TrendMacrolytics

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

MACROCOSM

No Bail-Out for Bonds

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David Gitlitz

A growth plateau won't save bonds from rising inflation and a behind-the-curve Fed.

Treasuries seized on a data soft spot to post their lowest yields in more than two months, with the 10-year trading below 4.5%. But the dollar's nearly simultaneous erosion against gold and foreign exchange has underscored the dubious sustainability of the rally. For sure, a **Fed** already biased to move at a snail's pace in normalizing its super-easy stance would likely be even less inclined toward firm action if it suspects a growth slowdown looms. But the concomitant softening of the currency's purchasing power -- best indicated by gold again trading above $400 -- suggests that whatever short-term gains bonds might reap on hopes for an even less aggressive Fed would be more than offset in the longer run if those hopes were actually realized. The longer the Fed dawdles in bringing the funds rate to an equilibrium level, the greater the ultimate inflationary consequences, with bonds inevitably getting squeezed in the pincers between a rising price level and a behind-the-curve Fed racing to catch up.

As skeptical as we've been about the Fed's readiness to root out the incipient inflationary impulses implanted by over-staying an excessively accommodative posture, the scaling back of rate-hike expectations which has powered this bond rally appears significantly overdone. In the past month, betting in fed funds futures has ratcheted down the expected year-end overnight rate from 2.5% to 2.0% on the strength of what, to this point, seems scanty evidence of economic deceleration. Although durable goods orders and the final revision to first quarter GDP disappointed the consensus, the bulk of the dovish tilt in expectations is attributable to June payroll growth coming in at less than half the expected gain of 250,000 jobs. No doubt, for a Fed that regularly confuses labor market conditions for its task of stabilizing the currency, a continued downshift in job growth would give rise to second thoughts about continuing to pursue even a "measured" approach to tightening.

Yet we find little to support the notion that the fundamental support for this expansion is weakening in any appreciable way. Our interpretation of recent data is that rather than a material growth slowdown, the economy currently is plateauing at a rate of expansion that should remain robust for the foreseeable future. In May, for example, capital goods orders fell by 3.5%, arousing concern that the recovery in business fixed investment could be at risk. But that overlooks the sharp turnaround in capital goods over the previous several months. Between January and April, new orders on a three-month annualized basis surged from -10% to better than 28%. After such a steep acceleration, a falloff in monthly growth rates is not unusual or indicative of a faltering pace of expansion. Even during the late-1990s investment boom, the three-month annualized growth rate for capital goods orders registered in negative territory on several occasions.

Our confidence that the capital investment recovery is unlikely to ebb soon is bolstered by market-based indicators suggesting that expected returns continue to support a healthy pace of risk-based investment. Junk bond spreads, for example, remain below 500 basis points,

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

suggesting a level of risk-tolerance that has historically corresponded with vigorous investment-led growth. By the same token, the rise of the risk premium in the cost of capital that gutted the investment boom and led the economy into recession was first signaled by the high-yield spread shooting above 500 basis points in spring 2000.

That's not to suggest that we are incognizant of current risks to the growth outlook. As we have detailed previously, in this political season those risks primarily are bound up in the contrasting economic philosophy that would likely emerge in the event of a **Democratic** *vs.* **Republican** victory (see "The Republic of Hanging Chad" July 7, 2004). We don't dismiss the possibility that political uncertainties more than three months in advance of the election could yet pose enough of an obstacle to investment and risk taking to seriously damage the pace of growth. At this juncture, however, evidence of any such obstacles is not yet present. And, of course, our still-upbeat view in no way dismisses the risks presented by the potential for monetary error during this critical policy transition period. It may be the last thing bond buyers want to hear at this point, but the odds favoring longer-run durability of this expansion would be significantly enhanced by the Fed coming to terms sooner rather than later with the reality it faces, and in so doing administering some tough love to a complacent bond market. TM