TrendMacrolytics

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Hope Springs Eternal

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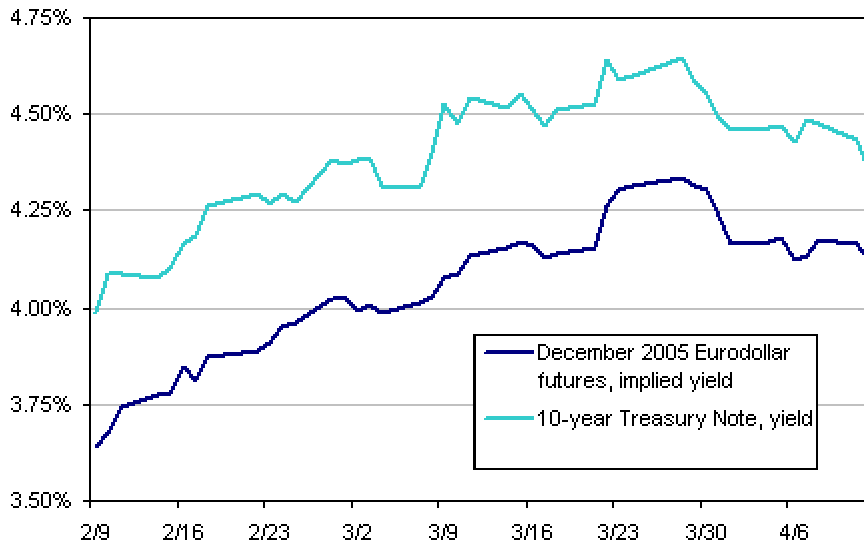
Wishful thinking in the bond market won't keep rates from heading higher.

By now, we suppose, we should be pretty well inured to seemingly untenable knee-jerk market responses to various economic news events. By our estimation, the bond market has -- with occasional interruptions -- had an amazing run on the basis of unrealistically sanguine expectations both about incipient inflation pressures and the degree of policy action that will be required to subdue those pressures. But with yesterday's rally following release of the March 22 **FOMC** minutes the market appears to have been seized by a nearly incomprehensible spasm of wishful thinking, driving the benchmark 10-year yield, at 4.35%, to its lowest levels since early March. The afterglow of yesterday's gains could linger for some limited period of time. But from a somewhat longer-term perspective, such an extreme upside response likely will only end up exacerbating the inevitable downside pain.



The first thing to bear in mind is that yesterday's release was the policy record of the FOMC meeting last month when **the Fed**, for the first time, acknowledged that "pressures on inflation have picked up in recent months and pricing power is more evident." That announcement sparked a bond market sell off that took the 10-year Treasury yield to 4.64%, with interest rate futures discounting for a year-end funds rate target of at least 4%, edging toward 4.25%. In attempting to explain yesterday's move, a number of market mavens suggested that in the wake of the March 22 statement, the market was positioned for highly hawkish language in the minutes, and rallied largely on relief that the minutes weren't as bad as had been feared. That doesn’t accord, however, with the fact that yields were already some 20 basis points below their highest post-FOMC levels heading into yesterday's session. If the market had been gripped by such fears of hawkishness, it's not likely to have rallied to that extent.

Most important, though, there was no hint in yesterday's release that the Fed was less concerned about budding price pressures than indicated by its March 22 announcement. One

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can always ponder whether the Fed's tone was relatively more or less hawkish than might have been expected, but any objective analysis would be hard pressed to refute that these notes portray a central bank where inflation complacency is now a thing of the past. "Meeting participants commented in particular detail on the inflation situation," the minutes say. "They noted with some concern the recent elevated readings on inflation in prices of core personal consumption expenditures, the producer price index, and indicators of prices at earlier stages of production, as well as the sizable further increase in energy prices."

Policymakers suggested that "uncertainty about the intensity of inflation pressures had risen in response to recent developments and that, in particular, the distribution of possible inflation outcomes was now tilted a little to the upside." And with "aggregate demand expanding robustly and the lower foreign exchange value of the dollar putting upward pressure on import prices, a degree of 'pricing power' had returned," the Fed said. Underscoring their new-found concern, several policymakers indicated that "they viewed an upside surprise to inflation as potentially more harmful than an equivalent downside surprise, partly because such an outcome could well impart additional upward momentum to inflation expectations."

As for the rate outlook, with policy "still quite accommodative," economic activity seeming to have more momentum than "had previously been perceived," and pressures on core inflation seeming "to have risen," the "required amount of cumulative tightening may have increased." In the only passage that, read in isolation, could conceivably justify a bullish take, the minutes then say "an accelerated pace of policy tightening did not appear necessary at this time," due to a degree of remaining "economic slack" and subdued unit labor cost increases owing to continued productivity growth. "Committee members judged that the measured removal of policy accommodation was appropriate for now."

While the market chose to seize on that language while ignoring the context, it could prove to be a costly choice. In a discussion of the advisability of maintaining the "measured pace" language in the post-meeting statement, the minutes note that the "odds that the Committee might need to step up the pace of policy firming were thought to have increased." The Fed, then, is only maintaining a measured pace of rate normalization "for now," because a more accelerated schedule is not thought necessary "at this time." But as the Fed itself acknowledges chances that it will have to move at a more "stepped up" pace have clearly increased. At the same time, nowhere in the release is there the slightest suggestion that any thought is being given to an early end, or even a pause, in the rate-hiking cycle.

Bottom Line: The **Associated Press** article that ran in today's ***New York Times*** regarding the market response to yesterday's release of the March FOMC minutes suggested that investors were "relieved" to see the FOMC willing to "keep interest rate increases minimal even as signs of inflation in the economy increased." We suppose that explanation makes about as much sense as any in this twisted market environment but, of course, it also points to the stark incongruity of the market response. It's simply an unavoidable fact of economic life that a Fed willing to sanction only "minimal" rate hikes in the face of rising inflation will inevitably engender significantly higher inflation, ultimately requiring sharply higher rates. Fortunately, though, the Fed appears much more attuned to this reality than the bond market wants to give it credit for. Unavoidably, that will mean a significant short-run comeuppance for bond investors. In the longer run, however, it would involve much less pain than if the Fed were to follow the market's lead and remain behind the curve on inflation until it is too late. TM