Demand for bonds and shares signals new trend in the wings

TECHNICAL ANALYSIS
ROD MYER

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THE uncertainty facing Australia as the nation waits to find who is going to govern us is being matched by a longer-running uncertainty in the finance markets.

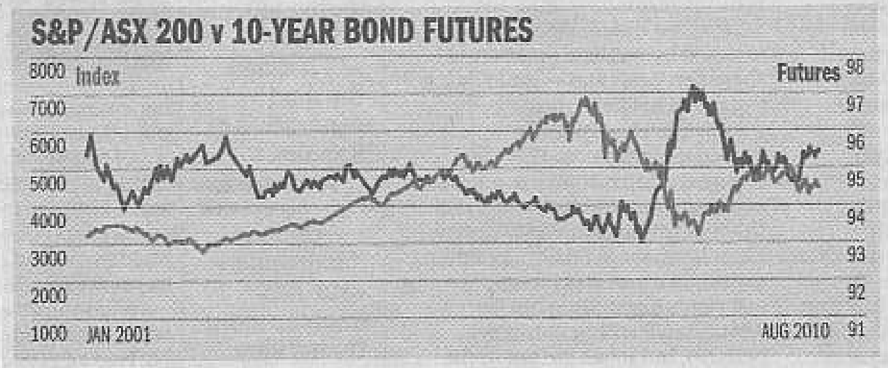
Standard economic textbooks have it that the relationship between stocks and bonds is fairly straightforward. When the sharemarket rises, bond prices tend to fall.

Conversely, when interest rates rise, the sharemarket should fall as investors look for a higher dividend yield (that is, a lower price) from the sharemarket to match the higher returns from simply putting low-risk bonds in the top drawer.

That, of course, is only part of the story. Market sentiment and confidence levels play a huge part in the relationship between the two markets, as the attached graph provided by Kevin Saunders of fund manager Non Correlated Capital shows.

Saunders, rather than simply looking at interest rates, watches the correlation between the sharemarket and the fixed-interest market to determine what investors are thinking and what is likely to happen next.

For example, look at the middle section of the graph, where the blue line (the S&P/ASX 200 Index) crosses the red line (10-year Australian government bonds). That was in 2006 and 2007 when the bull market in shares was running hot. The markets were in "negative correlation" (heading in opposite directions) as investors dumped bonds and bought shares. Bond prices fell and share prices rose until late 2007 when the financial crisis began.



Sentiment changed dramatically with the Lehman's collapse and a new negative correlation occurred as panicked investors dumped shares and stampeded for the relative safety of the bond markets. Then the panic subsided, share prices recovered and the two lines came close together.

Around May this year doubt reappeared, with the Greek debt crisis and concern about the US economy, but the previous negative correlation has not reappeared. Investors have piled into bonds but sharemarkets have fluctuated without collapsing.

Saunders says the correlation between the two markets has broken down: bonds are in big demand, but high sharemarket yields and conflicting economic news mean investors are still warily trading shares.

Such periods are often a hiatus before a new trend. Saunders says that early next month, when US equity traders return from holidays, they may set the next trend.

rodmyr@ozemail.com.au