TrendMacrolytics

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# Straightening Out the Curve

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**As the economic gloom lifts, bonds face the music.**

As each new piece of data crosses the tape, it becomes ever more apparent that not only is the **economy** *not* confirming the **slowdown** fears so prevalent just weeks ago -- critical indicators are pointing to a reinvigoration of **growth** at the **expansion's** wellsprings of **capital formation** and **risk taking**. Friday's **second quarter GDP report** showed that **equipment and software spending** powered ahead at a better than 11% annual rate, after a brief dip to below double-digit growth rates in the first quarter. That also accorded with last week's **durable goods** data showing a strong rebound in **new orders for non-defense capital goods excluding aircraft** -- a forward-looking proxy for **capital investment** -- up more than an annualized 21% in the June quarter. Today's **ISM** release continued the trend, with strength in **new orders** lifting the July manufacturing index to a higher-than-expected 56.6, its best levels of the year.

As the strong data accumulate, the slowdown scenario is finally being abandoned by the fonts of conventional economic wisdom which have long held to the notion -- against the overwhelming preponderance of empirical evidence -- that this has been a sub-par expansion by historical standards. Yesterday, even the ***New York Times*** -- a leading establishment media voice in casting doubt on the economy's staying power -- was compelled to acknowledge that the widely pronounced **"soft patch"** earlier this year was primarily a product of incomplete data.

This recent upgrading of the economic consensus conforms to our analysis which has held that reports of the near-death of the economic expansion were greatly exaggerated. And as we have consistently suggested it would, this realization of the economy's sound health has proven to be a rude awakening for a **bond market** that pushed **yields** to unnaturally low levels on the supposition that a weakening economy would mean an early -- and premature -- end to **the Fed's rate normalization cycle**. In that regard, we find it particularly noteworthy that the more-than 40 basis point backup in the **10-year Treasury** yield from its levels around 3.9% at the end of June has matched the yield jumping to above 4% on the **2-year note**, which is most closely tied to **funds rate** expectations. This experience stands as a direct rebuttal to suggestions that the **flatness of the yield curve** should stand as a warning to the Fed that further **rate hikes** would risk **inverting the curve**, with significantly adverse economic consequences. The low level of longer-term yields has been a function of expectations for less assertive Fed action. As those expectations have reversed, so have yields.

In any case, linking flat to inverted curves with subsequent economic downturns confuses cause and effect. In 1989 and 2000 the curve flattened, and eventually inverted, as a consequence of Fed **tightening campaigns** that raised the **real overnight cost of funds** to economy-choking levels. At the height of the Fed's **deflationary** tightening regimen in mid-2000, for example, the **real funds rate** -- using the **core PCE price deflator** -- stood at some 4.7%. The economy subsequently went into **recession** not because the curve inverted, but because the Fed was massively too **tight.** The current real funds rate, around 1.25%, is about half the historic norm.

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That is one measure of the extent to which the Fed's task remains incomplete, despite the yield curve remaining relatively flat.

**Bottom Line:** Recent data captures an economy putting to rest the slowdown scenarios of the economic consensus. Bonds that had been priced for a slowdown-conscious Fed are taking a significant hit. They probably have at least another 20 to 25 basis points to run as the market moves toward conformity with our expectation that the Fed will remain on course for a 25 basis point move at each of its remaining meetings this year, putting the **year-end funds rate target** at 4.25%. TM