TrendMacrolytics

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MACROCOSM

Stop Worrying and Love the Bond?

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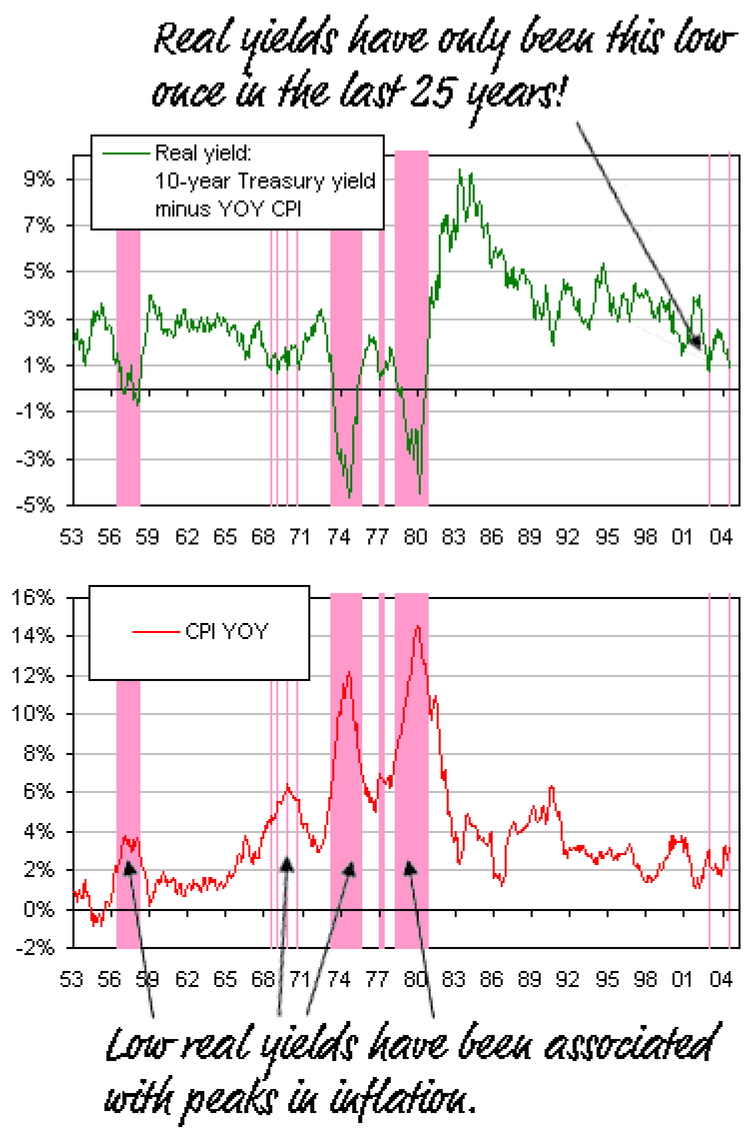
No -- bonds are as wrong as the Fed is if they imagine there is no inflation threat.

As bond bears, we are bloodied but not bowed. Yesterday's action in the Treasury market -- in which bonds staged a don't-worry-be-happy rally against a backdrop of *both* positive economic growth news *and* negative inflation news -- convinces us, more than ever, that Treasuries are a horrific accident waiting to happen. Surely we must be near the bond equivalent of a NASDAQ 5000 moment when we hear seemingly sober market participants rationalizing away the dangerous implications of a dollar making nine-year lows by expecting that foreign central banks will intervene to weaken their currencies, and then reinvest their dollars in Treasury bills. Conveniently forgotten is the stubborn fact that foreign central banks only have those dollars in the first place because **the Fed** has printed too many of them -- causing the dollar to depreciate relative to every major foreign currency. Yes, it's nice that the foreign central banks are bailing water out of the boat, but the reality is that we have a big, inflationary leak.



