Interest rate futures and the All Ords move in inverse harmony

TECHNICAL ANALYSIS
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THERE are lots of ways to make predictions about the sharemarket and its trajectory, but it seems, from today's chart, that interest rate futures make a pretty handy indicator.

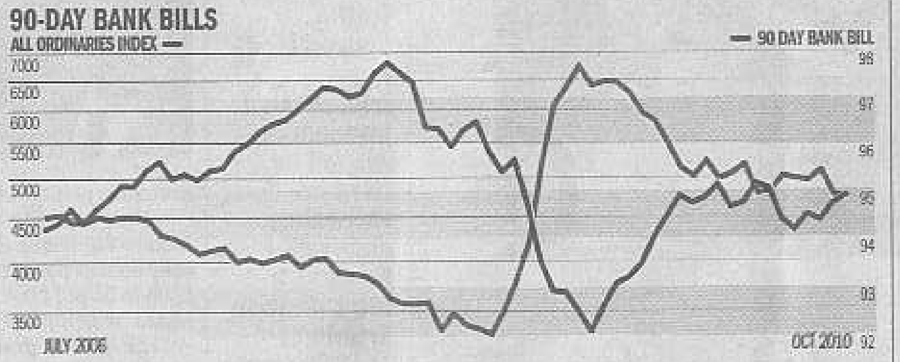
Mark Umansky, a senior member of the Australian Technical Analysts Association, says a comparison of the All Ordinaries Index with the 90-day bank bill futures contract back to October 2005 shows a clear inverse relationship between the two indices.

For the uninitiated, the value of bank bills is expressed in a way that seems counter-intuitive. When the chart is high, say at 97, it means that interest rates are low, at 3 per cent (the difference between 97 and 100), and conversely when bank bills are low, say at 90, then the interest rate on a bank bill stands at (God forbid) 10 per cent.

By looking at the chart "one can deduce that when the Australian stockmarket enters a phase of strength, the effect upon local interest rates is adverse to the consumer [they rise]," Umansky says.

That, economic theory tells us, eventually dints the price of shares as bank bills and other fixed-interest products yield more than share dividends. That, in turn, requires a fall in share prices to give investors a larger relative dividend. As the general economy weakens in response to more expensive money, rates eventually fall again.

Umansky points out that his chart shows the highest price of the



contract for 90-day bank bill futures over the period covered was 97.72 (representing an interest rate of 2.28 per cent) in February 2009. "This peak level and its timing coincides almost perfectly with the low point of 3090.80 on the All Ordinaries Index following the global financial crisis," he says.

The lowest price reached by bank bill futures over the period on the chart was 91.59 (representing an interest rate of 8.41 per cent) in June 2008, which was about halfway through the sharemarket's fall from its pre-financial crisis highs.

That's history, but what can it tell us about the future? Umansky points out that since peaking in February 2009, the 90-day bank bill futures contract fell steeply for eight straight months. Then it moved into a consolidation phase and has been trading between 95.70 and 94.50.

Over that time, the sharemarket also appears to be consolidating after recent strength. Interestingly the two lines on the chart have now almost come together. That, Umansky says, is likely to result in one of two things if history is to be repeated.

Either bank bill futures prices will fall (and local interest rates rise) along with a lift in the sharemarket, or the opposite happens, with bank bill prices rising, along with a fall in the sharemarket.

Umansky says that the Reserve Bank's recent decision to keep rates on hold while flagging possible rises, along with the recent trajectory of the All Ords, suggests that a rise in share prices and weaker bank bill futures is the more likely outcome.

But that, of course, is not investment advice and, if they are looking for that, our readers are advised to get their own professional advice.

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