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Gettin' While the Gettin's Good

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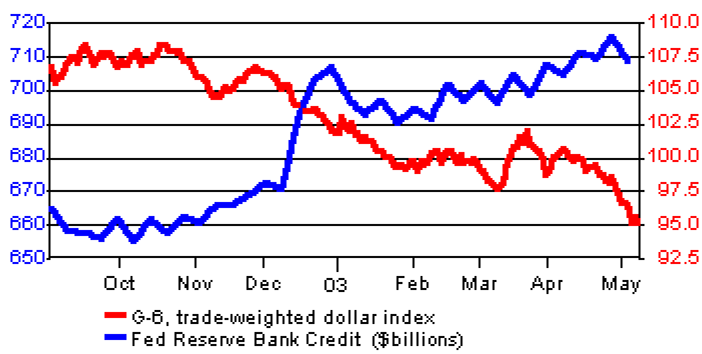
The Fed's talk about deflation has delayed the day of reckoning for long Treasuries.

There is a striking dichotomy in global markets today: the seeming disconnect between a US dollar weakening across a range of market-based indicators and a Treasury rally that has taken some 30 basis points off the 10-year bond yield since mid April.

Pushing yields to a range around 3.7%, Treasury market participants would, at first blush, appear to be embracing the specter of deflation raised by **the Fed's** statement following the **FOMC** meeting Tuesday (the yield is down nearly 20 bps since just since Monday's close). Deflation, of course, raises the real purchasing power of the bonds' nominal repayment stream, and is a boon to assets backed by the Treasury's full faith and credit guarantee.



Markets most directly attuned to policy-induced shifts in the currency's real value, however, show that the dollar -- now brushing the $350 plateau against gold and at four-year lows in terms of foreign exchange -- continues to weaken. With the unit of account having declined by some 12% against these sensitive market-price gauges just since last fall, and by upwards of 20% since early last year, it's clear that whatever deflationary influences were previously in place have been extinguished. As suggested by the attached chart, that anti-deflationary impulse has been the important result of a Fed liquidity posture that has been significantly more generous since the late stages of 2002. In the past five months, the Fed's balance sheet has expanded at an annual rate of better than 15%, versus a five-month rate of just 6% in early December 2002.

For now, though, Treasuries are mesmerized by the deflation-distracted Fed raising the prospect of additional near-term rate cuts, and putting off consideration of higher rates into an indeterminate future. Making hay while the sun shines, bond holders are capitalizing on an exceptionally steep yield curve (the 10/2 spread was 236 bps prior to Tuesday's meeting) to push longer-term yields lower relative to a short end that will remain pinned down as long as the Fed is on deflation-watch. Essentially, the shifting Fed rate expectations environment has produced a decline in real long-term yields. That is probably best illustrated by the response of inflation-indexed Treasuries (TIPS), which on net have moved this week in parallel with their nominal counterparts. At just below 180 basis points, the TIPS spread has barely budged in response to the Fed's deflation warning. That spread would likely have contracted if the market perceived deflation as a real threat, absorbing the inflation expectation premium in nominal yields while, at the margin, opting to forego the insurance of inflation-protected debt.

While Treasuries are probably not in danger of imminent reversal in the face of the Fed's deflation preoccupation, neither are they likely to be sustained at these levels over any long-term horizon. Although deflation is the financial media's story of the week, we continue to see only an outside chance of the Fed following up on Tuesday's announcement with additional easing action. Disappointment over the lack of Fed follow-through would likely deal somewhat of a setback to the long end of the curve. On top of that, though, the continued upward thrust of equities, junk bonds and other financial indicators suggests the market's risk aversion continues to ease and that more robust growth lies ahead. At some point, that will be reflected in a rising real-yield component of nominal Treasuries, and could send yields sharply higher.

There is another, darker, potential scenario supporting the proposition that Treasuries at these rich levels could be highly vulnerable. As we have suggested, the risk of Fed overshooting should not be dismissed in this environment. Should the central bank determine that aggressive action is required to subdue what it considers a deflationary threat, a liquidity glut could be created, the result of which would be an accelerated inflation breakout. While we still regard that as a low-probability risk, it's now higher than it was prior to Tuesday's FOMC meeting. TM