Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Wake-Up Call

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David Gitlitz

Bonds are rethinking the economy and the Fed. Next for rethinking: inflation.

Update to strategic view
US BONDS: The sell-off in bonds reflects a long overdue reappraisal of growth prospects and the chances that the Fed will cut rates in the near term. The sell-off will be accelerated by another reappraisal likely to come soon -- that inflation pressures, expected to moderate, are in fact still strong.
[see Investment Strategy Dashboard]

We have been warning for the past couple months that a credit market pricing for bond buyers' nirvana -- sharply slowing growth, nonexistent inflation risk and a Fed poised to begin cutting rates soon -- was highly vulnerable given the tenuous ground on which those suppositions rested (see "Update to Our US Bond Forecast" August 25, 2006). Since late last week, bonds have gotten an early taste of that vulnerability with two of their three pillars of support -- growth slowdown and friendly Fed -- for the first time facing significant doubt. Even with the reversal of nearly 25 basis points on the 10-year Treasury, at this point the market remains priced for nearly 50 basis points in rate cuts next year. Not only will those easing expectations continue to erode amid indications of sustained economic vibrancy, it's also far more likely than not that at some point the Fed will be compelled to acknowledge that the inflation outlook is considerably less benign than it has wanted to believe. The prospect of a return to the rate-hiking regimen, potentially prior to year end, will be another unwelcome and unexpected development for bonds.

It's interesting to note that the proximate catalyst for this bond market wake-up call, last Friday's employment report, did not, at first blush, appear particularly strong. With the report of an addition of just 51thousand jobs last month, payroll growth came in at its slowest rate since the aftermath of Hurricane Katrina last fall. But more significant was the upward revision of 60 thousand to August payrolls, now showing 188 thousand new jobs. In addition, the household survey reported growth of 271 thousand jobs, coming on top of 250 thousand jobs in August. In the past year, household jobs have risen by some 2.4 million, compared to the establishment survey showing payroll growth of about 1.8 million. We have contended that by lagging in its reporting of new and small business hiring and completely excluding the self-employed, the establishment survey has been missing critical dynamics of the current labor market, rendering it less indicative of overall economic conditions than the household data. The latest jobs report provided confirmation for this contention, with the Bureau of Labor Statistics releasing the preliminary estimate of its annual benchmark revision. The BLS now estimates there were 810 thousand more jobs added in the year ending in March 2006 than originally reported, one of the largest revisions on record. That amounts to an average of more than 67 thousand jobs per month that the payroll survey did not pick up.

It's unknown whether this underestimation is continuing to that degree, but the latest data also show average hourly earnings were up 0.2% for the month and 4% year-on-year. That's the best growth in five years, and hardly consistent with labor market exhibiting signs of slack. That also goes for an unemployment rate of 4.6%, on par with the lows of this expansion and down from levels above 5% a year ago.

One of the striking aspects of this Treasury sell-off has been the abrupt sentiment shift it has occasioned. Only a week ago, hardly a word could be heard taking issue with the consensus that growth was petering out, the Fed was a one-way bet, and bonds were the place to be. That has seemingly been turned on its head, with the new buzz being that the market had gotten ahead of itself, the economy is showing considerable resilience, and the wait for the Fed to begin cutting rates could well be a long one. Just as the bullish bond narrative carried the market a long way the past few months, so this turnaround in opinion could have the equal and opposite bearish effect.

Of course, to a great extent the market will continue to take its cues from the Fed, and there's little question but that the Fed's dovish turn over the summer was pivotal in shaping the perceptions that drove bonds to stratospheric heights. But there appears to be a significant reconsideration at work among policymakers, who are now signaling -- as we forecasted they would -- that they saw bonds moving beyond the point that could be justified by rational policy expectations (see "Hoping Against Hope" October 5, 2006). That process appeared to continue today with release of the FOMC minutes from last month's meeting. "Many meeting participants emphasized that they continued to be quite concerned about the outlook for inflation," the minutes say. "Several participants worried that inflation expectations could rise and the Federal Reserve's willingness to carry through on its intention to seek price stability could be called into question if cost and price pressures mounted or even if there was no moderation in core inflation." While most still saw a reduction in inflation pressures as most likely, "the anticipated decline was only gradual and the uncertainties around that forecast were skewed toward higher rather than lower inflation rates." Bonds, which had been up slightly on the day prior to release of the minutes, proceeded to fall by nearly a quarter point, with the 10-year yield approaching 4.8%.

BOTTOM LINE: The bond market party that took yields down by some 70 basis over the course of little more than the past three months could be at an end. The back-up of some 25 basis points since late last week appears to reflect an abrupt reappraisal of the growth and policy outlook, with all signs suggesting the movement has been toward a more reality-based perspective. There's another shoe that's yet to drop, however: admission by the Fed that the inflation landscape is not nearly as "contained" as it has wanted to portray. Today's FOMC minutes may represent another incremental step in the grudging effort by policymakers to inch toward such an acknowledgement. At some point, though, we expect it to become clear that the Fed will have no choice but to return to rate-hiking mode, leaving bonds exposed to an even more virulent downdraft. TM