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# Technical Research

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## Structural Review of Interest Rates: Transitional Range Intact

"Technical Research" is drawn from our full *Market Interpretations*, dated September 22, 2004; order no. US09M097. The report is also available online on Smith Barney's Global Equities Online (GEO) system, Smith Barney Direct, and FC Linx.

For most of this year the consensus has been that interest rates were poised to rise considerably over a short period of time. We have technically disagreed.

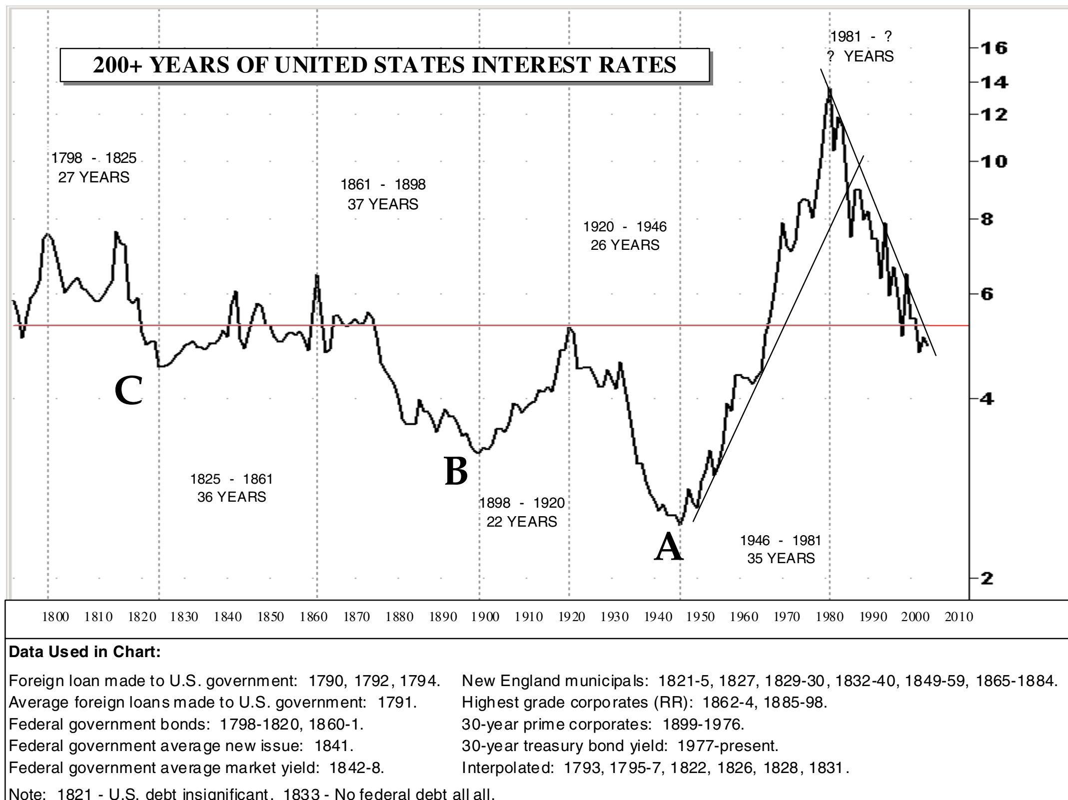
Based on the technical history, a major rise in interest rates is still unlikely over the near term. Our now three-plus-year transitional trading range (3.5%–5.5% for the 10-year note) remains, and could remain, intact for at least another year. Nevertheless, the trading range has been volatile and difficult to trade. Later, our colleague Ron Daino examines the current profile, which has seen rates drifting down over recent months.

### A Quick Review

- Interest rate cycles in our 204-year history have been long: 22–37 years (see Figure 1). The current cycle from 1980 is 24 years old, so our bond bull trend has indeed come of age (notwithstanding our further observation that rates can continue to decline two-plus years beyond the ultimate bear market low [see *Market Interpretations* dated March 5, 2003; order no. US03L023]).
- Rates have effectively achieved our long-standing technical targets: 4.5% for the long bond and 3.5% for the 10-year. Our further 10-year target of 3.0% may well be considered achieved with the June 13, 2003, low of 3.10%.

