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Bond Illusions

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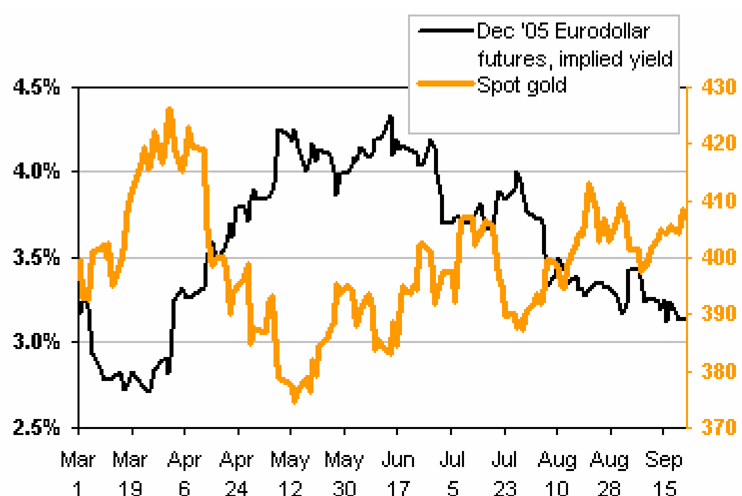
At 4%, bonds are priced on fantasies that growth is slowing and that the Fed is fighting inflation.

On Monday, we suggested that the bond market would be hard pressed to maintain its rally footing, or even hold all its recent gains, absent **Fed** confirmation of the market's gloomy economic perspective (see "Rude Awakening?" September 20, 2004). As it turned out, Tuesday's post-meeting **FOMC** statement was ambiguous enough -- "output growth appears to have regained *some* traction, and labor market conditions have improved *modestly*" (emphasis added) -- to back up either an optimistic or a cautious interpretation of the Fed's view.

But a momentum-driven Treasury market, eager to identify any marginally plausible rationale to continue bidding up prices, found encouragement in what is being construed as a signal that the central bank sees an abatement of inflation risk. "Despite the rise in energy prices," the FOMC said, "inflation and inflation expectations have eased in recent months."

With the 10-year note hovering around the 4% level, remaining upside appears highly limited. For the period immediately ahead, however, stubborn economic skepticism -- helped along by the latest pop in crude oil prices and combined with the perception of a reduced inflation threat -- figures to put off a bond market sell-off that we see as nearly inevitable in the longer run.

In this tumultuous market environment it's important to distinguish between an *actual* mitigation of inflation risk and the currently convenient interpretation that the Fed's apparent comfort with the inflation outlook implies a less aggressive rate-hiking campaign. In some circles, the Fed is being given credit for the bond rally based on the notion that the nation's creditors have become increasingly confident that inflation risk is being quelled by effective policy action. That view was put forward, among other places, in a ***Wall Street Journal*** editorial yesterday: "Realizing that the Fed has established a solid commitment to nipping inflation in the bud reassures lenders that the value of their investment will be protected. That's the best tonic for the bond market."



To be sure, this supposition has a certain compelling surface logic. If inflation risk and expectations were rising due to easy money, then a credible Fed course of policy tightening *should* bolster faith in the unit of account, with government bonds a primary beneficiary. Under

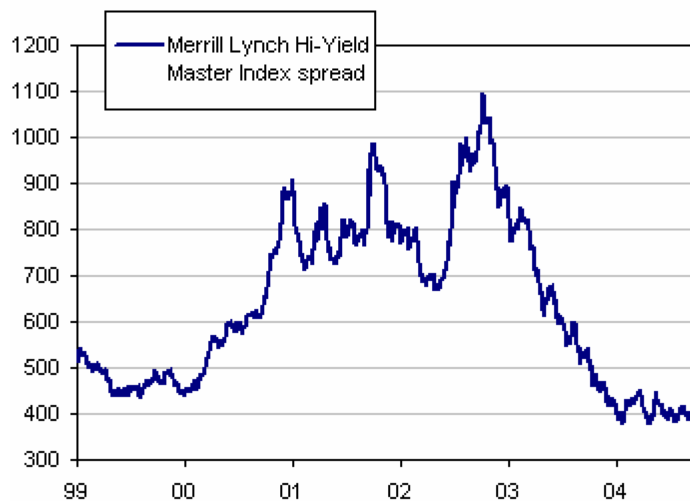
closer scrutiny, however, the hypothesis fails to hold up as a convincing explanation for market activity. Had the Fed actually adopted a posture considered likely to root out incipient inflationary impulses, we'd expect to find confirmation in market price indicators including the price of gold. Fact is, though, at above $410 per ounce, gold today is trading more than $35 higher than it was in mid-May, and has popped some $6 higher just since the FOMC's announcement purportedly conveyed the Fed's "solid commitment to nipping inflation in the bud."

