TrendMacrolytics

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MARKET CALLS

What's Ahead for Bonds?

Friday, September 27, 2002

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The pressure driving up long Treasuries is abating -- but so far there's no pressure for them to come back down.

The head-spinning rally that brought Treasury yields to their lowest levels since the **Eisenhower** administration likely has come close to running its course, if it hasn't already peaked. The rangebound volatility of long-maturity issues since the **FOMC** meeting Tuesday suggests the growing possibility of fresh rate cuts probably isn't enough to continue powering a rally that in four weeks already clipped more than 60 bps off the 10-year note, a total of 120 bps since early July, and nearly 180 bps since April. For the most part, the market appears fully priced for the likely extent of any potential **Fed** move, with little near-term upside available from that source.

By the same token, the prospect of at least one 25 bp funds rate cut before year end is likely to be a factor keeping a lid on yields, at least for now. That could change, however, if the stock market's sell-off turns out to create a base for at least a tradeable rally, and/or the economic data surprises on the upside. We don't rule out either possibility. Our analysis suggests that the broad equity market is attractively priced strictly on a valuation basis, and the economy -- while comporting to no one's idea of vigor -- is stronger than today's dismal market valuations would suggest.

A host of rationales have been offered to explain the extraordinary surge in long-term bond prices: as a safe-haven move against cratering stocks and rising geopolitical risks, a reflection of mounting deflationary pressures or, most recently, a play on the "duration gap" of mortgage lenders caught short in the refi boom. No doubt, each of these at various junctures has contributed to perceptions supporting a strong bid in the bond market. Primarily, though, this rally has most closely tracked the collapse of the market's growth expectations over the past six months, from the "super-V" recovery fantasies of winter and early spring to the continuing "double-dip" recession fears at present. That is demonstrated by the fact that the rally has been led by the short end of the curve most sensitive to funds rate expectations, with the two-year note yield falling from about 3.7% in early April to current levels around 1.9%. As one would expect, longer-dated issues lagged the front-end response to the changing estimates of likely Fed action, but they caught up. By its post-FOMC close Tuesday, the low-point for the yield thus far, the 10-year at 3.64% had covered almost exactly the same ground as the two-year. The 10/2 curve started April in a range around 175 bps, soared to nearly 245 by mid-summer, and is now back to about 180.

To be sure, this stunning advance in long-term Treasuries represents self-evident proof that both current inflation and inflation risk remain a non-factor in this market. With the collapse of Fed rate-hike expectations, the lack of any semblance of a risk of eroding dollar purchasing power left available a gaping real-yield premium in nominal Treasury debt. But while we continue to be highly cognizant of lingering deflation risks, it's difficult to find much support for

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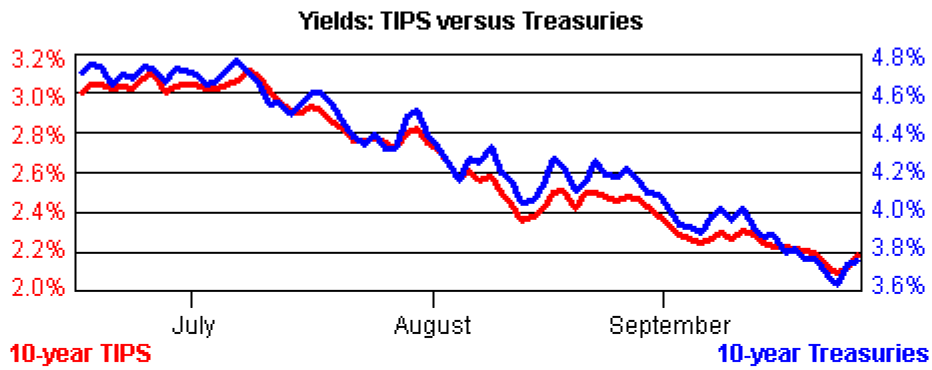
the notion that deflation has been a causal factor in the rally. Were this a "deflation play" it's unlikely, for example, that Treasury's inflation-indexed debt (TIPS) would so closely track movement of nominal issues (see chart, below). With their repayment stream keyed to changes in the Consumer Price Index, the price of the inflation insurance offered by TIPS is a yield lower than that on nominal securities. In a deflation, presumably the value of such protection would decline relative to the availability of the higher yield on non-indexed debt. In other words, in a deflationary event non-indexed bonds would rally against the inflation-protected debt, and the spread between the two would tighten. It appears, however, that the market remains unwilling to make a 10-year inflation bet of less than 1.6% - 1.8%. As a result, the TIPS have rallied in virtual lock-step with conventional Treasuries to maintain that spread since mid-June.



That's not to dismiss deflation risk as a significant factor in the current environment. That risk resides primarily in continuing uncertainty over the Fed's commitment and competence to maintain a price-stable environment. Having watched the Fed's wrong-headed campaign to control what it considered run-away growth appreciate the dollar by some 30% in real terms, what confidence can there be that the deflation relief seen in the 10-15% depreciation of the currency this year against foreign exchange, gold and other commodities won't be reversed? The answer is "not much," especially when the central bank gives no hint that it understands its earlier error and will take the necessary steps to avoid repeating it. The result of that uncertainty can be seen in the continuing reluctance to put capital at risk across the spectrum of enterprise.

Meanwhile, given the changes in the expectations environment engendered by the Fed opening the door to a possible rate cut, we are closing our Model Position betting on a yield-curve flattening, which we established last month. For the period immediately ahead, we wouldn't expect to see major flattening *or* steepening along the curve. We have closed out the position, having captured a flattening of 27 basis points, and with a profit of 2.6% on a cash basis, and 47.4% on a futures basis. TM