And so we find the 10-year Treasury bond yesterday trading at a real yield that has only been lower once in the last 25 years. By "real yield" in this case, we mean the difference between the 10-year Treasury yield and year-over-year growth of the Consumer Price Index. Yesterday the 10-year yield was 4.14%, with October CPI growth announced at 3.24% (by the way, the highest such growth in almost three and a half years). So the real yield -- the yield above and beyond the CPI inflation rate -- was 90 basis points. In March 2003, it was lower, at 72 basis points. But other than that single instance,

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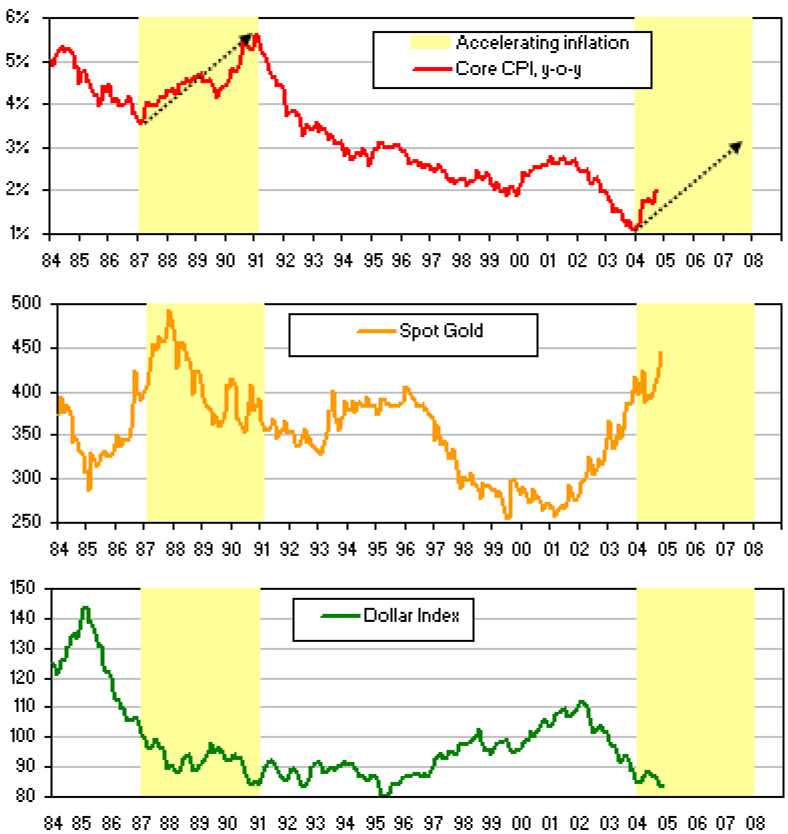
you have to go all the way back to January 1981 to find lower real yields than today's.

Any number of factors, monetary and non-monetary, could potentially give rise to low real yields at a given point in time. But it seems clear that real yields as low as today's have consistently been associated, over the last fifty years, with periods surrounding peaks in inflation. In other words, low real yields appear to embed forecasts that the rate of inflation will fall over the life of the bond -- thus low real yields are not, in fact, as low as they would appear to be. But as it turns out, the predictions embedded in real yields are not especially good. Over the last fifty years, they've had a track record over one, five and ten year periods that is only minutely statistically indistinguishable from throwing darts. In other words, just because real yields today *appear* to be forecasting lower inflation in the future, there is no reason based on precedent to expect that inflation will, in fact, be lower.

Consider March 2003, the last time real yields were lower than they are today. The reasons for a low real yield then have proven to be quite wrong. First, CPI inflation had risen to 3.08% in March 2003, but all the talk then was about the risk of deflation. 3.08% inflation turned out to be a peak in the short term, but it has now been exceeded. And second, March 2003 marked the very crest of economic pessimism engendered by the run-up to the invasion of **Iraq**. That turned out to be much ado about nothing, as several months later the economy launched upon a growth run better than anything seen in almost 20 years. The Fed bailed bond holders out of those errors, though. Bond prices are lower today than they were in March 2003, by about 2-1/4%. Yet bond traders who put on the "carry trade" then have been just barely made whole by the steep yield curve, and the intervening "considerable period" period of 1% overnight rates (the canonical "carry trade," since March 2003, is in profit on net by about 75 basis points on notional principal).

