TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MARKET CALLS

Update to Our US Bond Forecast

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David Gitlitz

Bonds are very vulnerable: they're tracking Fed rhetoric, not reality.

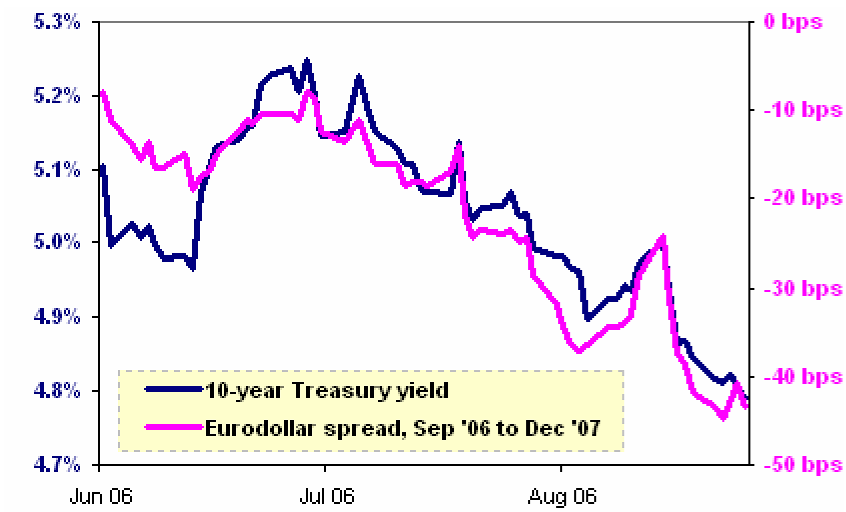
Update to strategic view
US BONDS: Bonds are priced for moderating inflation and for the Fed's next move to be to lower rates. Prices are very vulnerable to a rapid shift in sentiment when data makes it clear that inflation is still on the rise, and that the Fed's next move will be higher.
[see Investment Strategy Dashboard]

Our long-held bearishness on bonds has been seriously tested since late June, when the Fed first opened the door to a "pause" in its policy normalization cycle (see "Fed Roulette" June 30, 2006.) Since June 28, when the benchmark 10-year Treasury yield hit a four year high of 5.25%, bonds have ridden a wave of enthusiasm powered by deepening economic pessimism, growing confidence that the Fed would respond to the darker outlook by at least suspending its rate-hiking exercise, and topped by confirmation earlier this month when the Fed refrained from moving up the funds rate target and indicated that the pause could be sustained (see "Surprise on the Doveside" August 9, 2006). Throughout this 45 basis point rally, the market's complacency about inflation risk has remained intact, helped along considerably by the Fed's own assurances that "factors restraining aggregate demand" should also subdue inflation pressure. But we have not altered our view that near-term economic prospects remain upbeat, inflation pressures continue to build, and ultimately policy makers will face little choice but to return to rate-hiking mode, and likely with considerable vigor. None of this is likely to bode well for bond bulls, and we have not been deterred from our view that the market inevitably faces a day of reckoning that will prompt a sharp downdraft in fixed income asset prices.

Fed chief Ben Bernanke and his colleagues have gotten a lot of pats on the back recently from the economic cognoscenti for the presumed prescience of their dovish turn, with many seeing the bond rally as proof positive that inflation is a non-issue. But despite deeply entrenched perceptions to the contrary, as we recently detailed, bonds have long been a highly flawed inflation forecasting tool (see "Judgment Day" August 3, 2006). During the late 1960s and throughout most of the 1970s, bonds lagged badly behind the virulent inflation breakout. Then, having reluctantly learned a painful lesson, over much of the next two decades bonds continued to price in a hefty premium for what had then become a nonexistent inflation threat. In recent years, the market has been appeased, first by the Fed's ill-timed deflation warnings and then by the central bank's episodic market signaling exercises. That began with the pledge that accommodation could be maintained for a "considerable period." It progressed through assurances that rates would be raised at a "measured pace," and continued with the assertion -- despite much contrary evidence -- that inflation expectations remained "contained." This has culminated, in the most recent twist, with the conjecture that moderating growth would quell inflationary impulses and thereby mitigate the need for further Fed action. Through the years, it has become apparent that the bond market is less a forward-looking inflation indicator than a reflection of Fed rhetoric about potential inflation, and what that implies for policy.

http://www.trendmacro.com	Offices:	Phone:
don@trendmacro.com	Menlo Park CA	650 429 2112
dgitlitz@trendmacro.com	Parsippany NJ	973 335 5079
tdemas@trendmacro.com	Charlotte NC	704 544 6900

