CHAPTER 1

A Review of the 1980s

To fully understand the dramatic turns in the financial markets that started in 1980, it's necessary to know something about the 1970s. That decade witnessed a virtual explosion in commodity markets, which led to spiraling inflation and rising interest rates. From 1971 to 1980, the Commodity Research Bureau (CRB) Index—which is a basket of commodity prices—appreciated in value by 250 percent. Bond yields rose by 150 percent during the same period and, as a result, bond prices declined. Figure 1.1 shows the close correlation between the CRB Index and the yield on 10-year Treasuries between 1973 and 1987. Long-term rates rose with commodities during the inflationary 1970s and fell with them during the disinflationary 1980s.

The 1970s were not good for stocks, either. The Dow Jones Industrial Average started the decade near 1,000 and ended the decade at about the same level. In the middle of that 10-year period of stock market stagnation, the Dow lost almost half its value. The 1970s were a decade for tangible assets; paper assets were out of favor. By the end of the decade, gold prices had soared to over $700 per ounce. A weak dollar during that period also contributed to the upward spiral in gold and other commodity prices—as well as the relative weakness in bonds and stocks. All this started to change in 1980, when the bubble burst in the commodity markets. Figure 1.2 is a ratio of the Dow Industrials divided by the gold market. The plunge in this ratio during the 1970s reflected the superior performance by gold and other hard assets in that inflationary decade. The ratio bottomed in 1980 after gold peaked. The Dow then bottomed in 1982.

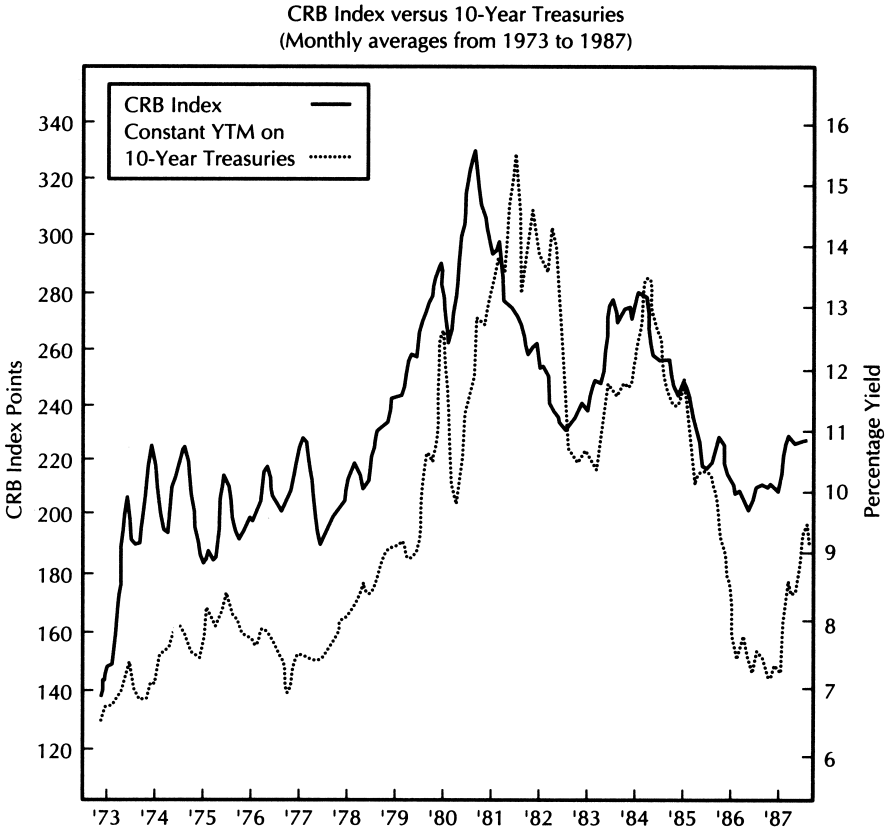

FIGURE 1.1 A demonstration of the positive correlation between the CRB index and 10-year Treasury yields from 1973 to 1987.

COMMODITIES PEAK IN 1980

In late 1980, the bubble in commodity prices suddenly burst. The CRB Index started to fall from a record level of 330 points—and began a 20-year decline during which it lost half of its value. During these same 20 years, gold prices fell from $700 to $250, losing over 60 percent of their value. (It was not until after the stock market peak in 2000 that gold prices started to show signs that their twenty-year bear hibernation had ended.) The 1980 peak in commodity markets ended the inflationary spiral of the 1970s and ushered in an era of falling inflation (or disinflation) that lasted until the end of the twentieth century. Figure 1.3 shows the dramatic rally in a number of commodity indexes during the 1970s and the major peak that occurred in 1980. Commodity prices declined for the next 20 years. Another financial market

