TrendMacrolytics

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MARKET CALLS

Betting on Growth

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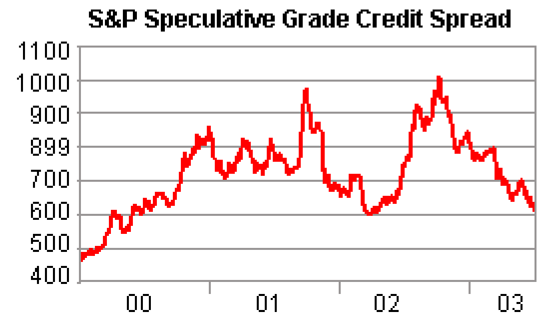
The financial markets appear poised for a significant growth rebound, but interest rate futures are lagging behind.

The financial markets' discounting for a significant acceleration in the pace of economic expansion becomes more convincing nearly by the day. Most visible, of course, is the equity market's ability to sustain its better than 25% rally off the March lows. Although the higher-cap averages have treaded water since about mid-June and shown some recent volatility, the NASDAQ's uptrend has continued. On net, the index has outgained the S&P 500 by nearly 10% since March, and 6% just since the last week of June. With its concentration of riskier, growth-sensitive technology companies, NASDAQ outperformance indicates the market's risk tolerance is on the rise, and that's nearly always a precursor of more robust expansion.



Growth-positive restoration of the market's risk-bearing capacity is also apparent in the impressive strides that continue to be made in the high-yield debt market. The S&P speculative grade credit spread has contracted by more than 100 basis points since early April and -- at just above 600 -- is back to the levels of mid-2000 seen prior to onset of the blow-out bear market in high yield bonds. True, the most recent spread-narrowing is in good measure attributable to the back-up of Treasury yields over the past several weeks. But the ability of the high yield market to hold its gains in the face of the Treasury reversal, with the Merrill Lynch High-Yield Index up more than 10% since early April, manifests a climate of improved risk preference which reflects rising growth expectations and is itself a key growth catalyst. In fact, as we have noted, the Treasury market sell-off is pricing primarily for rising expected real returns in a faster-growth environment (see "Bond Market Blow-Off" June 20, 2003). The real yield on 10-year Treasury inflation-indexed TIPS, at 1.95%, has risen by about 55 basis points since mid-June. The rise in real yields, in other words, accounts for all but 5 of the approximately 60 bp back-up in the nominal10-year yield.

There is, however, a corner of the market that as yet appears largely unmoved by these positive readings and could offer compelling opportunities when it catches on. Over the past decade or so, out-month short-term interest rate futures have become a good proxy for contemporaneous growth expectations. This is due largely to **the Fed's** now-prevalent model equating inflation risk -- and therefore the expected movement of short-term rates -- with economic strength. At present, though, the futures market remains transfixed by the Fed's stated concern that due to a protracted period of economic sluggishness, recent disinflationary trends could morph into outright deflation. That, it is widely agreed, will keep the Fed on hold longer than it would be otherwise in the face of a decent economic rebound, or at least restrain it from raising rates as much as it ordinarily would.

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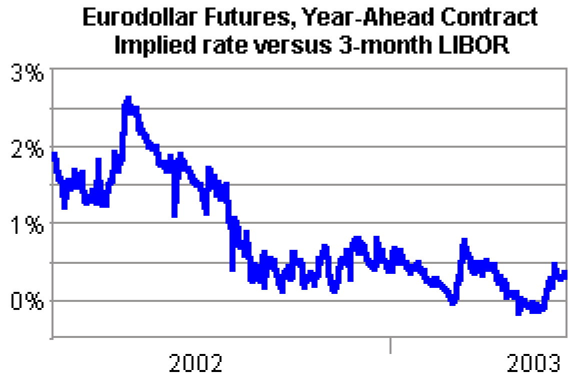

As a result, the Eurodollar futures contract maturing in June 2004 is now priced for just one 25 bp Fed tightening move, as captured in the spread of less than 30 bp between the implied yield on the contract and the current 90 day Libor rate. There are reasons to believe, however, that this bet could soon be vulnerable to reassessment. For one thing, deflation fears have ebbed considerably in the past several weeks owing to a rising sense of economic optimism, which the Fed's June 25 decision to cut the funds rate by 25 bp rather than 50 seemed to affirm. As we have repeatedly noted, of course, the sensitive market price signals by which we gauge the purchasing power of the unit of account show that the earlier deflationary impulses have been doused. Indeed, our upbeat view on the economic and market outlook has been keyed importantly to the reflated dollar reducing the risk premium in the cost of capital and paving the way for a period of more robust capital formation.

It's also important to recognize in this regard that within the Fed's demand-based, output-gap model, what are perceived as deflationary risks arise from the economy growing at a rate below "potential." Those perceived risks would stand to be ameliorated significantly as the pace of economic expansion picks up. **Alan Greenspan's** congressional testimony next week could bring an early hint of such rethinking. We don't doubt that the Fed is likely to take a more cautious approach in the coming economic up-cycle after the disastrous consequences of its most recent venture in "preemptive" policy-making. Current Fed expectations, however, appear to us unrealistic given the developing changes we see in the economic and financial climate. We are establishing a new **Model Position short June Eurodollar futures** as of today's close. TM