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Hoping Against Hope

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The Fed is starting to aim tough talk at the bond market -- will the bond market listen?

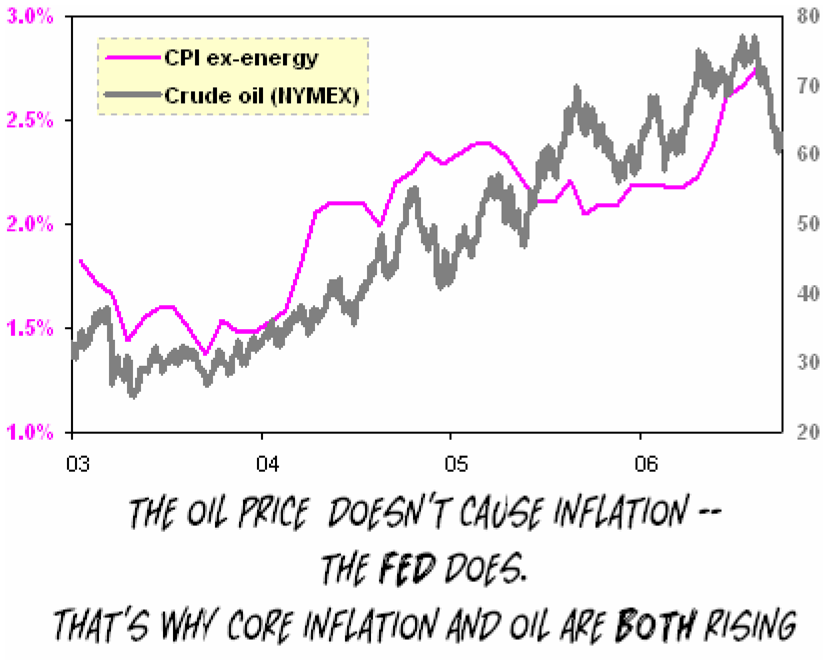
Update to strategic view
US BONDS: Donald Kohn's speech could be a shot across the bond market's bow, intended to condition the market away from rate cut expectations currently embedded in yields. Even reverting to neutral expectations for future Fed actions will be devastating to bond prices. **FED FUNDS:** Data surprises are unlikely to emerge in time to move the Fed to raise rates at the October FOMC meeting. But we assign a better than 50/50 chance to a rate hike at the December meeting.
[see Investment Strategy Dashboard]

Fixed income markets are not going down without a fight. With today's mild reversal, yields rising just back to the 4.6% levels of earlier this week, the bond market is gallantly attempting to cling to its story that the Fed's next move will be to cut rates, and soon, even as policymakers make it overtly clear they have no inclination to support that supposition. Still, it seems that the market's blissful interlude in a state of denial could finally be coming to an end.

In a speech last night at New York University, Fed vice chairman Donald Kohn became the first central bank official to publicly give voice to the strong doubt about the market's rate cut bet that we've picked up in private contacts with Fed officials (see "The Frustrated Fed" September 28, 2006). Kohn noted that the "risks to my outlook for economic activity may be skewed to the downside, while those to my forecast of gradually declining inflation are tilted to the upside." However, he said, "In the current circumstances, the upside risks to inflation are of greater concern." Then, he added: "I am surprised at how little market participants seem to share my sense that the uncertainties around these paths and their implications for the stance of policy are fairly sizeable at this point." Underscoring the point, he advised, "Don't sell the Fed's concerns about inflation short. Further upward movements in inflation would be very adverse to the economy and would, I think, require policy actions."

Kohn devoted a substantial portion of his speech to the housing market, focus of the bond market's contention that the popping of a residential real estate "bubble" is fated to bring the rest of the economy down with it. Kohn suggested, though, that income growth, household formation and still low interest rates will continue to support housing, and offered that housing starts "may be closer to their trough than to their peak." He also noted that "to date there is little evidence that this correction in the housing market has had any significant adverse spillover effects on other parts of the economy." While production of building supplies has decelerated, "resources freed up in the residential market appear to have been largely absorbed in nonresidential building."

Indeed, Fed chairman Ben Bernanke made a similar point in his appearance yesterday at the Washington Economic Club, as have we (see "Denial" September 5, 2006). Although Bernanke made headlines for his estimate that the housing slowdown would "probably take about a percentage point off" GDP growth in the second half of the year, a follow-up observation was largely ignored. At the same time that housing is contributing to a slowing of growth, he noted that "other parts of the economy are remaining relatively strong," and specifically cited the growth in commercial building as offsetting the decline in the residential sector. On net, in other words, the current divergence between residential and nonresidential activity is probably a wash.



Meanwhile, the decline in the oil price -- now at about $60 per barrel, down from $77 two months ago -- likely is part of the story continuing to back the rate cut bet. The thinking is that in the near term, the receding energy price bulge will keep inflation under wraps and allow the Fed to stay sidelined. Then somewhat further out, as the economy slows, the Fed will be free to cut rates, liberated from its concerns about the "pass through" of higher oil prices into core inflation. This might be a plausible rationale were it not for the fact that the rise in non-energy prices in part reflects the extent to which the Fed's still easy posture has allowed the oil price spike to become accommodated in the general price level. Were the Fed not easy, higher energy prices would not have passed through to other prices.

For example, during the Fed's tight-money regime of the late 1990s, a tripling of oil prices had virtually no effect on non-energy inflation. Between December 1998 and March 2000, oil prices went from less than $11 per barrel to about $34, while non-energy CPI, on net, was unchanged at 2.4% year on year, rising by later in 2000 to just 2.5%. Over the same period, the price of gold was virtually unchanged, at just above $290. By contrast, as oil prices have seen an approximate doubling in the past three years, non-energy CPI inflation has also doubled, from 1.4% to 2.8% year-on-year. Exposing the easy money policy error at the root of this price phenomenon, the price of gold has soared from less than $375 to about $570.

The lesson is that while in the late 1990s tight money precluded a recovery in the relative price of oil from being accommodated in the general price level, the more recent oil price episode has in itself been partly an inflation event. And while the decline in oil and gold prices from their highs represent marginal moves in the right direction, they can hardly be seen to reflect monetary equilibrium. At $570, gold is still more than 60% above its 10-year moving average, suggesting that without further action to restore policy neutrality, a protracted period of rising statistical inflation would be virtually assured.

BOTTOM LINE: Fed vice chair Don Kohn has delivered a reality check to markets that remain very reluctant to face reality. As a Fed staff lifer and unquestioned authority figure within the insular world of the central bank, it can be safely assumed that he was speaking with an institutional voice when he as much as dismissed the notion that rate cuts can even be fathomed at this point. But while Kohn also holds open the possibility that further rate hiking action may yet be required, he remains some distance from acknowledging the probability of that as a near-term prospect. We continue to maintain, however, that such an eventuality is inevitable, and that the longer the Fed waits, the more it will have to end up doing to catch up.

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