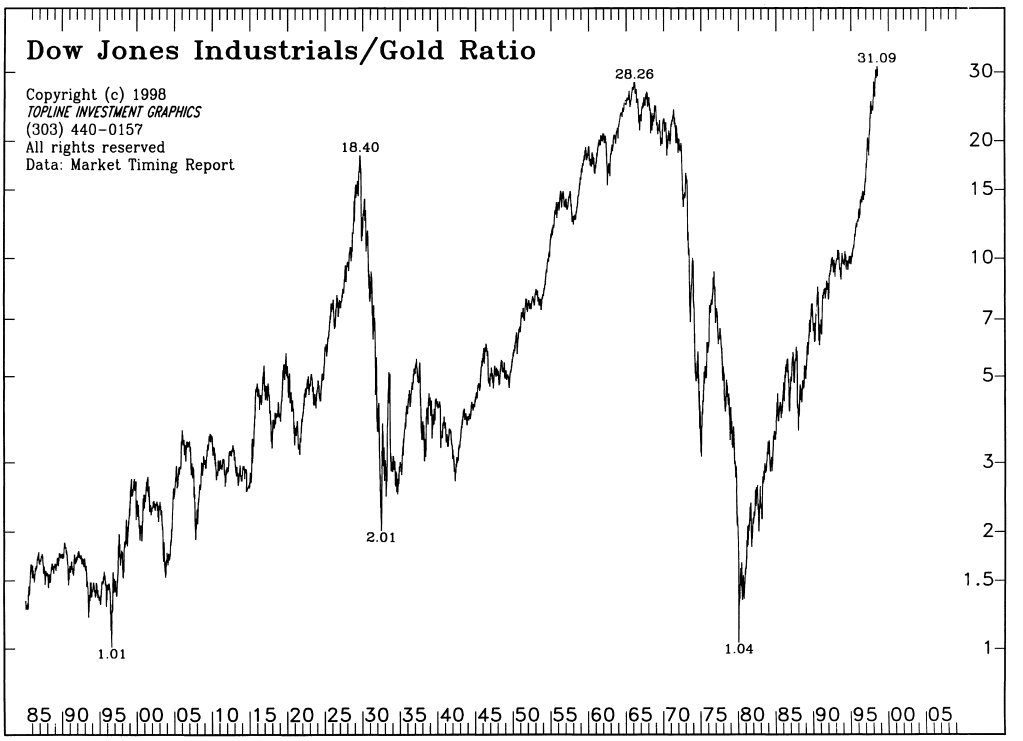

FIGURE 1.2 The plunge in the ratio during the 1970s reflected the superior performance of gold during that inflationary decade.

made a big turn in 1980 that had a lot to do with the big peak in commodities: the U.S. dollar.

DOLLAR BOTTOMS IN 1980

The U.S. dollar hit a major bottom in 1980 and doubled in price over the next five years. One of the key intermarket relationships involved is the *inverse* relationship between commodity prices and the U.S. dollar. A falling dollar is inflationary in nature, and usually coincides with rising commodity prices (especially gold). A rising dollar has the opposite effect and is bearish for commodities and gold. This is why the significant upturn in the U.S. currency in 1980 was such an important ingredient in the historic turn from hyperinflation to disinflation that characterized the next 20 years. (Starting in year 2002, a major decline in the U.S. dollar contributed to a major upturn in gold and other commodities.)