Gold and the dollar are calling for a replay of late-1980's inflation.

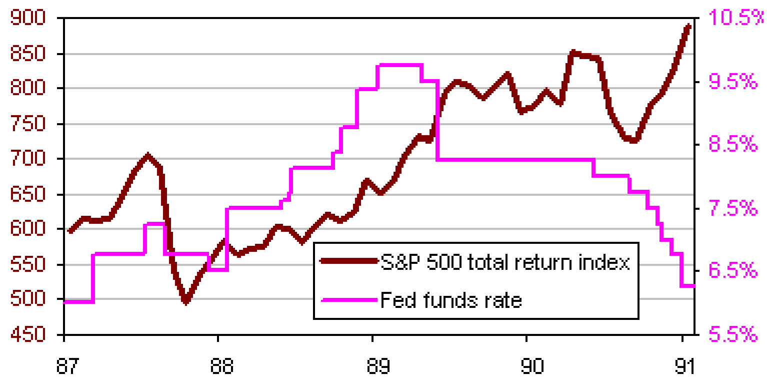


We think the bond market today is even more wrong on the economic and monetary fundamentals than it was in March 2003. With the overnight-to-10-year yield curve today almost half a percent flatter than it was in March 2003, there's just not any room on the upside, and less cushion on downside. And the downside will likely be considerable, when the scope of the economic re-acceleration now being discounted by a rising stock market (see "Unlocking 'The Bush Rally'" November 12, 2004) -- and the inflation being signaled by commodity and forex prices, and already beginning to be strongly reflected in official price statistics -- become so obvious that even the bond market can't ignore it.

Yes, **the FOMC** claims that "Inflation and longer-term inflation expectations remain well contained." But they are wrong. Already "core" CPI is up in the first ten months of this year almost twice as much as it was up *all* last year. The Producer Price Index rose last month -- in just a single month -- more than it had risen in the entire year ended last March.

Perhaps the FOMC is right about "expectations" -- if the only expectations you consider are those of the bond market. But the commodities and forex markets beg to disagree. Consider the charts on the previous page, which many of you will recall from in-person meetings, but may not have seen before in our written reports. Both gold and the trade-weighted dollar index -- two of the most sensitive market-based indicators of inflationary expectations -- have behaved, over the recent past, almost precisely as they behaved in the period preceding the last significant acceleration of inflation. Leading into the four-year inflationary period that began in February 1987, gold had risen as much 68% (in this cycle it's risen even more -- 75%). Leading into the 1987 inflation, the trade-weighted dollar had fallen as much as 38% (in this cycle it has fallen 24%).

Stocks did well during the inflation years 1987-1991 -- because the Fed raised rates.



In August 1987 **Alan Greenspan** was new on the job as Fed chairman, and he eventually conquered the inflationary acceleration he inherited by raising the Fed funds rate from 6% to 9-3/4%. It wasn't pretty for bonds, as the yield on the 10-year rose from 7.25% to as high as 9.36% before it was over. It's never pretty for bonds when an inflationary acceleration gets started -- the treatment is bad, and so is the disease. There's no way around it. But that's not the case for stocks. There was one notable stumble in 1987 shortly after Greenspan took office, but thanks to his vigorous attention to the inflationary acceleration under way then, the S&P 500's cumulative total return for the four inflation years from 1987 to 1991 was a respectable 48%. Stocks don't mind rate hikes in the name of inflation-fighting -- but they hate inflation. So the risk for stocks today, then, is not that the Fed will raise rates -- but that it won't. That means that when the blessed day comes that the Fed starts indicating that it intends to get more aggressive on rates, any mistaken short-term negative reaction in stocks should be bought. TM