TrendMacrolytics

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The Great Unwinding

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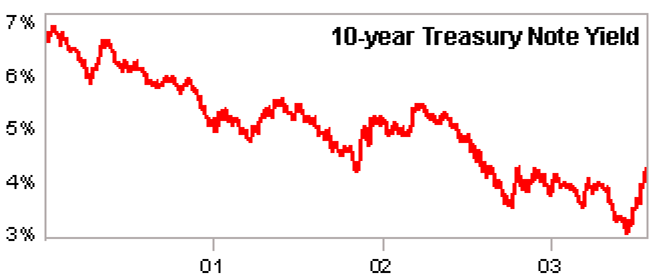
Don't fret. This bond market blow-back is overwhelmingly good news.

The extraordinary cratering of the bond market has now pushed the 10-year Treasury, at about 4.4%, to levels last seen a year ago -- up some 130 basis points since the yield on the benchmark note hit more than four-decade lows just last month. While this bond market blow-back is likely to arouse further trepidation that the rise in yields threatens to short-circuit a nascent strengthening of the expansion, we think the yield jump amounts to a reckoning with reality that has largely positive economic implications.



Obviously, the intensity of this rout of the past six weeks can be sustained only for so long, and the volatility of the past few sessions around these levels suggests we may see a short-run pause in the bond market's downward path. Given the growing sense of an economy now poised for significant acceleration, however, bonds seem unlikely to stabilize for long before the10-year yield moves into a range well above 4.5%.

It's important to place this bear market interval for bonds in its proper perspective. For the most part, this great unwinding has reflected a snap-back of real yields that had been depressed this year by a double-whammy -- first, of risk abhorrence attributable to extreme geopolitical uncertainty, and second by a deflation-distracted **Fed** clearing the way for a seemingly irresistible easy-money carry trade.

At just below 2.4%, the real yield on 10-year inflation-indexed Treasuries (TIPS) has now returned to levels last seen in early January prior to the intensification of **Iraq** risk. As the climax of uncertainty peaked in early March, the TIPS yield fell to 1.62%. With geopolitical uncertainty and risk aversion easing, the real yield moved back above 2% by early May when, following its May 6 meeting, the **FOMC** issued its now-notorious statement placing higher weight on deflation than inflation risk. By signaling that short-term rates would be kept at levels no higher than 1.25% for the foreseeable future, backed by numerous public statements, the Fed overtly encouraged the market to capture a piece of a gaping yield curve. The nominal 10-year Treasury yield fell to 3.11 from 3.88%, a move nearly equally matched by a 70 bp collapse in the real yield, with the 10-year TIPS bottoming at 1.41% on June 13.

Perhaps bond market participants will think twice before again allowing themselves to be so easily seduced by central bank blandishments. There seems to be a nearly palpable sense in the market that **Greenspan** and the Fed committed an act of betrayal by suddenly and unexpectedly shifting toward a more upbeat view of the economy following the late-June move

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to cut rates again, by 25 bp rather than the hoped-for 50. But as we noted on a number of occasions, the deflation impulses that belatedly came to preoccupy the Fed had already been rooted out by the time the monetary masters chose to focus their attention on them. That meant that the deflation risk premia in asset prices was already being absorbed, paving the way for a period of more robust capital formation and a more rapid pace of expansion. It also meant that in training its sights on a non-existent deflationary threat, the Fed was flirting with potential inflationary overshoot. A Treasury market with long maturity issues priced at multi-generation highs was not priced for prospects of faster growth and somewhat higher inflation risk, and we are now witnessing the inevitable correction.

Again, using the TIPS yield as a rough-and-ready proxy for the real component of the nominal bond yield, we see that fully 100 of the130 bp move off last month's yield bottom -- 77% -- is explained by the recovery in real yields. That is overwhelmingly a good thing, as it indicates yields are rising to provide a competitive return in the context of higher real opportunity costs. It suggests, in other words, that expected real investment returns are on the rise, which is what one would expect after the quashing of long-running deflation risks and the enactment of a new tax law improving the after-tax return to investment and risk-taking.

The notion that yields have now risen to a point that could stand as a threat to economic recovery does not withstand scrutiny. For one thing, current long-term rates are still at levels that would have been considered inconceivably low by the standards of just a few years ago. In a freely functioning capital market, yields equilibrate the time preference of lenders and borrowers. During a period of rising expected returns and increased investment opportunity, real interest rates rise in accord with the increased preference for a sum available today relative to the same sum available at some future date. If a time-preference premium cannot be supported by the extant expectations environment, it won't be paid. To be sure, the Fed can disrupt this market process by pushing short-term rates to levels exceeding expected returns. That was exactly what happened in the disastrous 1999-2000 deflationary tightening cycle that created an inverted yield curve and put an end to one of the longest secular bull markets in US history. At this point, however, the Fed obviously is not playing such a role, and it's highly unlikely that the market would freely push yields to levels exceeding an equilibrated rate.

We don't entirely dismiss the concern that a rise in mortgage rates will slow the housing and refinancing boom. Again, though, at present levels mortgage rates remain appealing in any historical context, and higher rates are unlikely to turn the affordability quotient against continued growth in residential investment any time soon. Moreover, to whatever extent a slowing in residential-finance may draw down support for overall growth should be more than offset by an acceleration in real investment activity.

It's worth noting, as well, that while the bulk of this move has been accounted for by a healthy rise in real yields, that still leaves a 30 bp increase in the inflation expectations component of the nominal yield. This bump in the inflation premium is consistent with our analysis detailing the risks implied by the Fed chasing a phantom deflation. Still, a TIPS spread of about 200 basis points is well within range of recent years and suggests the possibility of an inflation breakout remains remote. TM