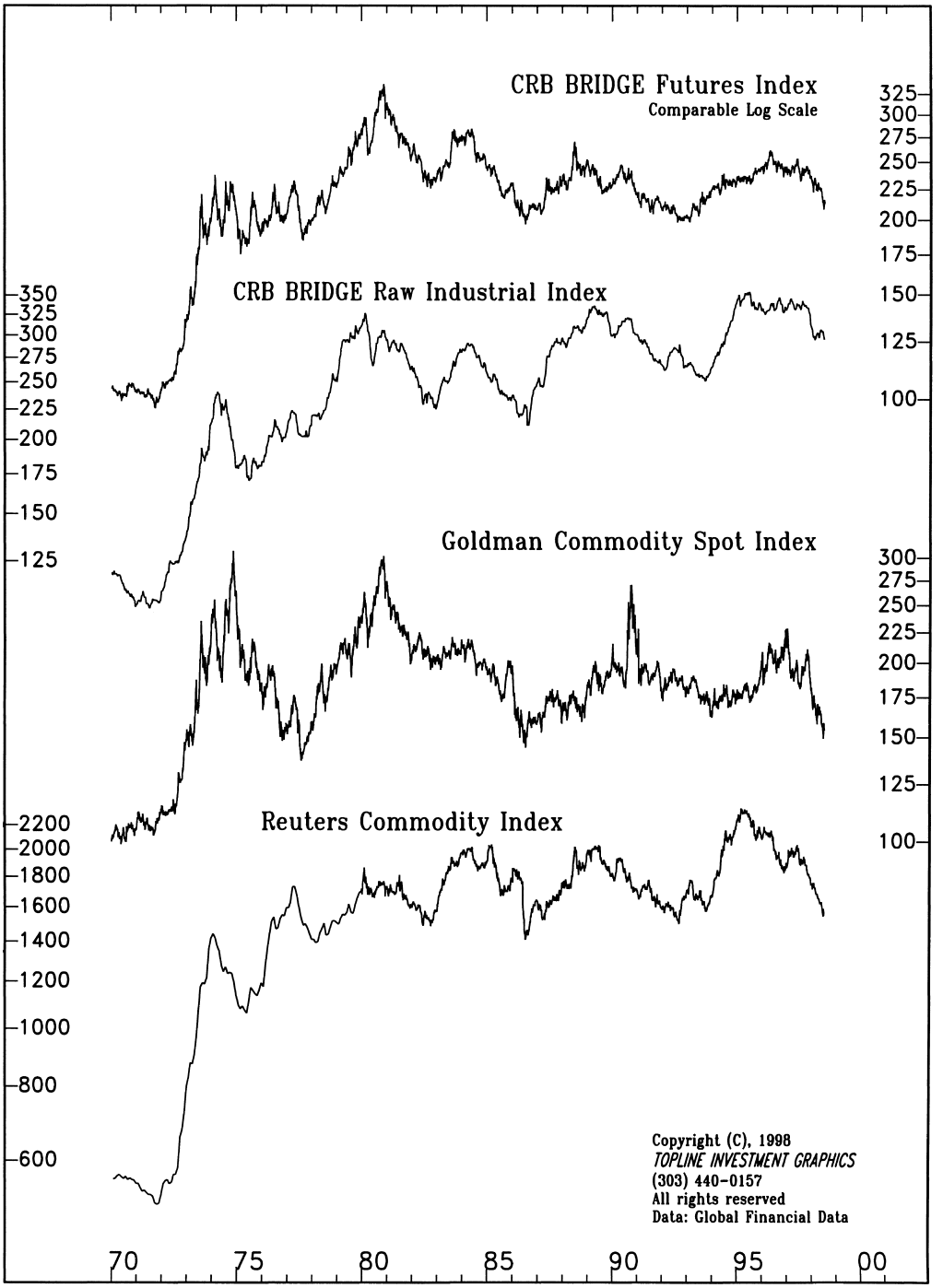

FIGURE 1.3 A number of commodities indexes show the dramatic rally during the 1970s and the major commodity peak during 1980.

BONDS BOTTOM IN 1981

Another key intermarket relationship has to do with bond and commodity prices. They trend in opposite directions. Rising commodity prices (like those seen in the 1970s) signal rising inflation pressure, which puts upward pressure on interest rates and downward pressure on bond prices. (Bond prices and bond yields trend in opposite directions.) Commodity prices often change direction ahead of bonds, which also makes them leading indicators of bonds at important turning points. At the start of the 1980s, it took a year for the drop in commodities to push the bond market higher.

During the second half of 1981, bond yields peaked near 15 percent. They fell to half that level (7 percent) within five years, which caused a major upturn in bond prices. The tide had turned. The stock market, which had been held back for a decade by rising interest rates, soon got an enormous boost from falling bond yields (and rising bond prices).

STOCKS BOTTOM IN 1982

During the summer of 1982, within a year of the bond market bottom, the biggest bull run in stock market history started—and lasted for almost two decades. The fact that the bond market bottomed ahead of stocks is also part of the normal pattern. The bond market has a history of turning ahead of stocks and is therefore viewed as a leading indicator of the stock market. The intermarket scenario had completely reversed itself at the start of the 1980s. Hard assets (like commodities) were in decline, while paper assets (bonds and stocks) were back in favor.

This turning point was one of the clearest examples of how intermarket relationships play out. Notice that four different market groups were involved: currencies, commodities, bonds, and stocks. All four played a major role as the inflationary 1970s ended and the disinflationary 1980s began. Let's review the groundrules for how the financial markets normally interact with each other, which form the basis for our intermarket work.

HOW THE FOUR MARKET GROUPS INTERRELATE

Intermarket analysis involves the simultaneous analysis of the four financial markets—currencies, commodities, bonds, and stocks. It is how these four

markets interact with each other that gives them their predictive value. Here is how they interrelate:

- The U.S. dollar trends in the opposite direction of commodities
- A falling dollar is bullish for commodities; a rising dollar is bearish
- Commodities trend in the opposite direction of bond prices
- Therefore, commodities trend in the same direction as interest rates
- Rising commodities coincide with rising interest rates and falling bond prices
- Falling commodities coincide with falling interest rates and rising bond prices
- Bond prices normally trend in the same direction as stock prices
- Rising bond prices are normally good for stocks; falling bond prices are bad
- Therefore, falling interest rates are normally good for stocks; rising rates are bad
- The bond market, however, normally changes direction ahead of stocks
- A rising dollar is good for U.S. stocks and bonds; a falling dollar can be bad
- A falling dollar is bad for bonds and stocks when commodities are rising
- During a deflation (which is relatively rare), bond prices rise while stocks fall

The list sums up the key intermarket relationships between the four market groups—at least as they are in a normal inflationary or disinflationary environment, the likes of which existed during the second half of the last century. This held up especially well during the 1970s, the 1980s, and most of the 1990s. (The last item in the preceding list which refers to deflation was not normal in the postwar era. Later in the book I explain how deflationary pressures starting in 1997 and 1998 changed the normal relationship that had existed between bonds and stocks.) With a basic understanding of intermarket relationships, it is easier to see how well the markets followed that script at the start of the 1980s. A rising dollar led to falling commodities, which led to rising bond prices, which led to rising stock prices. Things stayed pretty much this way until 1987.

1987 STOCK MARKET CRASH REVISITED

The stock market crash during the second half of 1987 was an even more dramatic example of the necessity for intermarket awareness. It happened swiftly and the results were dramatic and painful. Those who ignored the

action in related markets during the first half of that year were blindsided by the market collapse during the second half. As a result, they sought out scapegoats like *program trading* and *portfolio insurance* (futures-related strategies that can exaggerate stock market declines) to explain the carnage. While these two factors no doubt added to the steepness of the stock market decline, they did not cause it. The real explanation for the stock market crash that year is much easier to explain, but only if viewed from an intermarket perspective. It started in the bond and commodity pits in the spring of that year.

