TrendMacrolytics

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FED SHADOW

# Bernanke to the Rescue?

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**Donald Luskin**

**Bernanke's homage to deflation-fighting will provide only short-term comfort to battered bond bulls.**

The speech this morning by **Federal Reserve governor Ben Bernanke** feels as though it is explicitly designed to calm a bond market that has suffered since mid-June its worst price decline in nine years. We've been warning repeatedly of a bond market blow-off (see "Bond Market Blow-Off" June 20, 2003), and now that it's happened, Bernanke must feel that there are some bond traders in need of a pep-talk about the Fed's deflation-fighting zealotry. The speech offers much in this regard, including the statement that "In my view, though recognizing that such an action imposes costs on savers and some financial institutions, we should be willing to cut the funds rate to zero..."

Bernanke also offers the strongest endorsement yet for "so-called nontraditional monetary policy measures." Bernanke says, "Thanks in part to a great deal of fine work by the staff, my understanding of these measures and my confidence in their success have been greatly enhanced... I see the first stages of a 'nontraditional' campaign as focused on lowering longer-term interest rates. ...Such measures might include, among others, increased purchases of longer-term government bonds by the Fed..."

But beneath these seemingly comforting thoughts, there is really little here for bond bulls to celebrate, either long-term or short-term. First, the long-term bull case is based on continued deflation, and this speech only renews the Fed's commitment to fighting deflation. If the Fed is successful there -- or especially if it overshoots and induces a new cycle of *inflation* -- it won't be good for bonds, and it will matter not at all that the Fed purchased bonds along the way.

The short-term bull case for bonds has been propped up by the Fed's commitment to keep the Fed funds rate at a low absolute level for a long time. This commitment induces traders to put on the "carry trade," borrowing overnight funds to finance long positions in bonds, thus earning an interest rate spread on a cash investment of zero. Inducing traders to put on the carry trade can be thought of as the Fed using intermediaries to make purchases of long-term Treasuries -- in essence, it is Bernanke's "nontraditional measure" implemented by proxy. But traders holding the carry trade get burned when expectations for a continuing low funds rate are reversed -- they suffer losses in their long positions as bond prices fall, with the prospect of no opportunity to compensate by earning the spread over time. *That* is precisely the dynamic behind the bond market rout of the last six weeks.

Stock prices and other evidence from capital markets are inescapably saying that growth may accelerate faster than the Fed expected three months ago when bond prices began to be propped up by prospects of a low fed funds rate "as far as the eye can see" (see "Betting on Growth" July 11, 2003). It was confirmed by **Alan Greenspan** in congressional testimony last week (see "Greenspan at House Banking" *TrendMacro Live!* July 15, 2003) and was soon reflected in interest rate futures markets, as the implicit date of the first Fed rate hike has come in over the last ten days from June 2004 to March 2004. That's been very bad news for holders

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of the carry trade, and it looks like Bernanke's speech has been able to go some way towards ameliorating the pain -- at least for the moment.

But for the long term, Bernanke makes it clear that even in the context of deflation fighting, the funds rate is hostage to economic growth: "the factor most likely to exert downward pressure on the future course of inflation in the United States is the degree of economic slack..." Yes, he throws the bond bulls a bone by adding that this slack "will likely continue for some time yet." But the key question for holders of the carry trade remains the definition of "some."

While Bernanke reiterates a confused economic model in which it seems entirely unclear whether slow growth causes deflation, or it's the other way around -- or both! -- both his and our own would converge as bad news for bonds under what we see as the most likely scenario for the coming year. Continuing evidence of accelerating growth will continuing to raise the already rising real interest rate, and the Fed will be obliged to track it on the rise just as they tracked it on the decline all during 2001. And as accelerating growth is seen by the Fed as either ameliorating deflationary risk (or as the result of deflationary risk having already been ameliorated -- or both!), the Fed will have no reason to fight the tape.

So the bond bulls can thank Bernanke for a little relief after what must seem as a long siege. But the writing is on the wall. TM