**Figure 1**

**200+ Years of U.S. Interest Rates**




Source: Bloomberg and Smith Barney



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- Stepping back one more degree, we have shared over the past three years that we have been witnessing *up to 20-plus-year structural trend reversals* in various markets, not seen since 1981–82. These observations had been a part of our technical case for the structural equity bear market:

1. The Dow and S&P 500 broke 18-year uptrends;
2. The Dow/Consumer Price Index (CPI) uptrend violated a 20-year bull uptrend;
3. Gold reversed a 20-year bear market, entering a new bull market;
4. The dollar reversed an eight-year uptrend (first time since 1979–85);
5. The Commodity Research Bureau (CRB) index reversed a 22-year downtrend (inflation for Consumer Essentials? [see *Market Interpretations* dated May 29, 2002, order no. US05K292, and May 17, 2001, order no. US05J205]).
6. Now, in 2004, oil has emerged through a 24-year plateau (see *Market Interpretations* dated July 21, 2004; order no. US07M115).

- The 24-year bond trend is the last outstanding structural trend yet to reverse. It was also the last structural trend to reverse in the early 1980s, identified technically in 1985, three to four years after other major market trend reversals.

The bond bull is now coming of age, and we need to keep an eye on him. The *long-term trend* off the 1981 peak in yields is *still intact* (see Figure 2). The main observation here, with yields plotted inversely, is that every backup in yields, over the 22 years since 1981, failed to exceed the prior backup in yield. This demonstrated *aggressive demand for bonds*. That sequence is still in place until yields rise through 5.5%.

#### Soaring Rates Not a Technical Worry

So, given the noted major trend reversals, it might not come as a surprise that yields are again the laggards in a structural reversal of their trend (see *Market Interpretations* dated March 6, 2003; order no. US03L023). We believe conceptually that this trend, too, will eventually join the others in a structural reversal, but as yet we have *no technical evidence of its immediacy.* Therefore, it is not a question of "if" the rate trend will reverse, but more a question of "how" or "when." Our long-term chart also has been helpful for projections in this area (see Figure 1).

Based again on our 200-plus-year history of U.S. interest rates, one can notice that transitions from rising rate cycles to falling rate cycles have been sharp, quick, inverted "V" affairs.

However, if we look at the reversals of the prior three *declining rate cycles* labeled "A," "B," and "C," one can see they are more gradual, saucer-like *multiyear* affairs. We can thus actually establish a precedent for rates continuing to decline, even beyond an established equity market cycle low (once identified), as occurred in the other periods: Taking the first prior 26-year yield cycle decline from 1920 to 1946 (see "A" on Figure 1), we know the equity market achieved its bear market pivot low in 1932, yet rates continued to fall for 14 years beyond that market low.

The next prior yield cycle decline, of 37 years from 1861 to 1898 (see "B"), contained an equity market low in 1896, yet yields declined further through 1898, or two years beyond the low in equities.

The earliest declining rate cycle ran for 27 years from 1798 to 1825 (see "C") and experienced an equity market low in 1812–13, yet rates continued to decline into 1825, or for another 12 years.

Considering the Elliott Wave "Alternation of Cycles" principle, one could suggest that the extension of time for declining rates, beyond any equity market low in the current cycle, would be *less like the last cycle*, "A," which was a long extension, and more like the alternate cycle, "B," a short extension. This implies a lag of perhaps only about two years of falling rates beyond any identifiable current *or future* equity market low.

**Figure 2**

**Long-Term Government Bond Yield**

Source: Bloomberg and Smith Barney



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### Transitional Trading Range in Place

For several years, we have been suggesting a potential *transitional trading range,* perhaps between 3.5% and 5.5% for the 10-year note, which could last from months to years in the eventual interest rate reversal process. This transitional range is now entering a four-year duration.