In any case, it's clear that an explanation for the bond rally of the past two months has had very little -- if any -- connection to the subduing of inflation expectations. Nearly the entire 45 bp reduction in long-term nominal Treasury yields, from 5.25% to 4.80%, has been matched by a drop in the Treasury's inflation-indexed TIPS "real" yield, which has fallen from 2.68% to 2.25%. The TIPS spread, a crude proxy for market inflation expectations, has remained virtually flat on net, at 2.55% down just 2 bps since June 28. The TIPS yield is regarded by some as a market-based reflection of real returns available economy-wide, but this is a supposition without empirical grounding. Like their nominal Treasury counterparts, TIPS have primarily reflected sentiment about the course of Fed policy. While obviously influenced by growth prospects, such sentiment hardly represents a foundation for directly pricing expected available returns. First introduced in 1997, the 10-year TIPS didn't trade below 3% until mid-2002, in the midst of the Fed's relentless drive to a hyper-accommodative policy stance. A year earlier, in the depths of the last recession, the TIPS yield was just slightly below 3.5%. Positing that available returns then were some 125 bps higher than they are now would seem quite a stretch.



The extent to which bonds have latched onto the idea that slowing growth will compel the Fed not only to refrain from further rate hikes but to enter rate-cutting mode in the not too distant future can be seen in the accompanying chart, plotting the 10-year Treasury yield against the Eurodollar futures curve out to December 2007. Those futures are now nearly 90% priced for 50 basis points in rate cuts. In other words, the bond market is essentially priced for recession. It's important to note that we by no means exclude the possibility of recession as the end result of this policy episode. But that recession would come about as a consequence of the Fed's current underestimate of both inflation pressures and growth, compelling a return to tightening, and likely a fairly aggressive one. Given the central bank's long and sorry history, an overshoot into economy-choking territory could well be the ultimate outcome. In the interim, though, bonds would stand to get hit hard considering how much they've staked on the bet that the Fed's next move will be to ease, not tighten.

Meanwhile, the popular notion that these policy expectations are being logically supported by an economy in the midst of a rapid deceleration continues to defy the available evidence. All the key indicators of risk preference and capital formation remain highly positive, pointing to a likely pickup -- not slowdown -- in second half growth. In fact, yesterday's durable goods report, in addition to showing that the capex surge remains in full bloom, contained revisions to previous months' data suggesting that the initially reported 2.5% second quarter GDP growth rate is likely to be revised higher, probably to around 3%.

Much of the gloom -- or, from the bond market's perspective, excitement -- over the economy stems from the housing slowdown, and a belief -- which has been encouraged by the Fed -- that this will impose a drag on the pace of expansion. We remain highly dubious. No question, a housing market that was fueled to extraordinary heights by an exceptionally easy Fed is now cooling significantly. From the perspective of the past few years, it looks like an implosion. From a somewhat longer-term perspective, however, it simply looks like a return to normality. For example, existing home sales -- which account for more than 80% of the residential real estate market -- have fallen about 13% from their peak rates last year. Currently, however, sales remain some 25% higher than their levels during the late 1990s economic boom. Moreover, if as many suggest, the primary economic fallout from the housing slowdown is a diminution of the wealth effect, at this point such an eventuality is nowhere in sight. In the July data released this week, the median single family home price rose to new highs of more than $231,000, up from less than $217,000 earlier this year. It's true that the year-on-year pace of price appreciation has dropped dramatically, from a high of nearly 17% last fall to about 1.5% currently. But given the overall appreciation in values over the course of the boom, it's not likely that prices will deteriorate enough to have a significantly deleterious economic effect.

Bonds have also gotten a lift from recent consumer and producer inflation data, which were generally greeted as confirming the Fed's suggestion that increases in the core price indexes were likely to cool. But to make that supposition based on one month's reading from deeply lagging and volatile data series is ludicrous. It appears that the indexes were held down last month by one-time declines in isolated sectors -- cars and light trucks in the PPI, apparel in the CPI -- unlikely to be repeated (see "Data Delusions for Doves" August 16, 2006). A return to monthly rates of about 0.3% in core CPI, for example, is far more likely than not. Within the next few months, we expect to see a 3 handle on the year-on-year core CPI for the first time since 1995. While the market-based inflation indicators we watch most closely have come somewhat off their recent highs, they remain at levels pointing to continued liquidity excess, suggesting that monetary policy remains accommodative and continues to impart additional inflationary influences. At about $620, the price of gold is down about $30 from its levels of two weeks ago, but is still about $60 higher than its recent lows in mid-June. That was the high point of the Fed's effort to restore market confidence by showing a bent toward hawkish-seeming rhetoric. Since then, however, the veneer of vigilance has been stripped away, and the central bank has been exposed again as having little real accountability for pursuing the only task for which it is institutionally suited -- stabilizing the purchasing power of the unit of account.

BOTTOM LINE: Bonds have taken quite a ride the past two months since the Fed began hinting at a suspension in its rate-hiking cycle while attempting to give the market comfort that inflation was more likely to be headed lower than higher. But we see this as a policy interlude that will prove unsustainable, both because growth is likely to remain stronger and inflation is unlikely to be as well behaved as the Fed expects. Bond prices will be hit hard when the market discovers that the Fed's next move will be to resume the tightening cycle, not embark upon a new easing cycle.TM