TrendMacrolytics

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Following the Curve

Friday, December 21, 2001

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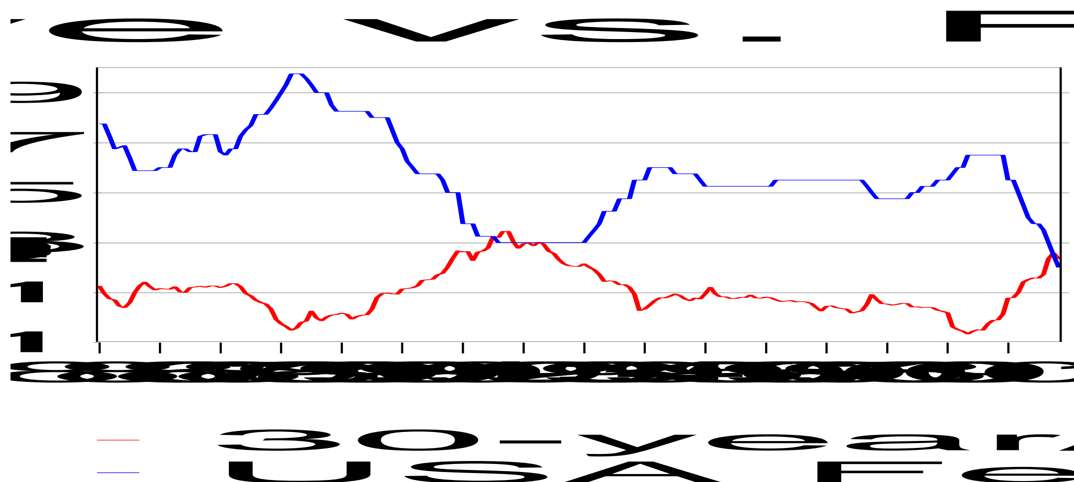
Volatility in long-term Treasury bonds – and an even more intense than usual outpouring of misinformation from the pundit class – continues to set up an impressive opportunity to capture historically high real yields in a deflationary environment. The four point rally of the long bond from its lows at mid-session Monday, the yield skidding nearly 30 basis points to just above 5.4%, suggests that a significant shift in the market's risk-reward assessment is already underway. We've been saying for several weeks that the long bonds is a "screaming buy," and there is still the potential for further significant gains.

To be sure, the short end remains highly sensitive to every twist and twiddle of the data, the two-year note moving in virtual lockstep with **Fed** policy expectations reflected in the interest rate futures markets. But after hewing closely to the same short-maturity signals in the extraordinarily volatile trading environment of the past several weeks, the market now looks to be moving to capture the attractive real-yield premium that has been made available in longer-term issues. It appears, in fact, that we could be witnessing the preliminary stages of the sort of curve-flattening bond rally that has followed earlier episodes of aggressive Fed rate-cutting (see chart below).

Another bond rally at this point confounds much of the analysis that has poured forth to explain the recent sell-off in long-term Treasuries. For some, the soaring bond yields confirmed that the Fed had "done enough," a sign the market was beginning to sniff out inflation risk arising from the rate-cutting campaign. A related analytical line held that the bond rout was a strong recovery signal, as higher yields imply a restoration of real growth expectations, an inference seemingly supported by the equity market's strength since late September.



Lending at least a surface appearance of plausibility to these explanations is the yield curve steepening that has appeared in recent months. At a range around 240-260 bps, the 30/2-year

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curve is about 100 bp steeper than the levels prevailing last spring and summer. As can be seen in the accompanying chart, the curve is approaching the steepening last seen in the late stages of the Fed's massive rate-cutting effort in the early 1990s. Certainly, such a sharp widening of the curve *could* suggest an element of inflation risk entering the market's calculations, which would disproportionately affect long-term instruments most exposed to the risk. As well, the rising curve *could* indicate improving growth prospects, with competition for capital at the margin pushing real long-term yields higher.

Neither rationale, however, proves satisfying under closer scrutiny. For one thing, the bulk of the curve steepening was accounted for in early post-September 11 trading when the Fed's emergency response to the panic encouraged expectations of aggressive action, which have been confirmed in spades. Recall that within than a month, the central bank had engineered two 50 bp funds rate cuts, and has since dropped the rate another 75 bps in two additional installments. Between September 10 and October 8, meanwhile, the yield curve jumped, on net, from about 190 bps to nearly 265 bps, as the two-year fell more than 80 bps to below 2.7%.

One could say that the failure of the long bond to blindly follow short rates lower reflects "inflation risk" in the broadest sense. That is, the long end of the market must always remain alert to the risk of monetary policy overshooting, and thus can normally be expected to lag behind large moves in shorter maturities. In this month's sell-off, though, the relevant risk factor was not inflation *per se* but the possibility that the Fed would read any hint of an economic rebound as potentially inflationary and an excuse to begin reversing its earlier rate cuts. Thus, as the "V" recovery scenario became accepted wisdom, the bond rout affected short and long-term yields nearly equally, with yields at both ends of the curve rising about 40 bps. As the losses were not attributable in any way to higher inflation expectations, the rising yields *ipso facto* amounted to higher real rates, as suggested by the rebound of the "real" yield on the Treasury's inflation-indexed bonds (TIPS).

That can be seen as framing the opportunity for sizable gains that could still be captured in longer-maturity Treasuries. With the strength of dollar purchasing power as indicated by gold, commodities and foreign exchange showing no evident signs of easing, real yields remains high by historical standards. Even assuming reported statistical inflation, as indicated by the core personal consumption deflator, as high as 1% (it's currently running at about 1.25%) over the next year would leave an expected real yield approaching 4.5%, which is still high relative to a long-term average of 3.5 to 3.75%. More likely, as suggested by the **FOMC** statement last week, reported inflation should continue falling. Indeed, the deflationary forces evident for so long in a host of market indicators could well finally surface in official price indexes next year, with appealing implications for the nation's long-term creditors. TM