COMMODITIES RISE, BONDS FALL DURING SPRING OF 1987

During the four years after 1982, two of the main supporting factors behind the stock market advance were falling commodity prices (low inflation) and rising bond prices (falling interest rates). In 1986, both of those markets started to level off; commodities stopped going down and bond prices stopped going up. The intermarket picture did not really turn dangerous, however, until the spring of 1987. In April of that year, the CRB Index of commodity prices turned sharply higher and "broke out" to the highest level in a year. At the same time, bond prices went into a virtual freefall. (Rising commodity prices usually produce lower bond prices.) These intermarket trend changes removed two of the bullish props under the stock market advance and gave an early warning that the market rally was on weak footing. Figure 1.4 shows the inverse relationship between bond and commodity prices from 1985 to 1987. It shows the CRB Index rising above a *neckline* (a trendline drawn over previous peaks) in the spring of 1987 (which completed a bullish *head and shoulders* bottom) just as bond prices were falling under the lower trendline in a yearlong triangular pattern—a bad combination for stocks since it suggested that rising inflation was pushing interest rates higher.

STOCK MARKET PEAKS IN AUGUST

The stock market rally continued for another four months into August 1987 before finally peaking. The fact that bond prices peaked four months ahead of stocks demonstrates the tendency for bonds to turn ahead of stocks. Again,

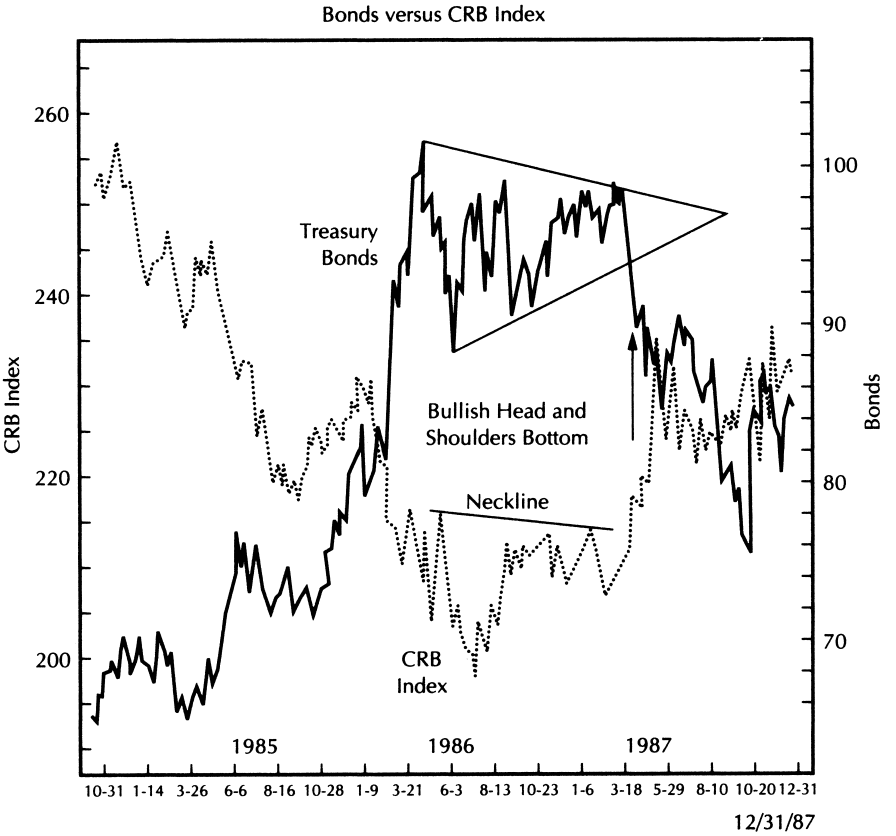

FIGURE 1.4 The inverse relationship between bond prices and commodities can be seen from 1985 through 1987. The bond market collapse in the spring of 1987 coincided with a bullish breakout in commodities.

bonds are considered to be leading indicators of stocks. Figure 1.5 shows the divergence between bond and stock prices from the spring of 1987 (when bonds peaked) until August (when stocks peaked). Bonds fulfilled their role as a leading indicator of stocks. By October, bond yields had climbed above 10 percent. Probably more than any other factor, this jump in interest rates to double-digit levels caused the October stock market crash. Figure 1.6 shows that the October 1987 plunge in stocks followed closely after bond yields climbed over 10 percent. In addition, the U.S. dollar played a role.

DOLLAR FALLS WITH STOCKS

The dollar, which had been declining earlier in the year, started a rebound in May that lasted into the summer. This rebound ended in August as the stock

