally stopped intervening in the bond market which allowed bond yields to rise and bond prices to fall. That action helped launch a two-decade bull market in stocks. Chart 1 shows the **30-Year T-Bond Yield** staying relatively between 1942 and 1950 which was largely due to the Fed policy. The red circle shows bond yields breaking out to the upside during 1951 when the Fed got out of the way. The resulting jump in bond prices caused bond prices to fall which caused a huge rotation into stocks. Chart 2 shows the **Dow Industrials** in a large bottoming formation between 1932 and 1950. The blue circle shows the Dow finally breaking through the 200 barrier for the first time in twenty years. That upside breakout in the Dow took place in 1951 which coincided with the upside breakout in bond yields.



[(click to view a live version of this chart)]
Chart 1

[(click to view a live version of this chart)]
Chart 2

BOND YIELDS AND STOCKS ROSE TOGETHER AFTER 1951... Chart 3 plots the two markets together between 1942 and 1969. The two upside breakouts took place at the same time during 1951 (see circles). Bond yields and stocks rose together from that point until the late 1960s. The reasoning is relatively simple. When the Fed allowed bond yieds to rise after 1951, yields rose to keep pace with a strengthening postwar economy. Rising bond yields produce lower bond prices. It was most likely the drop in bond prices that forced investors to sell bonds and buy stocks, which they did for the next two decades. That's an example of how Fed intervention in the bond market prevents bond prices from falling, which prevents the normal rotation out of bonds and into stocks near the end of a deflationary era. In other words, Fed intervention in the bond market actually capped stock prices during the 1940s. They may be doing the same thing now.

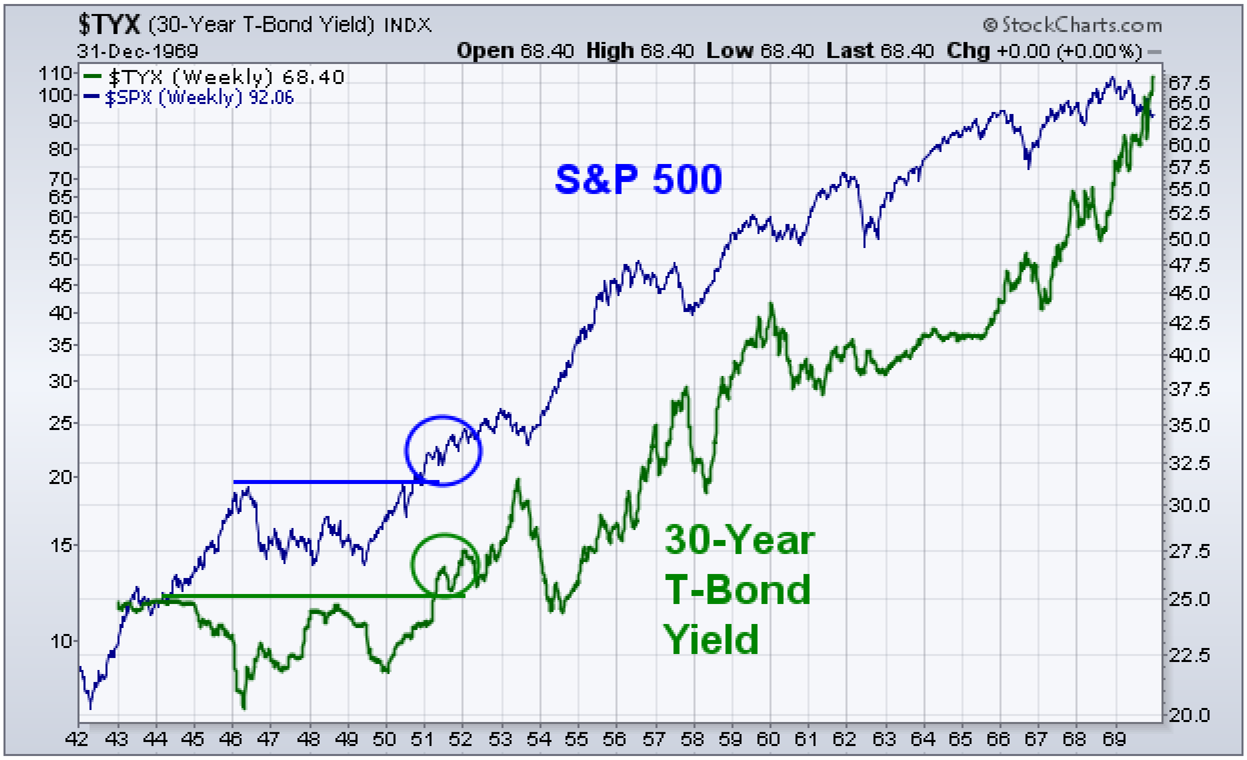


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Chart 3

THIRTY YEAR BULL MARKET IN BONDS... Chart 4 shows the trend of the bond market since 1980. After the inflationary 1970s ended, bond yields peaked in 1981 and have fallen for the thirty years since then. During those thirty years, the yield on the long bond fell from 15% to below 3%. That has produced a thirty year bull market in bond prices (solid matter). [Bond prices rise when yields fall]. After thirty years, it would be normal to expect that trend to start reversing. That would result in higher yields and lower bond prices. That can only happen, however, when the Fed stops intervening to keep bond yields artificially low. In so doing, the Fed is encouraging investors to stay in Treasury Bonds too long. That's preventing a rotation out of bonds and into stocks which normally takes place near the end of a deflationary period (just as it did during the 1940s).

