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MACROCOSM

Did Somebody Say "Inflation"?

Thursday, September 13, 2007
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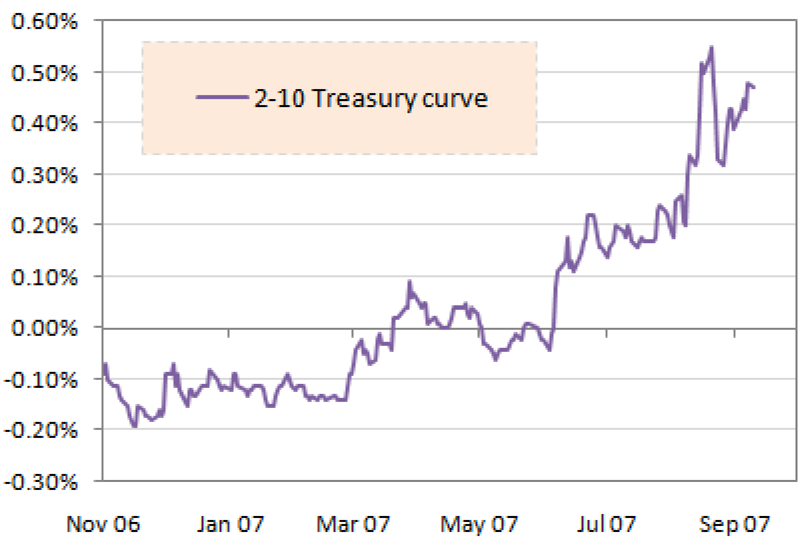
No, nobody did. Nobody but the Treasury curve, that is.

Amid the current financial market turmoil, with a Fed policy response now regarded as nearly a lock, the idea that inflation might still be an issue worthy of some attention has become a decidedly unfashionable notion. Downside risks to growth are widely seen having unchallenged priority over any consideration of continuing inflation risks, especially in the wake of last week's soft employment report (see "Bad Jobs" September 7, 2007). And the conventional Keynesian conception of inflation as a growth phenomenon provides all the cover the economic mainstream requires to relegate it to a decidedly inferior ranking on its roster of concerns. If growth is slowing, it must mean any inflation pressures are also being quelled. Right?

Update to strategic view

US BONDS: We believe that Fed rate cut expectations are wildly overdone, and that the Treasury curve will shift higher when those expectations are inevitably defeated. The long end has participated less than fully in those expectations, because of a long-delayed rebirth of the inflation premium -- and will suffer less than it would have had that premium not been impounded.

[see Investment Strategy Dashboard]



A LONG-OVERDUE RECOGNITION OF INFLATION RISK

But one place where that convenient formulation appears not to be holding sway is the government bond market. Yes, it's true that the 10-year Treasury has rallied by nearly 50 bp since the present market turmoil erupted in late July. But the yield on the 2-year note, now below 4%, has been cut by about 80 bp. Thus the 2-10 yield curve, now at about 45 bp, has steepened on net by some 30 bp.

Ordinarily, that would not be

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considered unusual. Because the effects of inflation are compounded by the length of maturity, longer terms bonds traditionally have trailed short maturities in responding to expected easing moves. But what's striking is the contrast between this episode and other fairly recent bond rallies in response to hoped-for Fed rate cuts. Last December, for example, when the 10-year yield fell to around its current level, the curve was *inverted* by about 10 bp. The long end of the bond market was so untroubled by the prospect of inflation at that time that it was willing to trade away any premium at all relative to short maturities. In March, the situation was similar, with the curve remaining inverted as the 10-year rallied by about 40 bp to 4.5% in response to a surge of easing expectations.

But those expectations are dwarfed by the rate cuts currently priced into the curve, with the 2-year yield essentially in accord with June '08 Eurodollar futures in discounting for more than 125 bp in cuts. But the 10-year yield is about the same as it was last December when rate cut expectations were less than half what they are now. It appears the bond market's period of dormancy in pricing for inflation risk is over.

From our perspective this is a long-delayed awakening, but the erosion of dollar purchasing power is becoming increasingly difficult to miss. Above $710, gold is now just a hair's breadth off the 26-year highs just below $720 seen in May 2006, when the Fed's commitment to restoring monetary equilibrium under new chairman Ben Bernanke was facing serious skepticism (see "Lesson Learned?" May 3, 2006). Soon after, Bernanke gave a speech in which his talk of "vigilance" seemed to draw a line in the sand beyond which the Fed would not cross (see "Bernanke Arrives" June 6, 2006). That helped restore confidence, and gold backed off and hadn't challenged those levels since -- even after the Fed went on hold last August. But neither did gold or the dollar show a recovery of the bulk of the currency's real value that had been lost during this extended era of accommodation. Now, with the Fed all but certain to respond to the recent turmoil with at least one 25 bp rate move, it appears poised to compound its accommodative policy error, and the inflationary consequences are being priced in terms of commodities and the dollar's forex standing. At around $1.39, the dollar has now reached all-time lows versus the euro. And the renewed escalation of crude oil to all time highs at $80 is also part and parcel of the dollar's weakening trend -- although that fact is somehow lost in the conventional analysis suggesting the climbing oil price reflects strength in consumption (a view, oddly, voiced by the same commentators who seem certain that the economy is headed for recession).

Unfortunately, one place where the buffeting being endured by the unit of account is probably receiving scant attention is at the Fed itself, which has little use for market price signals in its archaic demand-based output gap models. For the Fed, last week's employment report showing a surprising decline in payrolls served to underscore its concern about downside economic risks, and seems certain to compel it to put through a 25 bp rate cut. Further action, or a deeper cut next week, likely would require additional evidence of significant economic softening, and we doubt that they're going to get it. Nevertheless, any move toward ease at this point will only further distance policy from equilibrium, embedding additional inflationary impulses and augmenting the degree of adjustment that eventually will be required to restore a non-accommodative stance.

BOTTOM LINE: Although inflation is widely seen as being relegated to secondary importance in the context of recent market turbulence, Treasuries are pricing for a degree of inflation risk that has not been seen in recent years. That means that, effectively, longer maturities have stopped short of discounting the full extent of rate cut expectations now reflected at the short end of the curve. While the short end is now priced for 125 bp of Fed action, we see no more than one 25 bp cut as likely. By sometime early next year, in fact, speculation could well be turning toward anticipation of the Fed's first rate hike in more than a year and a half. If we're right, bonds across the curve stand to give up their gains of the last two months. For the long end, having not fully participated in the rest of the curve's wildly overdone bet on Fed ease may cushion what would otherwise be a catastrophic reversal.