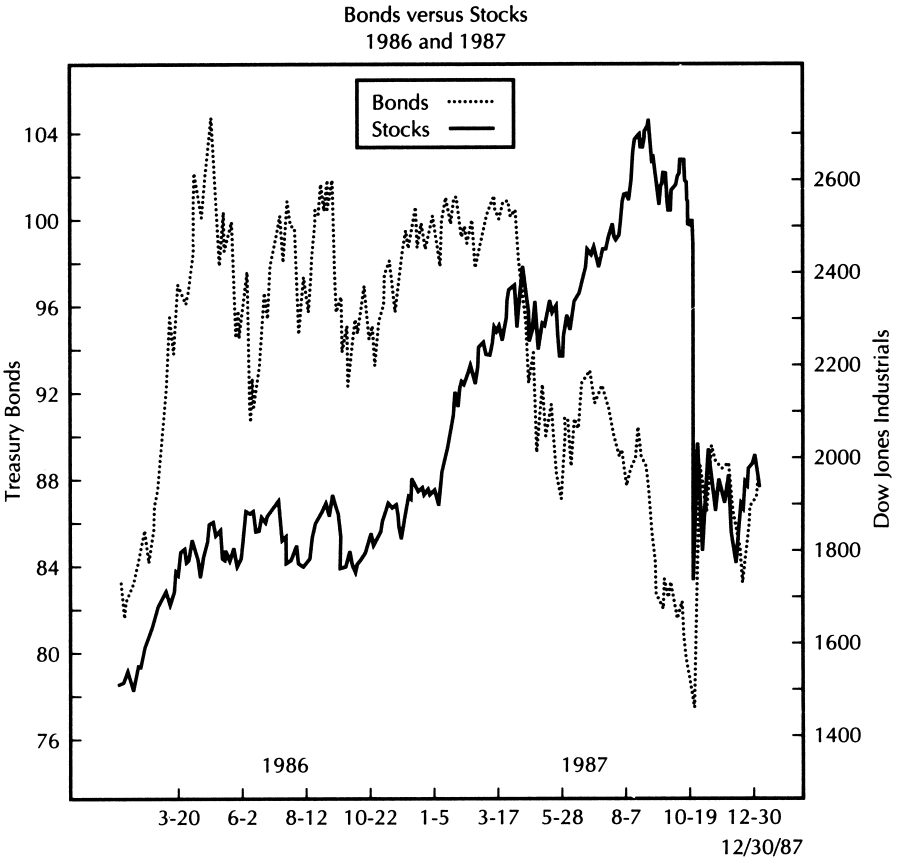

FIGURE 1.5 Bonds versus stocks during 1986 and 1987. Bonds collapsed in April of 1987 and preceded the August peak in stocks by four months.

market peaked. Both markets then fell together. A second rally attempt by the dollar during October also failed, and its subsequent plunge coincided almost exactly with the stock market crash. Figure 1.7 shows the close correlation between the peaks in the dollar and stocks during August and October 1987. Consider the sequence of events going into the fall of 1987. Commodity prices had turned sharply higher, fueling fears of renewed inflation. At the same time, interest rates soared to double digits. The U.S. dollar suddenly went into freefall (fueling even more inflation fears). Is it any wonder that the stock market finally ran into trouble? Given all of the bearish activity in the surrounding markets, it is surprising that the stock market held up as well as it did for as long as it did. There were plenty of reasons why the stock market should have sold off in late 1987. Most of those reasons were visible in the action of surrounding financial markets—like commodi-

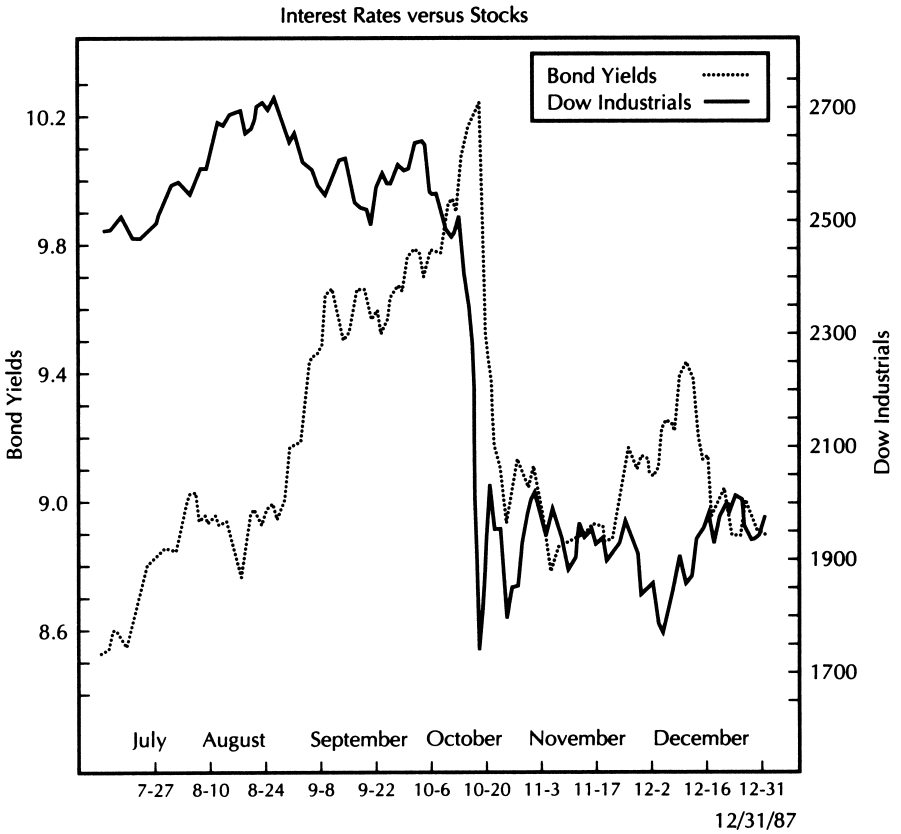

FIGURE 1.6 The surge in bond yields in the summer and fall of 1987 had a bearish influence on stocks. From July to October of that year, Treasury bond yields surged from 8.50 percent to over 10.00 percent. The surge in bond yields was tied to the collapsing bond market and rising commodities.

ties and bonds—but not necessarily in the stock market itself. The events of 1987 provide a textbook example of how intermarket linkages work. That traumatic market year also makes a compelling argument as to why stock market participants need to monitor the other three financial markets.

THE 1987 MARKET CRASH WAS GLOBAL

Another important lesson of 1987 is the fact that the market crash was global in scope—world markets fell together. This is important for two reasons. First, it is a dramatic demonstration of how global stock markets are linked.

