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MARKET CALLS

Treasuries: Face the Inevitable

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Accelerating growth and inflation risk mean that Treasuries are headed for a big fall.

While it is uncomfortable to fight the tide, we continue to believe that long-term Treasuries are an accident waiting to happen. The deflation case for Treasuries is gone, completely insupportable at this point by any evidence at all. The only factor holding yields down is **the Fed's** repeated assurances to the market that it will hold the funds rate at today's low level as far as the eye can see. We believe the Fed's posture is unwise and unsustainable, and that when it finally changes this rally will end in tears.

The rally will end when inflation risks force the Fed to relent. We already see incipient signs of inflation risk in the highly volatile trading in gold, flirting with 10-year highs.

The key source of inflationary risk is the Fed's failure to comprehend that a funds rate held at today's levels becomes increasingly accommodative against an expected rate of return that is rising economy-wide. This is a serious concern with the Fed seemingly treating a single and approximate measure of job growth as its principal policy indicator

At the same time, the **Bush administration's** protectionist meddling in currency markets introduces an additional element of inflation risk. An avowed weaker-dollar policy -- or even a policy that throws uncertainly on the commitment to a strong dollar -- reduces the demand for dollars. This, too, in effect makes today's funds rate increasingly accommodative.

With each passing day, the Fed is putting itself further behind the curve, which could make the eventual response all the more dramatic when it finally comes. Clearly, it could be triggered by a turnaround in jobs statistics, or perhaps even by other sufficiently strong evidence of accelerating expansion. Just this morning the 10-year yield has jumped almost 10 basis points, apparently on nothing more substantial than that **Dallas Fed chief McTeer** believes that productivity growth will turn into job growth (a belief, by the way, which we strongly share) -- and this against the backdrop of slightly disappointing new claims data. But even absent such things, the longer the Fed persists in its current stance, the more likely it becomes that the bond market itself will end up forcing the Fed's hand. The Fed will find it difficult to remain on hold for long if yields finally begin to jump in response to rising inflation expectations.

This confluence of factors appears to point to the inevitability of a significant bond blowback. Therefore we are doubling our existing Model Position short long-term Treasuries. TM