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MARKET CALLS

# A Gnash Equilibrium?

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That sound that you hear every couple of weeks is the grinding of teeth. First it's the bulls, and then it's the bears as, in turn, the stock market bamboozles and disappoints them *both*. It's a gnash equilibrium... also known as a trading range. It's been a time when it's been possible for *everyone* to be wrong -- a beautiful mine-field.

So it's been a good time for our tactical asset allocation Model Position -- short NASDAQ 100 and long long-term Treasuries. After all, in a trading range stocks end up going nowhere, but they're just as risky as ever.

The position has been motivated by an extreme value disequilibrium between technology stocks and long-term Treasuries (see "Vay Out of Vack -- Even for a 'V'" December 10, 2001). On that date, the "yield gap" between the income yield of long-term Treasuries and the forward earnings yield of the S&P 500 Information Technology sector was negative 3.6%, compared to its long term average of negative 1.1%. At 3.6%, the gap was more negative that it was before the crash of October 1987, and almost as negative as it was when the NASDAQ was at 5000 in March 2000.

We took profits by unwinding 25% of the Model Position on February 4, when the yield gap had narrowed to 3.0% (see "On The Road to Equilibrium" February 4, 2002). Writing mid-day with the NASDAQ 100 up about 50 points and the long-bond yielding 5.52% -- and with forward earnings estimates up about 8% with the latest monthly refresh of that data, the yield gap now is still at 3.0%.

The yield-gap narrowed to 2.65% at the NASDAQ's lows last week. And my own teeth are gnashing a bit today because I said in a TrendMacro "Live!" report on February 20 that I was on the verge of taking off a second 25% of the trade -- but I never pulled the trigger. Well, perhaps that just goes to show that tactical asset allocation isn't the same thing as market timing. At least it's not the same thing as *perfect* market timing.

The consensus is coming increasingly strident about the inevitability of economic recovery, and until or unless there are extreme and visible disappointments that will put a floor under equity prices. But we continue to expect only a *technical* economic recovery, one that will lack the necessary ingredients for self-sustaining growth (see "A Green Eyeshade Recovery" by **David Gitlitz**, January 9, 2002; and David's forthcoming report). So we continue to believe that the most growth-sensitive sectors or the stock market -- especially technology stocks -- which have already priced in an extremely vigorous economic recovery -- will have a lot of difficulty making much progress. Increasingly tangible fears of **Fed** rate hikes later this year are making it difficult for long-term Treasuries to make much progress either. But that doesn't change the fact that, with yields above 5.5% in a zero-inflation environment, a dangerous disequilibrium continues to exist between long term Treasuries and technology stocks.

So having missed the moment to unwind another piece of the Model Position last week, perhaps we'll get the opportunity to put on again the piece that we unwound last month, as recovery fever drives the stock market back to the top of the trading range.

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