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Bonds: Sell 'Em While They're Hot

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A mere data revision triggered a bond market rout -- and there are more revisions ahead.

Our contention that the bond rally of recent months was built on a highly unstable foundation of unrealistically pessimistic assumptions and wishful thinking was fittingly illustrated by the market's response to Wednesday's upward revision of second quarter GDP. Under normal circumstances, a revision to the previous quarter's growth rate coming at the tail end of the current quarter has virtually zero information content relevant to capital markets which function to convert future expectations into current prices. In this case, however, initial estimates suggesting a slowing rate of expansion were a key factor contributing to the unwinding of **Fed** tightening expectations beginning in late July. That in turn fueled a bond rally which drove 10-year Treasury yields from 4.6% to 3.96% at their lows last Thursday, the day we wrote that "bonds are priced on fantasies" (see "Bond Illusions" September 23, 2004). For a market so clearly overextended on dubious economic grounds, the upward revision in the second quarter growth rate from 2.8% to 3.3% amounted to a highly unwelcome wakeup call. Wednesday's three-quarter point backup, with the 10-year yield rising to 4.09%, could serve as the catalyst for an overdue reckoning with economic reality.

Indeed, a rapidly developing turn in sentiment could also be seen in this morning's half-point sell-off on the **ISM** manufacturing survey. While at 58.5 the purchasing managers' index was slightly stronger than consensus expectations, it was below the "whisper number" that circulated following yesterday's upside surprise in the **Chicago** PMI. And while the overall survey continued to convey strength in the manufacturing sector, the forward-looking new orders component of the index -- at 58.1 -- dropped below 60 for the first time in more than a year. When bonds were in rally mode, such a "disappointment" could well have spurred additional gains. Today, it couldn't stem further losses. A market that had been powering higher on any excuse to buy could now be vulnerable to traders finding any excuse to sell.

With the September employment report looming next Friday, any remaining bond bulls figure to face stiff resistance in the short run at least. As we noted in a report earlier today (see "Many A Slip" October 1, 2004), this report will incorporate the annual benchmark revisions, updating a year's worth of employment data based on more complete information than is available for the monthly estimates. During an economic uptrend, it's not unusual for these revisions to add as many as several hundred thousand jobs to the previous totals. More likely than not, such a development would represent a significant comeuppance for a bond market that has taken great solace from reports of labor market stagnation.

Nor are bonds likely to escape unscathed from the inflation uptrend indicated by the price of gold currently trading at nearly $420, versus $375 as recently as last May and relative to a 10-year moving average of about $330. It's possible, in fact, to see in this nascent bond sell-off the first inklings of a rising inflation premium. We find it interesting, for one thing, that while longer-term Treasuries rallied in accord with the reduction in Fed tightening expectations over the past few months, the nearly 20-basis-point backup in bond yields this week far outpaced any rise in out-month fed funds expectations. The implied yield on the December 2005 Eurodollar futures rose by only five basis points this week, and continues to price for a 3% funds rate, down from 4% last spring. Long yields rising relative to steady expectations for the overnight policy rate can be seen as one indication of rising inflation expectations entering into the bond pricing process. That holds as well for the nearly 20 basis point widening over the past two weeks in the spread between the nominal 10-year note and its inflation-indexed counterpart. TM