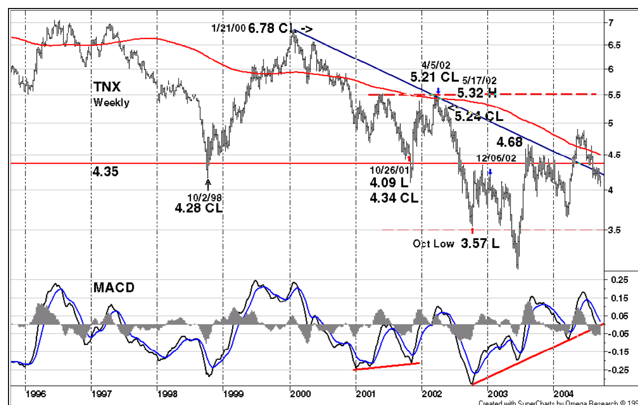
Looking specifically at the 10-year note (see Figure 3), one can more readily see the yield "support" at the 5.5% level and the lower band near 3.5%. What has occurred over three years has been an enormous amount of *volatility* (in which rate breakouts and breakdowns have failed to follow through) due to the daily economic noise. As a result of this volatility, we might suggest that interest rates may not be tradable. But they may indeed continue to *remain benign*.

There is an interesting observation in the 10-year note yield progression. Within the given range, rates spent from 2001 to mid-2002, or 1½ years, in the *upper half* of the range. Since then, another 1½ years has been spent in the lower half of the range, around the 3.1% pivot low of 2003. It now could technically be argued, from a *symmetry perspective*, that the 10-year note rate could spend *another year* in the upper half of the trading range before there needs to be concern for rates emerging through the 5.5% threshold.

Based on this chart, one need not contemplate a more sustainable rate rise until the 10-year reverses to the upper end of the range. However, as/if rates were to *exceed 5.5%*, we would then *definitively declare* that the 24-year bull market in bonds will have come to an end.

**Figure 3**

**10-Year U.S. Treasury Note**




Source: Bloomberg and Smith Barney

### Reasons

The technical study of price in evaluating the forces of supply and demand does not immediately present the reasons why a trend exists. Since the market is a discounting mechanism, those reasons are unlikely to clearly emerge until many months, even years, later. But we can hypothecate and ask questions.

History shows these slow transitions from falling to rising rates have occurred in quasi-deflationary environments. Maybe falling interest rate cycles take a longer, more gradual period of time to reverse because the worry of potential pockets of deflation keeps popping up periodically in the daily economic noise, even as things begin to improve. Those data reignite deflationary fears, interspersed with the struggling new economic buds. The result is a very slow process in the ability of rates to reverse with determination.

There may also be a factor in our concern that the powers that be are "looking for inflation in all the wrong places" (see *Market Interpretations* dated May 17, 2001; order no. US05J205). Thus, it is not being reflected as quickly in the rate response.

### Short-Term Yields

The profile of yields at the short end (see Figure 5) shows a very intriguing "symmetry" pattern. As such, continuing the pattern, we have argued for several years that *short rates* could *remain low* for another two to four years. We are now three years into this technical observation and there have been three rate rises by the Federal Reserve to date, yet they appear as barely a blip on the chart.

So even if rates *were* lifted 100 bps in this series of Fed increases, that entire move would *still be contained within the symmetry* of this pattern and still qualify as a *low interest rate environment*. This level would equate with levels of the early to mid-1950s, which was four-plus years into the last rising rate cycle when rates were also low. Notice, too, the wide (volatile) swings that occurred then in the early stages of the rise in rates, even as low levels prevailed overall. We could be looking at a similar experience today. ***Louise Yamada***

### Stocks: Switch for Success

**Figure 4**

**Dollar-for-Dollar Stock Switches**

| | | | |
|---|---|---|---|
| **Sell** | Coca-Cola Co. (KO-40.73) | **Buy** | Burlington Resources (BR-39.84) |
| **Sell** | Colgate-Palmolive (CL-46.07) | **Buy** | Apache Corp. (APA-49.70) |
| **Sell** | Pfizer (PFE-30.89) | **Buy** | General Electric (GE-34.46) |
| **Sell** | Wal-Mart Stores (WMT-52.26) | **Buy** | ChevronTexaco (CVX-53.52) or ExxonMobil (XOM-49.49) |
| **Sell** | Altria Group (MO-46.15) | **Buy** | Shell Transportation (SC-47.03) |