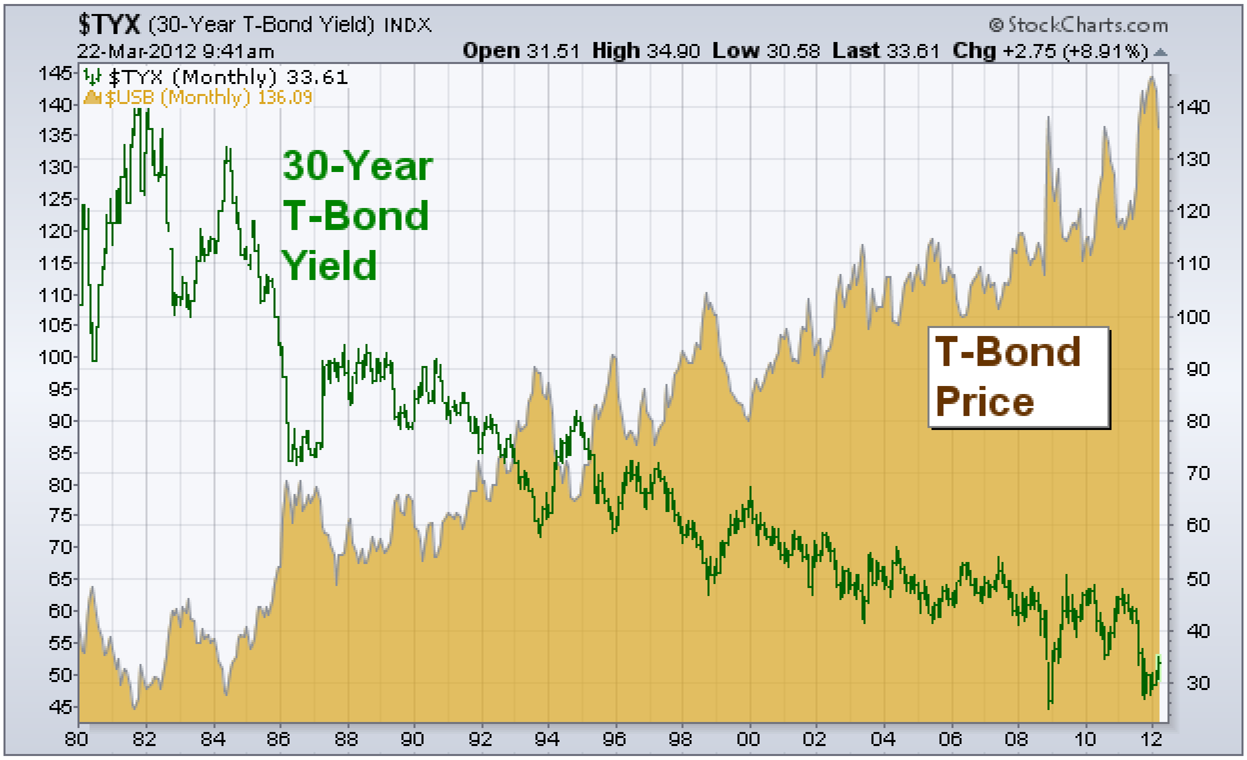

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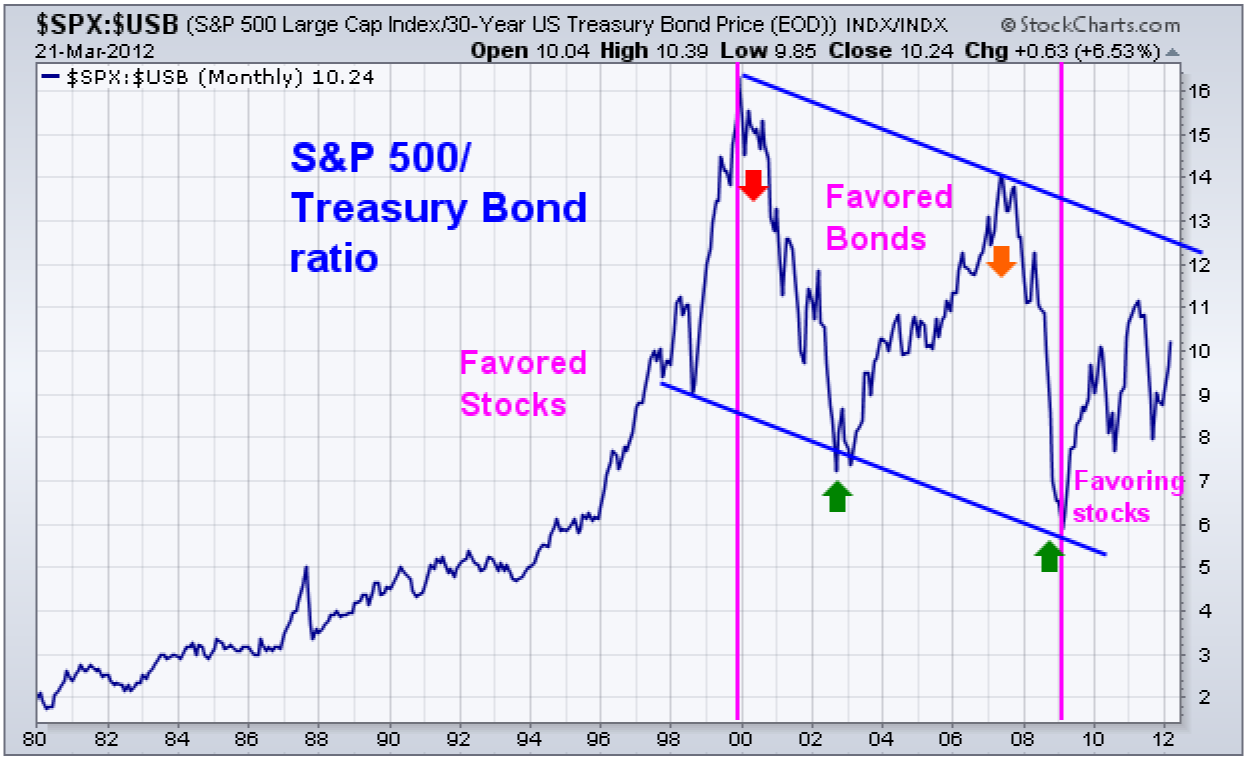
Chart 4

BONDS HAVE OUTPERFORMED STOCKS SINCE 2000... Chart 6 is a "ratio" of the **S&P 500** divided by the price of the **30-Year Treasury Bond**. Stocks did better than bonds between 1980 and 2000. Since 2000, however, bonds have been the stronger asset. In my view, that's because of the emergence of deflation over the last decade, which hadn't happened since the 1930s. [The emergence of deflation since 2000 is one of the reasons that Mr. Bernanke has resorted to tactics last used during that earlier era]. Two major stock market declines starting in 2000 and 2007 caused the stock/bond ratio to fall sharply (down arrows). Market upturns during 2003 and 2009 caused the ratio to rise. It's still rising. Chart 6 shows a huge descending price channel on the ratio since 2000. The ratio would have to break through the upper resistance line to signal a major shift back to stocks. But it may not be too soon to start planning for that to happen.



[(click to view a live version of this chart)]()
Chart 5

NASDAQ/BOND RATIO MAY BE BOTTOMING... My Tuesday message showed the Nasdaq Composite Index trading at the highest level in 12 years. I mentioned in that message that it was the plunge in the technoloyg-dominated market during 2000 that started the "lost decade" for stocks and a strong decade for bonds. I also mentioned that the