TrendMacrolytics

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

FED SHADOW

Measure *This!*

Friday, June 25, 2004

Donald Luskin

You can't fight the numbers: trusting the Fed has been an expensive mistake.

I will be on vacation all next week, riding horses on the western slope of the Rockies at the fabulous **Home Ranch** in **Clark, Colorado** (if the paradox of a ***Relais & Chateaux*** dude ranch is your idea of a good time, I recommend it *very* highly). I'll be completely incommunicado, so I'll miss the June 30 **FOMC** meeting at which **the Fed** will surely make history by raising interest rates from two-generation lows.

This will just be a short last-minute comment, inspired by a question we heard more than once from investors we visited this week. How dare we be so assured in our deep conviction that core CPI inflation will be running at no less than 3% within the next 12 to 18 months, when the intelligent people who sit on the FOMC seem so confident in *their* conviction that inflation is well under control? That's easy. All you have to do is look at the track record. It's a simple matter to quantify how much money bond investors have made or lost following the advice of those intelligent people.

The first time the FOMC announced its bias towards deflation was at the May 6, 2003 meeting, when they wrote "the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level." Investors who believed the Fed's deflation prediction and bought 10-year Treasury bonds -- a sensible thing to do if you expect deflation -- have earned 4.39% in coupon income since then, but lost 6.01% in principal, as yields have risen from 3.81% to 4.70% -- for a net loss of 1.62%. If you take into account the 1.61% opportunity cost of foregoing earning the overnight rate for all that time -- a cost that the Fed explicitly incentivized bond investors to bear, via the "carry trade" (see "A Considerable Seduction" December 17, 2003) -- you have to calculate the loss at 3.2%.

FOMC meeting	10-year yield	Income	Capital gain/loss	Net gain/loss	Opportunity cost	Total gain/loss
3/16/2004	3.69%	1.03%	-6.82%	-5.79%	0.28%	-6.07%
1/28/2004	4.20%	1.73%	-3.38%	-1.65%	0.41%	-2.06%
12/9/2003	4.35%	2.39%	-2.36%	0.03%	0.55%	-0.52%
10/28/2003	4.19%	2.79%	-3.44%	-0.65%	0.67%	-1.32%
9/16/2003	4.29%	3.36%	-2.77%	0.59%	0.78%	-0.19%
8/12/2003	4.36%	3.84%	-2.30%	1.54%	0.88%	0.66%
6/25/2003	3.36%	3.41%	-9.05%	-5.64%	1.01%	-6.65%
5/6/2003	3.81%	4.39%	-6.01%	-1.62%	1.61%	-3.23%

The table above shows that the same thing is true -- to varying extents, some less bad and some more bad (and a couple *really* bad) -- if you'd bought bonds on the day of any the other FOMC meetings since then, at which they reiterated their bias toward deflation. The single exception is the meeting of August 12, 2003, the first meeting at which the "considerable period" language was used. Bond buyers with that inception date have earned a whopping 0.66% for bearing risk for the "considerable period" of 317 days.

Of course all these losses are calculated only in nominal terms. If they were calculated in real terms -- taking into account the inflation that the Fed wasn't worried about -- they would be much worse.

The question is not how can we bet against the Fed. The question is exactly which way will the Fed betray bond investors *this* time. Will the Fed break its promise of "measured" rate hikes for the sake of combating inflation? Or will the Fed keep its promise, and let even more inflation build up in the pipeline? Those are the only choices. Either way, bonds are toast.

It's not hard for us to be highly confident betting against the intelligent people who run the Fed. For us, the only question is this: when will bond investors stop throwing their money away by believing them? TM