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Getting Real

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The bear move in bonds has been about growth, not inflation. Bond bulls should brace for more bad news on both fronts.

Update to strategic view
US BONDS: Long-term Treasuries are likely to stay in a trading range bounded by last week's highs in yield. The bear move in bonds will resume when further evidence of growth reacceleration makes it increasingly inevitable that the next move from the Fed will be to higher rates, and much sooner than the early 2009 expectation embedded now in futures markets prices.
[see Investment Strategy Dashboard]

Having blown out by some 65 basis points in little more than a month, the bond market was due for a breather from its head-long downdraft (see "When Doves Cry" June 8, 2007). But we'd resist putting much store in some of the ready rationales served up to explain the snap-back of the past few sessions, which has taken the 10-Treasury yield back to 5.15% from its highs last week around 5.3%. On Friday, bond buyers' inflation fears were supposedly soothed by the benign-looking consumer price data, with the core CPI reported rising just 0.1% in May. But there's very little to suggest that the sell-off of the past several weeks has been driven by a rising inflation premium in the first place. The "real" yield on inflation-indexed TIPS has risen just as much as the nominal Treasury yield, leaving the TIPS spread virtually unchanged at around 240 bps since the bond market turned. Had rising inflation expectations been a significant factor driving the bond meltdown, that spread would have widened. Thus it's unlikely that relief on the inflation front was a major factor explaining the bounce Friday. It's probably more the case that the muted core inflation data presented a convenient opening for some short covering and a short-run buying opportunity with yields at better than five-year highs.

That this has been a rising real yield phenomenon is consistent with our view that the market had pushed yields to unsustainably low levels on the unrealistically dour view that a faltering economy would soon compel the Fed to begin cutting rates. Amid mounting evidence of a striking reacceleration in growth, the Eurodollar futures market has completely unwound its bet for rate cuts this year, which peaked at about 60 bps -- or more than two 25 bp rate cuts -- in early March, and is now showing a slight chance for a hike.

The fact that this sell-off is chiefly a response to rising growth prospects also cuts against the notion that yields are approaching levels that could pose a significant restraint on the economy. At these levels, the long end of the curve is simply equilibrating with the Fed's prevailing overnight rate, 5.25%. Given the abundant evidence of a continuing gusher of liquidity issuing

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forth at the current funds rate, it's not likely that longer-term yields rising to about the same level will pose a significant obstacle to growth. Yields can become restrictive when they rise as part and parcel of a concerted Fed effort to slow growth through monetary tightening. At this point, the funds rate is probably still as much as 100 basis points below levels that would lend credence to such concerns.

Indeed, the growth pickup and accompanying spike in yields is probably being viewed by the Fed as sufficient, all things equal, to seriously consider resuming its rate hike exercise after the past year's pause. One factor likely to give them some hesitation is the risk that the higher yields will have a further depressing effect on the housing market. For the Fed, such a concern would translate into a perceived risk that a further deepening of the housing slump would negatively impact the broader economy. Although we see no reason to think that this would be the case, the net policy effect of the jump in yields likely further pushes out the date by which time the Fed is likely to return to rate-hiking mode.

We remain convinced that the Fed will inevitably have little choice but to complete the unfinished task of restoring monetary equilibrium. Initially, that likely will be motivated by a resumption of growth rates that will be seen by the central bank as beyond tolerable limits. In time, though, the liquidity excess now evident in a number of markets will show through in a renewed uptrend in core inflation and could be met by a fairly aggressive response. Friday's data was greeted as furthering the case that inflation is a non-issue, but a closer look provides a somewhat less favorable interpretation. For one thing, the core increase in May was 0.1498%, which only barely rounds down to 0.1%. Also, the May data saw another downtick in the owners' equivalent rent component, which comprises more than 30% of the core index. It rose just 0.1%, down from 0.2% in April. Through March, OER was rising at a year-on-year rate of more than 4%, but in recent months it has reflected the dampening of rents arising from the housing downturn. At this point, though, it has little scope to fall further, and is unlikely to continue to be a downward influence on the index. Also, certain seasonal anomalies are likely to wash out in coming months. Apparel prices, for example, were reported dropping 0.3% for the second consecutive month, which seems unlikely to be sustained through the summer season.

BOTTOM LINE: Long-term yields may have entered into an intermediate-term trading range, having shot up by some 65 basis points within a several-week span. At current levels, the 10-year Treasury has essentially equilibrated with the 5.25% overnight rate, and so may face little immediate further upward pressure. Going forward, though, upbeat economic news is likely to foster an expectations turn toward a growing chance of higher Fed rates, which will be reflected in yields moving up again to a higher plateau.