

MACROCOSM

## Fine Fettle

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### Bond bulls retreat today as manufacturing defies the case for stagnation.

After rallying yesterday in post-FOMC trading on the die-hard bulls' conviction that a **slowing economy** still augurs that the end is near for **the Fed's rate-hiking exercise**, **bonds** suffered a painful reality check today with the **ISM manufacturing report** adding to the growing evidence that this **expansion** remains in fine fettle. At 53.8, up from the May reading of 51.4, the purchasing managers' index halted six months of decline with a reading consistent with **4% GDP growth**. In truth, our read was that the supposed malaise of the **manufacturing sector** was greatly exaggerated in any case. But today's ISM index, highlighted by an 11% surge to six-month highs in the forward-looking **new orders** component, underscores that at this point there is little to dissuade the Fed from staying the course in normalizing its **excess liquidity** posture.

That this is very good news for the prospective **purchasing power** of the **unit of account** was confirmed by the **gold** price tumbling by more than \$8, to around \$427, even as the news drove the **10-year Treasury** down by a full point, putting the **yield** back above 4%. This pairing should help clarify the forces currently at work in the Treasury market. In yesterday's late-day rally, there were suggestions that bonds were responding to the FOMC's repeated boiler-plate assurance that "longer-term inflation expectations remain contained." That seems difficult to square, however, with the fact that the main driver for the latest rally has been the hope that the Fed would have to be less, rather than more, aggressive in normalizing rates due to rising **oil** prices, among other factors. At the same time, sensitive market-based indicators of **dollar strength**, such as gold, were indicating an intensification of **inflation risk**. Today's bond sell-off, by contrast, has coincided with a ratcheting upward of out-month Fed rate expectations. For the first time since early May, **December '05 Eurodollar futures** today are posting an implied yield indicating an expectation for the year-end **fed funds rate target** edging above 3.75%.

As for the Fed, yesterday's announcement confirmed our expectation that policymakers were in no way prepared to signal a divergence from their present course. Perhaps most significant, even with a new overnight rate target of 3.25% -- above 3% for the first time in nearly four years -- the FOMC affirmed that policy "remains accommodative," suggesting an end to the process likely is not yet in sight. And, importantly, the committee gave clear notice that it would not be distracted from its current task by the oil price escalation, stating that "Although energy prices have risen further, the expansion remains firm and labor market conditions continue to improve gradually."

**Bottom Line:** A deeply overbought bond market is getting hit today on news suggesting that the manufacturing sector is not conforming with its supposition that a slowing economy will mean an end to Fed rate hikes sooner rather than later. Even at these levels, we see the bond market as badly mispriced both for the likely extent of Fed action and the still-to-be-seen inflationary consequences of the Fed having remained too easy for too long. It's probably as yet premature

to suggest, however, that today's sell-off represents the onset of a major trend-shift and repricing. More likely, for the time being at least, the market will continue to be bounded by the broad **trading range** that has prevailed in recent months, putting the upside on the 10-year yield in a range around 4.2% to 4.25%. **IM**