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Facing the Music

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The Fed will soon have no choice but to deal with rising inflation, and bonds aren't ready.

We think the worst-case inflation scenario has been decisively averted by the calming of the financial markets in response to the Fed's new targeted liquidity facilities, but the overall inflation outlook remains uncertain (see ["Inflation: Not the Worst Case, But Still a Case"](#) March 26, 2008). The quicker the Fed moves to begin restoring monetary equilibrium by taking back its *force majeure* rate cuts, the less the inflation price that will ultimately have to be paid for this period of exceptional monetary largesse. But although the Fed has given clear signals that it has no intention to cut rates further, for now it seems content to foster the perception that it is in no rush to begin reversing the 325 basis points in cuts made since September. Over the coming months, the policymakers' tone will inevitably shift toward the unavailability of doing so. But it's already too late for the Fed to do anything to keep reported inflation from continuing to rise for the foreseeable future, no matter how aggressively they ultimately enter rate-hiking mode. There could be a particularly rocky time ahead for the bond market, which stands to get squeezed between a tightening Fed and an inflation reality which is becoming increasingly difficult to overlook.

Update to strategic view

FED FUNDS: Futures are priced for rate hikes to potentially begin at the October FOMC meeting, and certainly by December. But recovering growth prospects and mounting inflation pressures make us think the first hike might come as soon as August.

US BONDS: The Treasury curve is mispriced both for the extent of Fed rate hikes and growing inflation expectations. Damage will be worst at the short end, but the long end is highly vulnerable as well.

[\[see Investment Strategy Dashboard\]](#)

The Fed itself appears quite befuddled by the cross-currents it is currently confronting. According to the minutes of the April 30 FOMC meeting released last week, "Participants stressed the difficulty of gauging the appropriate stance of policy in current circumstances." While the FOMC cut the funds rate by 25 bp to 2%, "most members viewed the decision to reduce interest rates at this meeting as a close call," according to the minutes. Nonetheless, the policy record states it was felt that "an additional easing in policy would help to foster moderate growth over time without impeding a moderation in inflation." That expected moderation, however, appeared to be no sure thing in policymakers' minds. "On balance, participants expected the recent increases in oil and food prices to continue to boost overall consumer price inflation in the near term; thereafter, total inflation was projected to moderate, with all participants expecting total PCE inflation between 1.5 percent and 2 percent by 2010."

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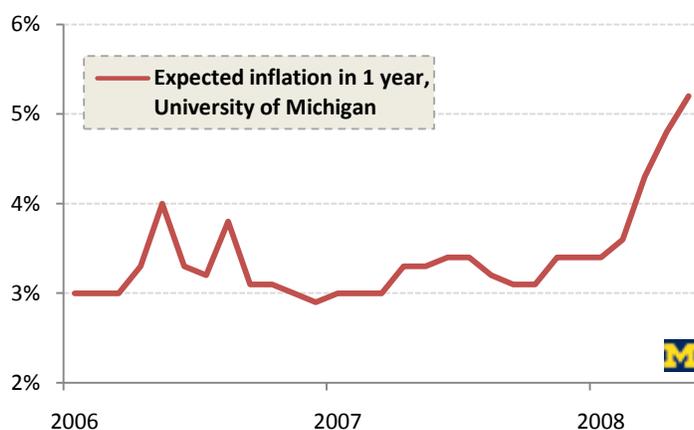
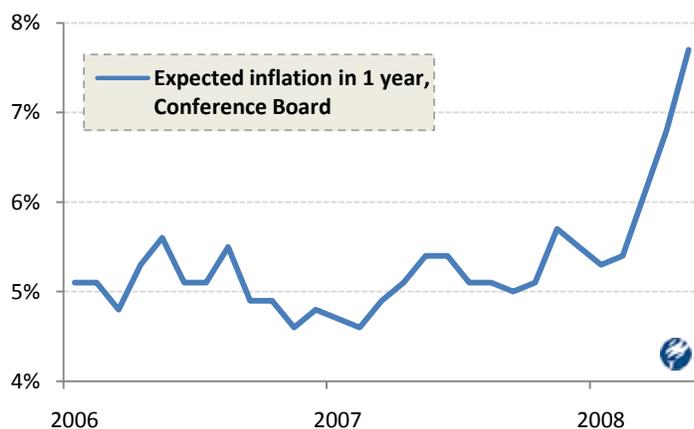
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However, in the Fed's conception, "the expected moderation in inflation was dependent on the continued stability of inflation expectations."