The chart on the previous page, in fact, illustrates an obvious inverse relationship between confidence in the dollar's purchasing power (as reflected in the price of gold) and shifts in the anticipated extent of the Fed tightening cycle (as reflected in December 2005 Eurodollar futures). Gold's bottom in May came at the same time expectations of future Fed tightening action neared their peak, with December 2005 Eurodollar futures priced for a funds rate of 4%. Today, those contracts are priced for a funds rate of less than 3%. Over the same period, the10-year Treasury yield declined by nearly as much, falling from about 4.9% to just below 4%.

It's hardly plausible, then, to think that the bond market rally has been a testament to the Fed's anti-inflation endeavors, even as the price of gold has risen by some 10% and expectations of forthcoming Fed rate hikes have unwound by more than 100 basis points. To a great extent, the unwinding of tightening expectations and corresponding ratcheting down of bond yields has been a hangover of the second quarter "soft spot" in job creation and growth. This has been compounded by an unsettled oil price environment, and facilitated by a regeneration of the carry trade -- with a still steep yield curve compelling investors to buy higher-yielding debt financed by cheap short-term borrowing.

The price of gold, of course, provides the crucial reality check on the ill-conceived idea that Fed policymakers can actually afford to take as much of a go-slow approach as the credit markets would like to believe they will. Particularly pernicious is the belief that the oil price situation should encourage a less forceful approach to offset any drag on consumption growth. Monetizing the oil price spike would be a recipe for an inflationary breakout the likes of which the **US** economy has not witnessed since the same disastrous policy error was last committed some thirty years ago. If anything, given the still accommodative policy stance, oil prices should bias the Fed toward a more, not less, aggressive approach.

Any suggestion, meanwhile, that the 75 basis points in rates hikes to this point have actually tightened the supply/demand balance for dollar liquidity is belied by the recent growth of the Fed's balance sheet, which over the past four weeks has expanded at an annual rate of more than 25%. That's the highest rate of growth since the central bank was in an aggressive liquidity addition mode in late 2002 and early 2003 to subdue lingering *deflationary* pressures. Such rapid expansion can be seen as indicative of the Fed maintaining its target rate at below equilibrium levels, as it must inject larger sums of liquidity to keep the rate from rising in keeping with market-wide opportunity costs.



It's very likely that the bond market will eventually be forced to reckon

with its own double-barreled reality, because neither growth nor inflation is likely to be nearly as quiescent as what it currently is priced for. Forward-looking market-based indicators reveal no signs that a period of economic sluggishness is in the offing. To the contrary, in fact, one such indicator of risk preference and growth expectations -- the **Merrill Lynch** high-yield bond spread -- at less than 400 basis points, is below its levels of the late-1990s boom.

From our perspective, such healthy growth expectations are the silver lining in the cloud currently hanging over the monetary policy environment. Confirmation that the economy has returned to a robust growth course should at some point in the not too distant future reverse policy expectations once again, and give the Fed the leeway to carry out a sustained -- and necessary -- tightening exercise. This won't be pretty for bonds that have so eagerly jumped to capture the handsome gains made available by the cutback in expected rate hikes. In the long run, however, it will be a lot less ugly than a readily conceivable alternative scenario, with the Fed forced to impose panic rate hikes to beat down an inflation that it's inappropriately relaxed approach allowed to fester. TM