recent upside breakout in the Nasdaq may be signalling that the long-term outlook for stocks is improving.. Chart 7 plots a **ratio** of the **Nasdaq Composite Index** divided by the **30-Year Treasury bond** price. The ratio peaked in 2000 (yellow circle) when stocks collapsed and bond prices soared. The ratio has trended sideways since then between its 2002 low and its 2007 high. It bounced off its 2002 low during 2009 (blue circles), and has risen since then. The **Nasdaq/bond ratio** is now moving up toward the upper end of its decade-long trading range. If it's able to exceed its 2007 peak, that would be a strong sign that the long-term pendulum has swung away from bonds and back to stocks. That may not happen, however, until the Fed stops keeping bond prices artificially high, and allows a normal rotation out of bonds and into stocks to take place. Mr. Bernanke is a student of the deflationary 1930s. I hope he's also a student of what happened during the 1940 and 1950s, and the decades after that.

$COMPQ:$USB (Nasdaq Composite/30-Year US Treasury Bond Price (EOD)) INDX/INDX
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21-Mar-2012
Open 22.46 High 22.71 Low 22.42 Close 22.52 Chg +0.13 (+0.59%)
$COMPQ:$USB (Weekly) 22.52
Nasdaq/Bond ratio
may be bottoming
52.5
50.0
47.5
45.0
42.5
40.0
37.5
35.0
32.5
30.0
27.5
25.0
22.5
20.0
17.5
15.0
12.5
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2000
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