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March Madness

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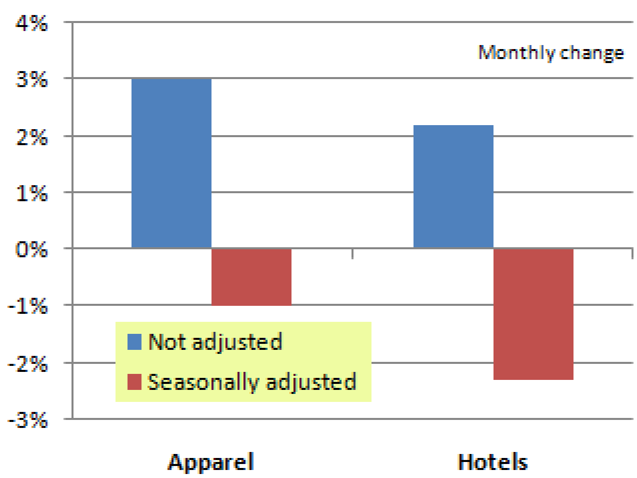
Bonds bulls will seize on anything -- even inflation statistics distorted by NCAA basketball.

Not surprisingly, credit markets took yesterday's seemingly benign core Consumer Price Index reading as a bullish signal, with the 10-year Treasury posting its best rally in the past month, the yield dropping from 4.74% to 4.68%. The market was rife with bond house commentary suggesting that the 0.1% uptick served, as one dealer put it, to "make the Fed's case that inflation pressure is correcting itself through slower growth." The movement in bond yields mirrored upbeat expectations seen in the interest rate futures market, with the December Eurodollar futures contract extending its bet on Fed rate cutting by year-end from 26 to 32 basis points. Without any fresh data to potentially spoil the fun, the feel-good bid was sustained today, with the 10-year yield dropping another three basis points and December Eurodollar futures pricing for 35 basis points in rate cuts in afternoon trade.

Update to strategic view
US BONDS: The bond rally fueled by yesterday's benign March core CPI reading is unlikely to be sustained. March's reported inflation was heavily influenced by anomalies in the statistical process of seasonal adjustment which, by construction, must wash out over time -- leaving the uptrend in core inflation very much intact.
[see Investment Strategy Dashboard]



MARCH CORE CPI: OVER-SEASONED

But while the March CPI release dropped the three-month annualized core rate from 2.6% to 2.3%, and the year-on-year rate from 2.7% to 2.5%, we would advise caution in extrapolating a single month's data into a fundamental trend shift. A year ago, the 12-month core rate was running just slightly above 2%, having already doubled from its lows around 1% in late 2003. The trend higher, in other words, remains firmly in place, and the details of yesterday's release suggest it was influenced by some statistical anomalies that are unlikely to be sustained.

The core rate in yesterday's release was

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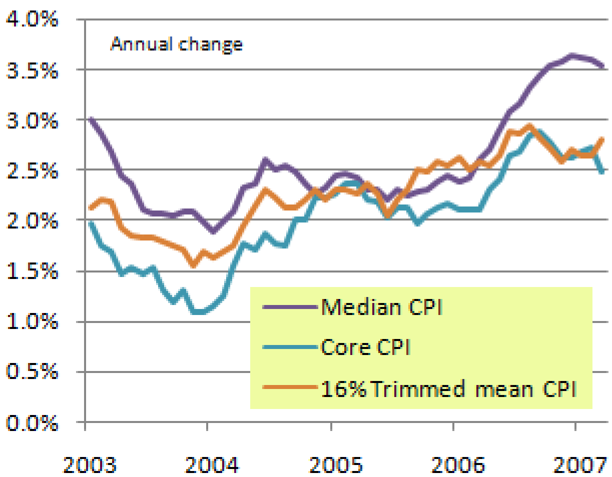
held down by a few volatile components, hotels and apparel in particular, which are just as likely to reverse course in coming months. Seasonal adjustments were a major factor. Unadjusted, the overall core rate last month posted an increase of 0.4%. Prior to seasonal adjustment, apparel showed a *jump* of 3%, which the seasonals converted into a 1% *decline*. Similarly, the unadjusted rate for hotels was *up* 2.2%, but after seasonal adjustment came out as *down* 2.3%. Staff at the Bureau of Labor Statistics acknowledged to us that the March release was affected to an unusually large extent by the seasonals, which may have been accentuated this year by unusual weather conditions and other one-time factors. For example, the hotel adjustment for March is known within BLS as "March madness," and is actually significantly influenced by the NCAA basketball tournament which is held that month every year. But for whatever reason, hotel prices in tournament cities didn't rise as much as was assumed -- the result was a virtually arbitrary 4.5% swing between adjusted and non-adjusted results in this category.



THE UPTREND IS STILL INTACT

Such arbitrary statistical distortions in volatile components of the index lend some weight to the observation that simply excluding food and energy doesn't necessarily yield a "core" rate providing a clean read on underlying inflation conditions. Other methodologies that seek to more comprehensively filter out volatility have recently varied significantly from core CPI. The Median CPI produced by the Cleveland Fed, for example, was up 0.3% in March and is now running at a rate of 3.5% year-on-year. Another measure, the Trimmed-Mean CPI, a version of which is also calculated by the Cleveland Fed, rose 0.3% last month and is showing a rise of 2.8% on a 12-month basis.

All in all, we are in no way dissuaded from our analysis that the excess dollar liquidity seen in market prices such as gold, foreign exchange and broader commodity indexes points to inflation continuing to trend higher. In the midst of such a long-term phenomenon, a counter-trend reading such as yesterday's core CPI release is not unusual. While the Fed with an overnight rate target of 5.25% is less accommodative than it was with a 1% target, there are no signs yet that its stance has shifted enough to even begin withdrawing the liquidity excess. We expect to see higher core inflation readings in the coming months.

With all available evidence suggesting the Fed remains in an accommodative posture, we have consistently challenged the notion that the economy is at risk of slipping into a serious downshift, and another piece of data released yesterday, industrial production, supported that view. While overall industrial production fell 0.2%, the decline was entirely attributable to a weather-related shift in utility output. Most encouraging, manufacturing production was up 0.7%, its best showing in three months and coming after manufacturing output showed declines in four of the past seven months. The manufacturing slowdown had coincided with a lull in business fixed investment, and there were signs in yesterday's release suggesting that the lull might also be coming to an end. The gains in manufacturing output were led by increases in business equipment and machinery, pointing to a resumption of capex activity.

BOTTOM LINE: Bond market perma-bulls waiting impatiently for a buying opportunity found it with yesterday's core CPI release, amid punditry suggesting that the 0.1% reading was just what the doctor ordered to settle the nerves of an anxious Fed. Don't count on it. While bond buyers would wish otherwise, Fed policymakers know that one month does not make a trend. There were enough anomalies in yesterday's data to raise serious question about whether it reflected anything more than a fleeting statistical respite from a sustained uptrend in core inflation.