TrendMacrolytics

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Bonds Away

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The Fed fooled bonds by treating high energy prices as inflationary, not contractionary.

Given the **bond market's** extraordinary run on a highly dubious set of expectations, hopes and assumptions, a certain degree of caution attaches to any suggestion that an awakening to reality might finally be at work. Certainly, we can't entirely rule out the possibility of **Treasuries** taking another gravity-defying leap in response to some exogenous event. In recent action, however, a shift in outlook has become discernible, with the market challenging the bullish case that has long dominated trading. For the first time in months, the path of least resistance for bond prices appears to be down, rather than up.

This shift was apparent Friday, when the September **CPI** was released showing an above-expectations jump in the headline number at 1.2% but another tame reading from the **core index**, at 0.1%. In the bias toward bullishness that had prevailed, the lower core number would have been taken as proof positive that underlying **inflation** was still a non-factor, requiring less work from **the Fed** to restore a **"normal" short rate target**. The initial response Friday followed that script, in fact, with the **10-year note** up a quarter point within minutes of the release, dropping the **yield** about four bps to 4.43%. Soon, though, the bulls were in retreat, and the bond yield spiked as high as 4.53% before closing the day at 4.49%, highest since last March.

What's changed? For one thing, the market is belatedly coming to terms with the significance of headline inflation, dominated by rising **energy prices**, to the current price and policy setting. In recent weeks a parade of Fed speakers, as well as the **FOMC** statement and minutes, has made it abundantly clear that a key policy concern is the potential for higher energy prices to get passed through to core inflation. All things equal, the Fed will be inclined toward a more aggressive approach for as long as the elevated level of energy prices persists. Until recently, the market bought into the notion that the main consequence of expensive energy would be a **slowing of growth** that was more likely to put the Fed on hold than inspire more assertive action, helping support bond prices. The undermining of that proposition has been a central factor in the credit market sell off of the past several weeks, as we suggested it would be (see "Katrina and the Fed" September 2, 2005).

At the margin, bonds might also be coming to a realization that the energy price run-up of the past two years cannot in itself be so easily ignored as an inflation signal. **Food** and energy are excluded from measures of core inflation because they are the most **volatile** elements of the price index, so the prices are usually not considered germane to underlying **price pressures**. That rationale is not nearly so air-tight, however, when substantial price changes are maintained on a sustained basis. As we have noted on several occasions, the **oil** price escalation of recent years has had a significant inflationary component. It began in earnest around mid-2003 soon after the Fed cut its overnight rate target to 1% to guard against what it considered a threat of **deflation**. At the time, we noted that the central bank had already rooted out serious deflationary pressures with its aggressive easing policy, and we warned that battling a non-

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existent deflation carried significant inflation risk. At about the same time, **gold** began a sustained rise from what we regarded as roughly price-stable levels below $350.

With gold now trading above $470, it's clear that the Fed remains highly **accommodative** even after 275 bps in rate hikes over the past 16 months. The last time the Fed was in such an accommodative position during an oil price spike was in the mid-1970s, producing the double digit inflation of that era. We don’t maintain that the Fed faces a realistic risk of producing a similar outcome in the current context. At least it appears aware of the forces at work and the action required to deal with the prevailing risks, which was not the case 30 years ago. It remains an open question, however, how much further action will be required to restore an **equilibrium** monetary environment, and at this point we don't rule out the possibility that a target rate somewhat north of 4.5% could be required. For bonds at these levels, it's difficult to see a happy ending. If the Fed gets it right, it means further significant action lies ahead to get out from behind the curve on inflation. If it's too slow to meet the challenge of the incipient inflation now embedded in the system, an inflation breakout to significantly higher levels -- say, 4 to 5% core -- would be likely. Either way, bonds lose.

Bottom line: Recent bond market behavior suggests that the long-standing bullish bias of the market is dissipating, with the path of least resistance pointing lower rather than higher. The Fed's cognizance of the inflation risks implied by rising energy prices appears key to this reappraisal, after many market participants were caught wrong-footed betting that the Fed would be less, rather than more, likely to continue its **normalization cycle** due to the energy price environment. Fixed income investors also could be awakening to the slow-dawning recognition that oil prices have been a signal of incipient inflationary pressures, and cannot be ignored simply because they are excluded from the core inflation measure. TM