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Hoping Against Hope

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Bond bulls cling to the instinct to buy on dips, but sentiment is beginning to change.

Update to strategic view

US BONDS: Residual momentum still enables long-term Treasuries the chance to rally briefly on bad news, such as this week's worse than expected CPI. But expectations for Fed rate cuts have collapsed as the economy reaccelerates and inflation remains elevated. Without a revival in those expectations, bond rallies will only be opportunities to sell.

[see Investment Strategy Dashboard]

Core consumer prices last month posted their largest gain in three months and, for the year as a whole, 2006 saw the biggest jump in the core rate -- at 2.6% -- in five years. But not to worry. The "experts" agreed that this was still reflective of a "tame" environment for underlying inflation, and what better proof could you want than a bond market that rallied on the news, pulling the 10-year Treasury yield back down to 4.75% after an early sell-off had seen the yield jump above 4.8% for the first time in nearly three months?

But this is also a bond market that as of early last month was priced for more than 75 basis points in rate cuts this year, and even at current levels continues to discount some combination of economic weakness and declining inflation that remains far fetched. Today's pullback from yesterday's best levels suggests market players might have taken a closer look overnight at the upbeat jobless claims, housing and Philly Fed data also released yesterday. But the bet is that the nearly 40-basis point "correction" of the past six weeks or so has erased the market's overvaluation, and at least opened up buy-on-dip opportunities. We think that's unlikely to prove a winning bet.

Despite the sell-off that has accorded with a sharp paring back of rate-cut expectations, the consensus that the Fed's next move will be lower, rather than higher, remains intact, with futures now priced for one 25 bp cut by year-end. But there are indications that a sentiment shift may be underway. For example, Briefing.com, an online market news service that has been a steadfast cheerleader for the bond bulls, today notes that "the stronger economic data and expectation for further improvement in 2007 as the housing effect fades" has led to a sizeable repricing of Fed expectations. "The strong economy and tight labor markets and their effect on inflation offer the potential for another rate hike -- as the FOMC has repeatedly warned in its policy announcements."

Indeed, it's hardly implausible to think that a consensus might be forming among policymakers that the margin for error in remaining on hold may quickly be running out. For one thing, from the perspective of the Fed's flawed neo-Keynesian demand-based models, the reemerging signs of robust economic health in employment, production and wages represent *prima facie*

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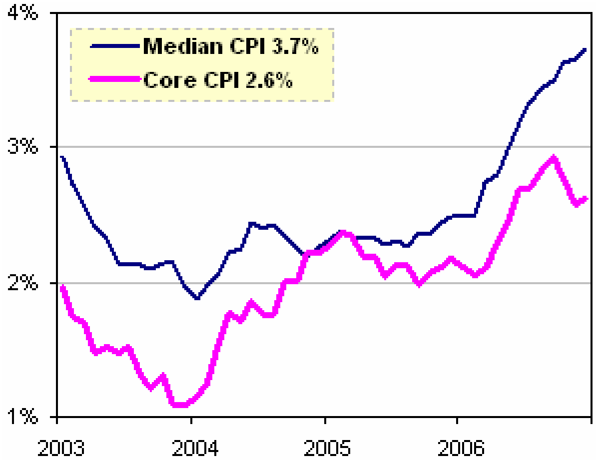
inflation risks in themselves. The latest Beige Book this week drew particular attention to the tightening labor market. And at 2.6% year-on-year, the core rate continues to run well above the 2% top end of the comfort zone that Fed officials have repeatedly committed to restoring.

In addition, while the economic establishment and much of the financial media treat data such as yesterday's report of a 0.2% monthly increase in core CPI as fundamentally benign, a more detailed assessment of the empirical record is not quite so reassuring. Sandra Pianalto, president of the Cleveland Fed, this week suggested that it has been difficult to draw much comfort from the apparent moderation of the inflation indexes in recent months. "Very few prices are increasing at the relatively low rates consistent with price stability," Pianalto told a group in Dayton. "With so much price dispersion, it is difficult to know where the inflation trend will settle out."



INFLATION JUST ISN'T GOING AWAY

In fact, the Cleveland Fed publishes an index, the Median CPI, which eliminates such dispersion. It was up 0.3% in December and, at 3.7% y-o-y, is now running at cycle highs. Much of the recent restraint in the statistical indexes has been attributable to goods prices, due partly to seasonal factors and various methodological quirks. But services prices have not shown such volatility, and core services also are now showing an increase of 3.7% y-o-y, up from 2.5% in September 2005.

At the same time, we continue to observe that various market-based indicators of the Fed's stance suggest that policy remains quite accommodative, showing no signs of a tight liquidity posture. Gold has rallied back to nearly $635, gaining about 5% in the two weeks since its brief downdraft in the wake of release of unexpectedly strong December jobs data. The CRB Spot Index has also recovered from that sell-off, and now sits just 1% below the record highs it hit early this month. Meanwhile the dollar's foreign exchange value relative to its major-currency counterparts in the G-6 dollar index is up about 3% from its recent lows last month. But that's still down some 8% from its cycle highs in late 2005.

BOTTOM LINE: Odds favoring multiple rate cuts this year have receded in the face of evidence of continued economic strength, but bonds refuse to entirely give up hope, clinging to a bet that the Fed will see its way clear to easing at least once this year. That prospect becomes increasingly less likely, however, as not only will the economy's growth dynamics continue to provide upside surprises but a far from sanguine inflation outlook will keep the Fed biased on the hawkish side, eventually compelling a return to rate-hiking mode. TM