Source: Smith Barney

The equity market may be stalled, but some stocks are not. Individual names and sub-industries are moving to their own drummers. Selected Consumer and Pharmaceuticals are violating structural support levels:



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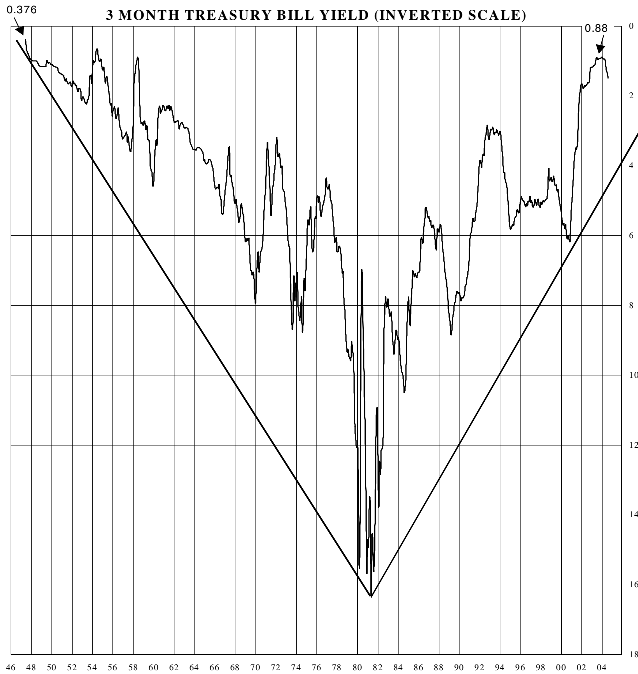
**Figure 5**

**3-Month Treasury Bill Yield (Inverted Scale)**




Source: Bloomberg and Smith Barney

- **Coca-Cola Co.** (KO-40.73): Is breaking five-year supports and may be *renewing* its six-year *structural bear market;* initiating a second leg down. Risk possible to 30, then the mid-20s.
- **Colgate-Palmolive** (CL-46.07): Broke five years of support and may also be initiating a second leg down in its structural bear market. Risk possible to the mid-30s.
- **Pfizer** (PFE-30.89): The support break under 32 now carries risk toward 25 and would renew a structural decline.
- **Wal-Mart Stores** (WMT-52.26): A break of 51 could carry price toward 45–47. A break of 45, under five-year support, could imply a structural decline with possible risk into the mid-30s.
- **Altria Group** (MO-46.15): A support break of 47 could carry back toward 35, then 30.
- We recommend that investors monitor support levels across the Consumer and Pharmaceutical universes, as other names are testing major multiyear supports that suggest the forces of "supply" are gaining the upper hand and the potential for risk and loss of capital is growing (e.g., **Forest Labs** (FRX-44.74) support 42; **Merck & Co.** (MRK-44.84) support 43; **Lilly (Eli)** (LLY-65.16) support 58; **General Mills** (GIS-45.35) support 44–45; **Heinz (H.J.)** (HNZ-36.71) support 36; and **Anheuser-Busch** (BUD-49.64) support 50 broken, next 48).

Yet, Energy stocks are outperforming and lifting up through multiyear bases. We propose the following dollar-for-dollar portfolio switches for investment reward.

Dollar for dollar, one could *sell positions of KO*, a stock with evidence of a major distribution pattern, downtrend, and potential price risk, and use the proceeds to buy **Burlington Resources** (BR-39.84), a stock with evidence of a major 19-year accumulation pattern that has just recently established an uptrend and carries technical potential for price appreciation. A similar switch would be *out of PFE* (a Dow stock) using proceeds, dollar for dollar, now available to buy into **General Electric** (GE-34.46) (another Dow stock), which is just lifting through a four-year consolidation. Another switch would be out of WMT (a Dow stock), which has done little for years and now looks vulnerable to a break below 50, and repositioning the proceeds into **ExxonMobil** (XOM-49.49) (also another Dow stock) or into **ChevronTexaco** (CVX-53.52). The breakdown in CL might offer an opportunity to switch to **Apache Corp.** (APA-49.70) and MO into **Shell Transportation** (SC-47.03) to capture a bit more yield (see Figure 4).

***Louise Yamada***



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