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The Conundrum Unravels

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Bond yields are finally getting back into line with the rest of the world's markets.

With yields having surged by more than 50 basis points in the space of just four weeks -- and by nearly 25 basis points last week alone, putting the 10-year Treasury above 4.5% for the first time since last July -- the cheeriest thing we can say to bond bulls is that some of the edge has come off the downdraft. Yesterday and this morning it seems long-suffering shorts found an opportune moment to cover and a modicum of buying interest surfaced at the higher yield levels. But continuing downside bias could be seen in today's trading, as the market could not maintain an early quarter-point gain, and at mid-afternoon was *down* more a quarter point, the yield back above 4.55%. There seems little doubt that bonds are continuing to redress the mispricing of a set of risks that had been blithely explained away when can't-miss curve-flatteners and the carry trade were the order of the day. While the recent pace of the blowback might not be sustained, the path of least resistance clearly remains lower.

After spending months clinging to rationalizations for an array of factors that would ordinarily have spelled trouble, bond market participants seem to be undergoing a rude awakening. A sustained decline in the dollar is nearly always bond-bearish, it being difficult to make a bullish case for an erosion of the real purchasing power of a bond's nominal fixed income stream. But bond bulls maintained it's different this time because a weaker dollar means more intervention by foreign central banks, which translates into more Treasury purchases and -- no fuss, no muss -- higher prices. It was a similar story with rising oil prices, which not only reflect the inflationary impulses implanted by **the Fed's** exceptionally accommodative stance over the last two years, but also pose an added inflation risk if higher prices are accommodated by too-easy monetary policy. But no, bond buyers persuaded themselves, it's different this time because the primary threat presented by the oil price spike is reduced growth, not higher inflation, and is therefore bond-bullish. In this "What, me worry?" mind-set, it was almost as if inflation itself could somehow be construed as a positive for bonds.

All that, it seems, has been swept aside. In last week's action, a changed dynamic was clearly evident, with the jump in oil prices spurring a gold rally, a dollar sell-off and a bond blowout. In fact, the nearly two-point plunge in bond prices was arguably disproportionate to the other market price moves, reflecting that bonds are now in the process of catching up to long-ignored realities.

The dimensions of that reality can be neatly captured by breaking down the oil price move over the last two years in terms of dollars versus euros. At just below $55 per barrel, the dollar price of crude is up nearly 60% from its levels around $35 two years ago. In euro terms, however, the price has risen about 25%. As the euro price of gold has been roughly stable, on net, over this period, we can take the move in the euro oil price as a good approximation for the "real" price increase. Another way of putting it: more than half the $20 move higher in crude over the past two years is attributable to the inflationary effects of a weaker dollar. That casts a somewhat

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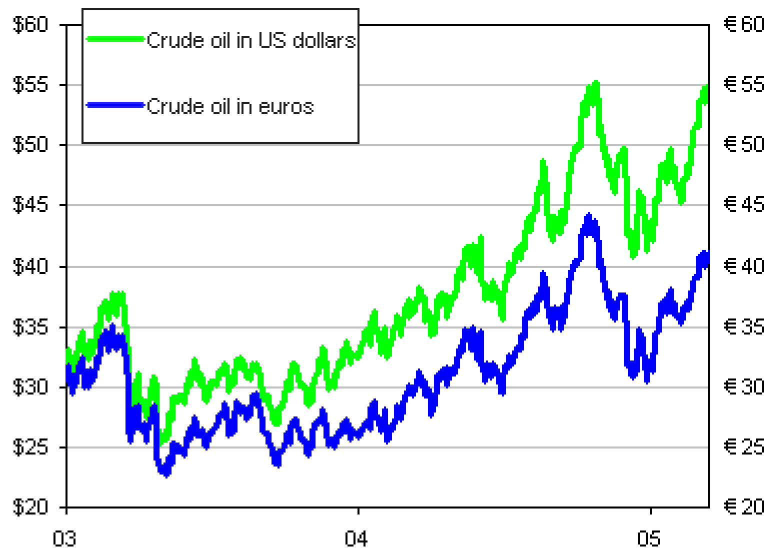
dubious light on press reports suggesting recent commodity price increases primarily reflect stronger global growth and higher demand, rather than inflation. In dollar terms, a sizeable inflation component is already built into commodity prices.



The sudden heightening of inflation awareness is seen in the surge of the TIPS spread which, at nearly 275 basis points, is challenging seven-and-a-half-year highs, and has ratcheted some 25 basis points higher in the past month. It is also part and parcel of the recalibration of Fed expectations in a decidedly more hawkish direction. December Eurodollar futures are now leaning toward a 4% funds rate by year end; four weeks ago, they were priced for a 3.5% target rate. The blow-out in longer term yields, in fact, is almost exactly matched by expectations of the more aggressive Fed posture reflected in the interest rate futures markets. At this point, then, the market has gone some distance toward aligning with our projection that the Fed will be moving by at least 25 bps per meeting for the remainder of the year, which at year-end would put the overnight rate target at 4.25%, and we see a 50 bp move at some point remaining a distinct possibility.

Bottom Line: The bond market's long-delayed awakening to reality is not yet close to running its course. While the market's expectations of Fed action are moving closer to restoration of monetary equilibrium, for the foreseeable future this is not likely to prove helpful to longer-maturity debt. For one thing, it implies that the front end of the curve will not only no longer provide a key source of support, but will pose a major obstacle. As well, while key commodities and foreign exchange rates incorporate a significant inflation component, these influences have only begun to feed through the broader price system, suggesting bond yields have a considerable margin yet to rise to equilibrate with the pending price level change. TM