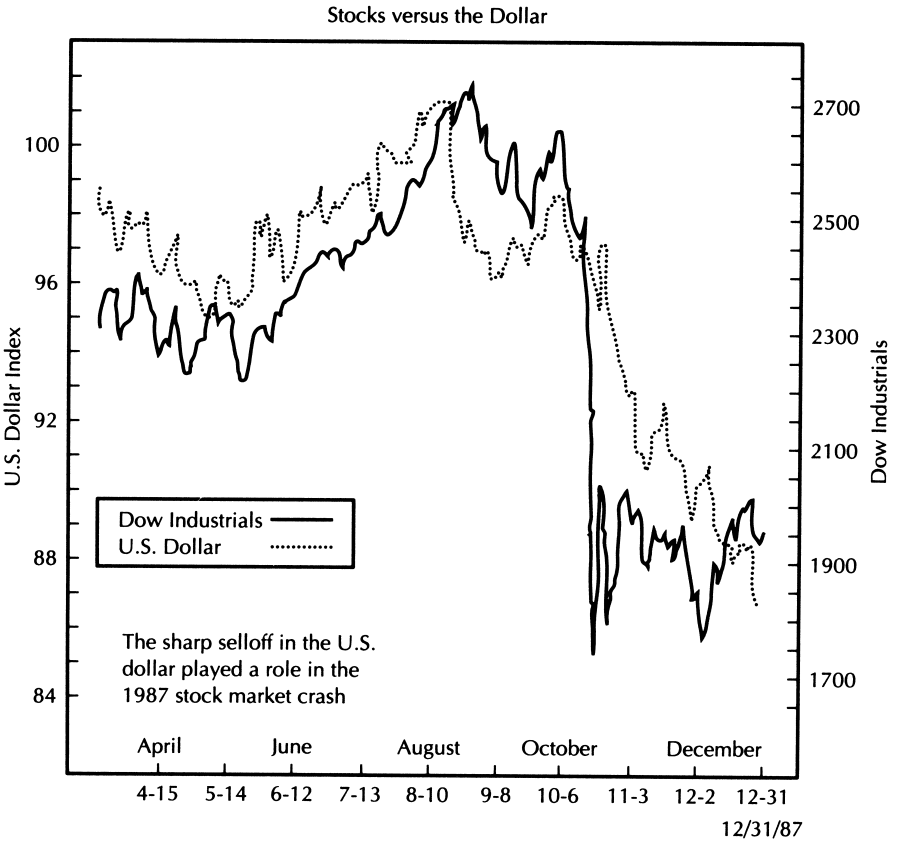

FIGURE 1.7 The falling U.S. dollar during the second half of 1987 also weighed on stock prices. The twin peaks in the U.S. currency in August and October of that year coincided with similar peaks in the stock market. The collapse in the U.S. dollar in October also paralleled the drop in equities.

Second, it shows that world stock markets become even more closely linked during serious downturns than they are normally. At such times, global diversification becomes a myth. (The same phenomenon of a global bear market in stocks is apparent starting in 2000.) Global linkages are not limited to stock markets, either. Foreign currencies are linked to the U.S. dollar. Trends in inflation and deflation (which are reflected in commodity prices) are global.

There is another lesson having to do with the global nature of the 1987 stock market crash. Many market observers at the time took the narrow view that various futures-related strategies—like program trading and portfolio insurance—actually caused the selling panic. They reasoned that there did not seem to be any economic or technical justification for the stock

market collapse. The fact that the equity crash was global in nature, and not limited to the U.S. market, argued against such a narrow view, especially since most foreign markets at the time were not affected by program trading or portfolio insurance.

LATER EXAMPLES OF GLOBAL LINKAGES

During the Iraq crisis of 1990 and again in 2003, rising energy prices slowed global economic growth and contributed to weakness in all of the world's major stock markets. The rise in oil prices during 1990 also pushed interest rates higher all over the world and once again showed how global interest rates rise and fall together. After 1998, a close correlation developed between falling global interest rates—including those in the United States—and a falling Japanese stock market, which was caught in the grip of deflation. Figure 1.8 shows interest rates moving higher around the globe during the inflationary 1970s and then falling together during the disinflationary 1980s and the deflationary 1990s.

THE DOLLAR'S IMPACT CAN BE DELAYED

Of the four financial markets used in intermarket work, the dollar is probably the most difficult to fit into a consistent intermarket model. Long delays between trend changes in the dollar and other markets are part of the reason for that. The events leading up to 1987 provide a good example of why this is so. After rallying for five years, the dollar started to drop in 1985, largely due to the Plaza Accord, a five-nation agreement designed to drive down the price of the dollar. Normally, a falling dollar would give a boost to commodity prices. But this boost did not come—at least not right away. It was not until a year later—in 1986—that the commodity decline that started in 1980 started to level off and bond prices stopped going up. When commodities started to rally during the spring of 1987, the real problems started. It took almost two years for the falling dollar to stimulate a serious rally in commodities—and cause problems for bonds and stocks. Figure 1.9 shows the lag time between two events (the 1985 dollar peak and the 1986 bottom in commodity prices) and the upturn that took place during the spring of 1987. The falling dollar eventually had an impact, but it took a year or two for it to take effect.