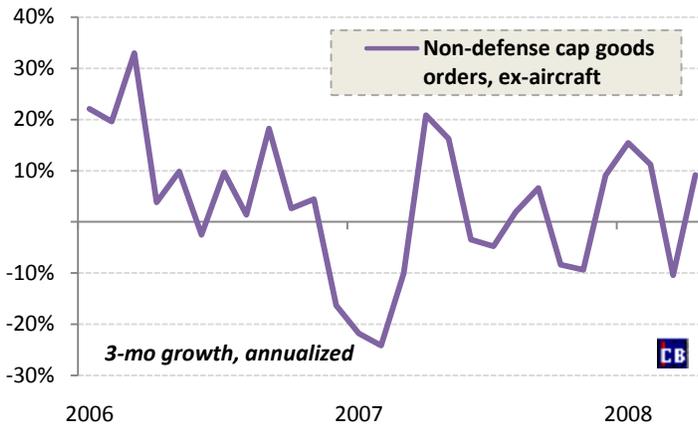
This notion that stable expectations can somehow be expected to overcome the inflationary influences being transmitted by an easy money policy stance strikes us as a highly flawed and shortsighted conception. Indeed, another passage in the minutes underscores the point: "A number of participants voiced concern that long-term inflation expectations could drift upward if headline inflation remained elevated for a protracted period...." Perhaps without realizing it, the Fed here is saying that higher inflation expectations are not a forward-looking indicator of rising inflation, but only the result of the perception of statistics which are themselves backward-looking. So how can expectations provide useful input to development of central bank policy that is supposed to act as a bulwark against inflation *before* it arises?



In any case, it is becoming more and more apparent that the expectations environment is rapidly shifting, and not for the better. The University of Michigan's consumer sentiment survey earlier this month showed year-ahead inflation expectations rising to 5.2%, the highest in 26 years, and up from 3.4% in January. In the Conference Board's consumer confidence release yesterday, expected inflation 12 months hence registered 7.7%. Among the few market-based indicators that the Fed monitors, TIPS spreads have also recently begun signaling that market inflation expectations are moving higher. Since the beginning of the month, the 10-year TIPS spread has widened by some 25 basis points, and now stands at about 250 bps. That's not an alarming level in itself, but since the inception of TIPS in 1997, TIPS spreads have consistently underestimated subsequent inflation. The significant development at this point is the steepening of the spread, not its absolute level.

In the Fed's own conception, then, the variable that it considers most critical to the inflation outlook -- expected inflation -- is moving decidedly in the wrong direction. How long it can avoid acknowledging this reality is an open question, but with its credibility already dented in this policy episode, it cannot do so indefinitely. And in the coming months, seasonal quirks that have held down reported statistical inflation the past few months will wash out, which likely will leave CPI running at about a 5% rate by sometime this summer. Senior Fed officials who have maintained a dim view of the immediate economic outlook also will want confirmation that better times are at hand before they move to begin taking back the rate cuts. We think the evidence to support that proposition is already surfacing in restoration of the market's appetite for risk. Offering real encouragement in that regard was yesterday's durable goods release, which showed 2.5% growth in all orders ex-transportation, the biggest gain since last July. Orders for non-defense capital goods ex-aircraft rose 4.2%, suggesting business investment is emerging

from the doldrums. Shipments of core capital goods, used to calculate business investment for the GDP accounts, are up 2.3% against the first quarter average.



With the 10-year Treasury yield touching 4% for the first time since early January, it could be that the bond market is starting to worry about the bond-unfriendly forces at work. But yields have been swinging in about a 20 bp range for the past month, as the data have offered a mish-mash of clues on whether the economy has returned to a healthy enough condition to withstand the initiation of rate-hiking, so it's not clear yet that a sustained Treasury sell-off is at hand. But such a sell-off appears unavoidable. The 2-year note,

for example, is yielding around 2.6%. That's as high as it's been since January, but it still is priced for just slightly more than 50 bps in rate hikes over the next two years. It's highly unlikely that the rate-hiking cycle, when it comes, will be limited to 50 bp. Typically, a tightening exercise is accompanied by a flattening yield curve, as yields at the short end rise more than at the long end. In this case, that might be less so, because the tightening will to be associated with an awakening to inflation reality after the market spent years content to assure itself that inflation was a thing of the past. However, even if the curve flattens somewhat, the fact that short yields will rise *more* won't keep the long end from getting hit as yields move significantly higher across the curve.

BOTTOM LINE: The fed funds futures curve is now priced for an almost 70% chance of a first 25 bp rate hike coming at the October FOMC meeting, and is more than fully priced for it at the December meeting, and for two hikes by the January, 2009 meeting. Given the cautious signals coming from the Fed, that conservative bet could turn out to be the right one, but we're inclined to lean toward the first move coming sooner, possibly as soon as August -- for which the futures markets now assign no chance at all. But however soon it comes the Treasury curve already appears mispriced for the extent of the hiking cycle. While the 2-year note is showing a total of 50 bps in hikes to come, the futures curve is now more than fully priced for 100 bp by June, 2009. ▶