TrendMacrolytics

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Efficient Equals Wrong

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We aren't buying the stories the "efficient" bond market is telling, and either is Greenspan.

With the **10-year Treasury yield** back above 4%, we won't be crowing about how right we've been all along on **bonds**. We understand that "early equals wrong." But it's even more wrong to give up on a too-early call just at that point of extremity when it's the most valuable to stick with it. The bond market has been at that point, and it's been demanding just that kind of capitulation from shorts, and even from disinterested skeptics. We're not giving in.

Respect for **efficient markets** requires that one always ask what message markets are trying to send, and the most extreme market moves suggest the most important messages. So as bonds continue to defy any historical precedent, we are bombarded by rationales for why "this time it's different." But efficient can equal wrong. Remember, there was no shortage of efficient market rationales for historically anomalous **US** stock prices both in the summer of 1987 and the spring of 2000, or **Japanese** stock prices in the winter of 1989. I respect efficient markets as much as anyone (running half a trillion dollars in index funds will do that to you) -- but the fact remains that when extreme market behavior requires extreme rationales, chances are that the rationales just aren't really going to hold up. Yes, if those stories *were* true they would be the very most important stories, and the cost of failing to believe them would be great. We mustn't fail to respect that risk -- but at the same time we must never forget that capitulating to *that* risk doesn't eliminate *overall* risk in the slightest. It didn't eliminate overall risk to buy technology stocks in March 2000.

We were glad to see that, as we had expected, **Alan Greenspan** give no sign in his **Joint Economic Committee** testimony and Q-and-A yesterday that he is about to capitulate (see "Hearing Impaired?" June 8, 2005). He respectfully recited all the most popular rationales putatively explaining the "market forces" behind today's anomalously low **global long-term interest rates** -- global **recession**, cheap goods from **China**, and so on and on. But at the end of the day, his conclusion was nothing more than that "There remains considerable conjecture among analysts as to the nature of those market forces."

That's wise, but at the same time it's somewhat disingenuous. The "market force" Greenspan failed to discuss yesterday was *himself*. He neglected to mention that the present epoch of low global rates was deliberately engineered by **the Fed** in November 2002, when the Fed became terrified that it was facing the risk of continuing **monetary deflation** just when it was running out of rate-cutting bullets (see "Listen Up" June 2, 2005). The response was to declare a "considerable period" of low **short-term rates**, designed to push down long-term rates. It worked -- all too well. But by the time the Fed had belatedly recognized the deflation threat, the deflation was already over. So the Fed's efforts have resulted in an unprecedented tsunami of **dollar liquidity** flooding the global fixed income market. Who knows if Greenspan is aware of his own role in the bond "conundrum." The good news is that he sees the consequences of it (such as "froth" in the **housing** market), and appears intent on fixing it with continued "measured" hikes in the **fed funds** rate.

Bottom line: We stand by our call that the Fed will continue to raise rates through the rest of this year, and that this will inevitably put irresistible pressure on bond prices -- as well as on **inflation**-sensitive **commodities** and the stocks that trade along with them. **Stocks** are already priced for continued rate hikes, and we see very little downside risk in equities overall here (though there could well be small short-term setbacks while stocks work through the conventional wisdom that rate hikes are everywhere and always bull market killers). We favor the **large-cap growth** sectors that stand to profit the most from the reining in of inflationary expectations.