Intermarket trends during the 1980s also show why the impact of the dollar's direction on bonds and stocks needs to be filtered through the com-

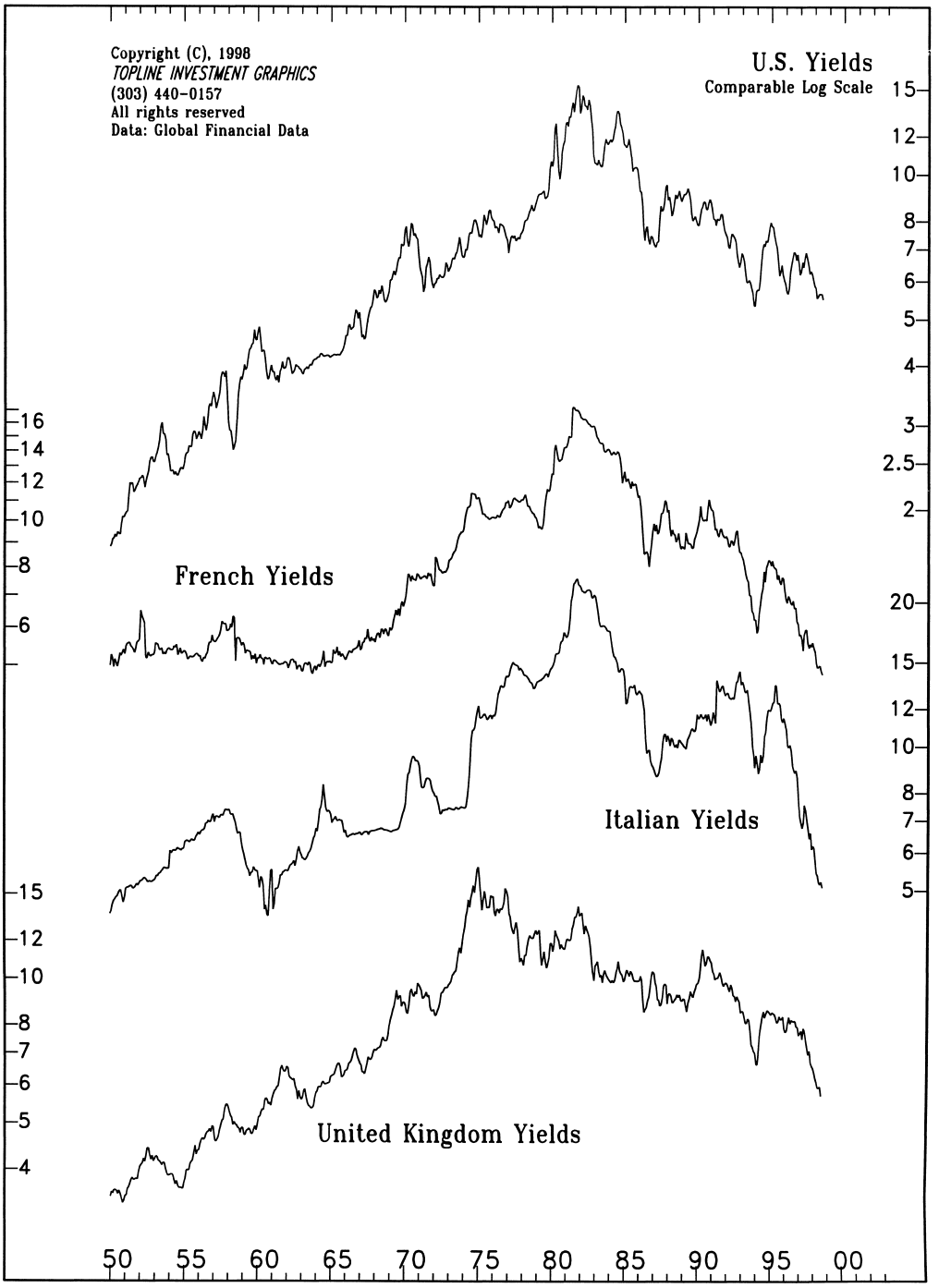

FIGURE 1.8 Global bond yields rose during the inflationary 1970s and fell during the disinflationary 1980s and 90s. Global rates usually rise and fall together.

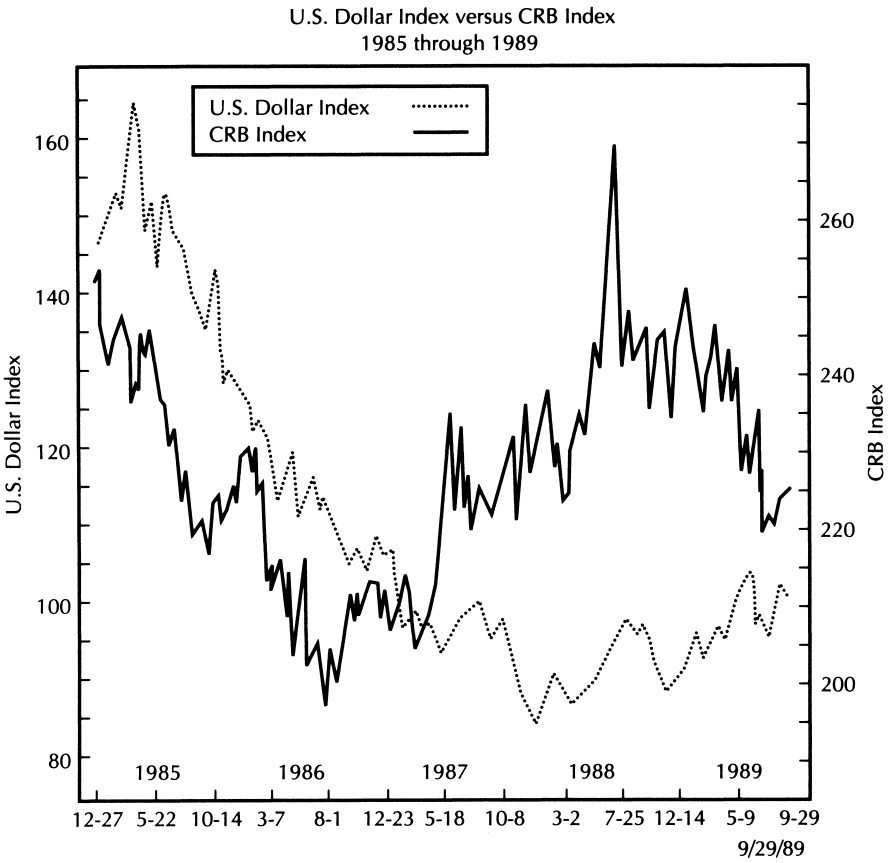

FIGURE 1.9 The U.S. dollar versus the CRB index from 1985 through the fourth quarter of 1989. A falling dollar will eventually push the CRB index higher. The 1986 bottom in the CRB index occurred a year after the 1985 peak in the dollar.

