Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MARKET CALLS

Writing On The Wall

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David Gitlitz

Bonds face the reality of the awakening of a long-slumbering Fed.

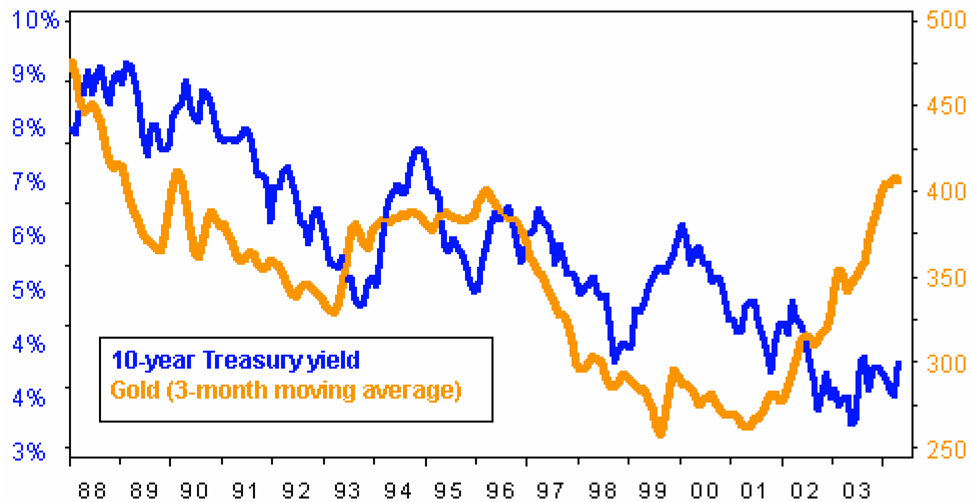
Treasuries took a break from their recent hammering Friday, catching a bid on a bit of market-friendly Fed speak and a seemingly authoritative report suggesting rate hikes still were “likely many months away.” But after the carnage kicked off by the April 2 employment report, with the price of the benchmark 10-year issue down more than four points, the market was due to find an excuse for a pause in its hair-rising slide. Friday’s half-point rally, with the yield dropping six bps to 4.34%, reversed most of the previous couple days’ damage, but it didn’t change the fact that even after the 50-basis-point-backup of the past two weeks, the risk/reward bet in long-dated Treasuries hardly appears promising.

That reality isn’t affected much by the report claiming “Fed officials will need far more than a month or two of good payroll numbers and a month or two of figures showing rising inflation rates before they are ready to act.” The author of the report, **John Berry**, had an influential market presence for many years. As the ***Washington Post’s*** long-tenured **Fed** correspondent, he developed a near-legendary reputation as the favored conduit for leaking the senior Fed staff’s internal policy perspectives when the timing was deemed right. Old habits may die hard, and there were references to Berry as a “Fed insider” in some places Friday, but his latest offering bears few of the hallmarks of his best-known work. Having taken early retirement from the *Post* several months ago, Berry is now a commentator for **Bloomberg News**, and appears no longer to command the same access that he enjoyed from his old perch. Gone are the juicy quotes and assertions attributed to unnamed “senior officials.” Instead, we are treated to the on-the-record comments of one regional Fed bank president, **Minnesota’s Gary Stern**, who -- no surprise -- was cautious in assessing the policy implications of the recent data. For the most part, Berry uses Stern’s comments -- intertwined with references to an earlier speech by **Fed vice chair Roger Ferguson** -- to support his own position that policy makers aren’t about “to pull the trigger on a rate increase any time soon.” Berry is certainly entitled to his opinion, but his prominence was never based on his offering such free-lance judgments.

The market also got a lift Friday from the early press reports of a speech by **Richmond Fed president Alfred Broaddus**, suggesting that the Fed was still “some distance” from hiking rates. Policy makers, Broaddus said, should “wait a little longer before we make judgments on whether or not the reports of the March economic data will persist or not.” It wasn’t until later that the full context of Broaddus’s comment was reported, including his observation that the “likelihood is pretty high” that recent indications of economic strength will persist. He also said that while he was not “unduly concerned” about a sudden inflation breakout, the sharp CPI uptick in March indicated that “disinflation may finally be ending.”

Indeed, the bottom line for bonds is that even if the Fed bides its time for a while longer before moving into rate-hiking mode, the writing is on the wall. The props that have buttressed the Fed’s rationalization for maintaining an unnaturally low overnight rate of 1% -- including

continuing disinflation, stubborn downside economic risks, and “lagging” hiring -- are being kicked out all at once. Speculation over the timing of the Fed’s first move will be an all-consuming preoccupation in the period ahead, but whether it comes in June or September won’t make much difference in the final analysis for holders of long-term bonds. Higher rates are clearly in sight, and the party **Alan Greenspan** staged for the bond market’s benefit is, in all probability, over.



Even if one supposes that the Fed is more likely than not to remain cautious in the period immediately ahead, the chart at left makes clear the tremendous asymmetry in the upside-potential-*vs*-downside risk tradeoff now working on bonds. The Greenspan soiree was nice while it lasted, but as the chart helps to illuminate, bonds now face an inevitable reckoning with economic reality. Over time, bond yields closely track changes in the real purchasing power of the currency, for which the closest proxy remains the price of gold. In fact, the chart makes clear that the sooner the Fed begins acting to withdraw the excess liquidity now reflected in gold, the better it will ultimately be for bonds. If the Fed moves soon enough to confirm the tightening expectations that have taken some $20 off the gold price in the past week, further firming of the dollar would be likely, and the market would avoid a worst-case outcome. One way or another, though, the chances of yields remaining below 5% much longer appear slim at best.

All eyes, of course, will be on Alan Greenspan’s testimony to the **Joint Economic Committee** Wednesday, but for now the Fed chairman may well be content to offer a highly qualified, largely *status quo* assessment. The changes in the Fed’s economic reality have hit with warp speed, and Greenspan is not one usually to turn on a dime. Given the premium he places on building consensus before initiating major policy shifts, it may still be premature to expect the Fed chief to put much of a new perspective on display. For the bond market, though, any celebration is likely to be muted.