modity markets. A falling dollar can be bearish for bonds and stocks, but only if it coincides with rising commodity prices. (It can also be said that a falling dollar is not a serious problem until it starts to push interest rates higher, which is usually the result of rising commodity prices.) A falling dollar can coexist with rising bond and stock prices, as long as commodity prices do not rise. The decline of the dollar that started in 1985 did not have much of an impact on either bonds or stocks—until commodity prices (and interest rates) turned up during April 1987. Figure 1.10 shows the delayed effect of a falling dollar on interest rates. The dollar peaked in 1985. Bonds peaked one year later, but did not really start tumbling until the spring of 1987. A falling

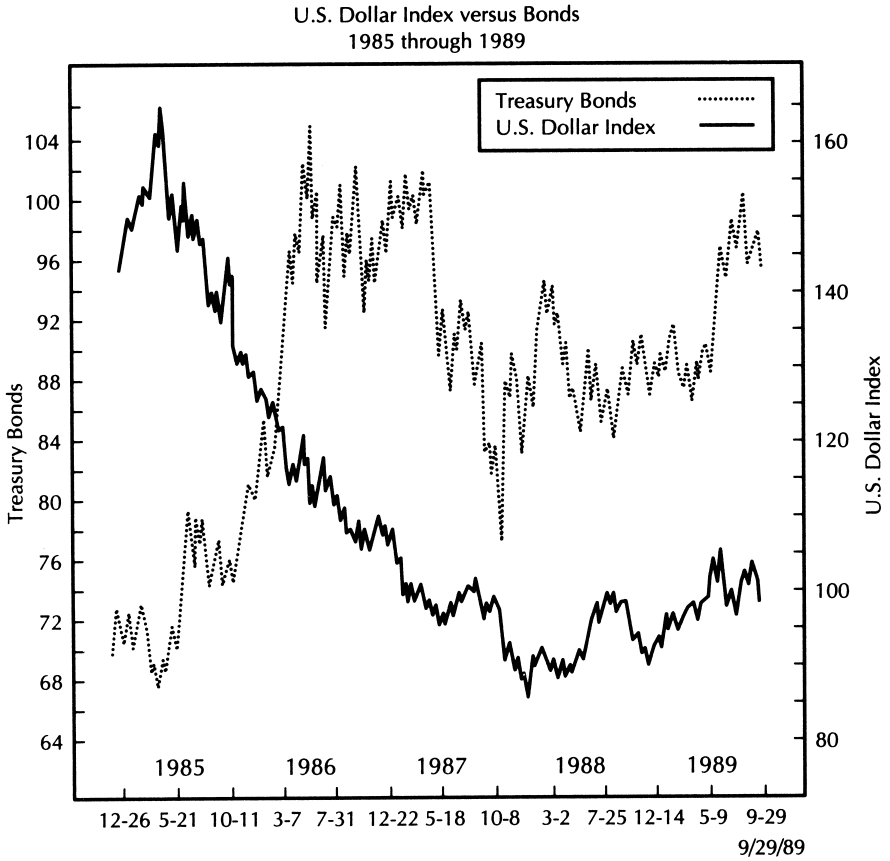

FIGURE 1.10 The U.S. dollar versus Treasury bond prices from 1985 through 1989. A falling dollar is eventually bearish for bonds. During all of 1985 and most of 1986, bonds were strong while the dollar was weak.

dollar became a problem for stocks when its inflationary impact pushed bond prices lower and interest rates higher.

Some have argued that the generally weak dollar in the years between 1985 and 1995 did not have much of a negative impact on bonds and stocks. There is some validity to this argument, since bonds and stocks continued to enjoy major advances during those 10 years. However, it is also true that dollar peaks in 1985 and 1989 preceded the 1987 and 1990 bear markets (in bonds and stocks) by two years and one year, respectively. In addition, commodities rallied during both bear markets as a result of that dollar weakness. It is also true that the 1994 bear trend in bonds and stocks followed another peak in the dollar and an upturn in commodity prices.

ONWARD AND UPWARD TO 1990

Bond and stock prices stabilized during the fourth quarter of 1987 and began a two-year advance that lasted from the start of 1988 to the end of 1989. The intermarket picture during those two years had reverted to a more benign alignment: a strong dollar, weak commodities, and rising bond and stock prices. At the start of 1990, however, things took a turn for the worse. It started with a drop in bond prices, a selloff in the dollar, and a rally in commodities, all of which are negative signs for the stock market. Then came the Iraqi invasion of Kuwait in early August of that year. Oil prices spiked to $40 per barrel. The result was a bear market in stocks and a recession. Because of the lessons that can be learned from studying the intermarket relationships of 1990 and their relevance to geopolitical events 13 years later, we will examine that landmark year in more depth in the next chapter.