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Signals and Noises

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Bond bulls are pummeled by evidence of reaccelerating growth, and grasp at statistical straws of supposedly benign inflation.

Update to strategic view
US BONDS: The persistent bullish sentiment in Treasuries is breaking. The evidence of economic reacceleration is mounting, and apparently benign core inflation readings are illusory and transient. Fed rate cuts are off the table. The only question is: how long till the next hike?
[see Investment Strategy Dashboard]

While the staying power of bullish sentiment seen these many months in the Treasury market probably should not be underestimated, we see growing indications that the market's tone may be undergoing a fundamental shift. The kind of news that formerly elicited a predictable upside response is no longer spurring that same response. Last week, we noted that a downbeat retail sales release that previously would have been seen as manna from heaven for fixed income investors couldn't prevent a marginal move lower for bonds (see "Retail No Relief for Economic Bears" May 11, 2007). This week, a consumer price reading widely taken as in keeping with the Fed's forecast for declining core inflation also failed to inspire a positive credit market response.

What gives? For one thing, bonds have been moving virtually in lockstep with expectations in interest rate futures. Although futures markets have significantly pared their bets since pricing for more than 50 basis points in Fed cuts this year following the March 21 FOMC meeting, they are still maintaining nearly an odds-on bet for one 25 bp cut before year-end, and nearly two by June 2008. Bonds thus have little upside room unless the case can plausibly be made that Fed cuts are more likely, which appears increasingly untenable. While the April core CPI reading of 0.2% was construed as offering evidence of "contained" inflation pressure, on an annualized basis that remains above the top end of the Fed's "comfort" level. Unless core inflation breaks significantly lower, or the economy shows considerably more weakness -- neither of which we expect -- the case for rate cuts likely will continue to dissipate. That is the new reality confronting the credit markets -- or more accurately, an old reality *finally* perceived by credit markets.

There may also be at least some marginal doubt creeping into the market about the sustainability of such a "benign" inflation reading. The current woes of the housing market played no small part in this latest release. Owners' equivalent rent, the statistical concept intended to estimate the implied cost of homeownership based on rentals for comparable space, accounts for about 24% of the overall CPI, and an even greater proportion of the core. The

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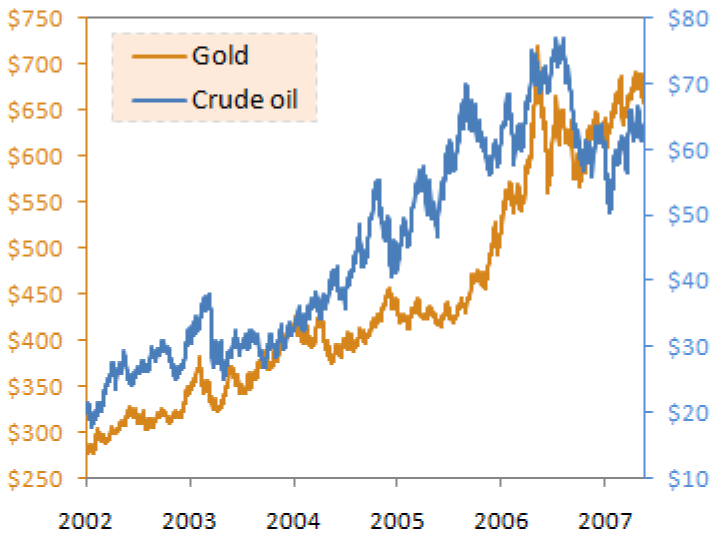
depressed condition of residential real estate is holding down rents as the oversupply of homes on the market also restrains rental increases. Apparently another significant factor is that prospective home-sellers dissatisfied with the prices their properties can currently fetch on the market are putting them up for rent, increasing vacancy rates. After showing monthly increases of at least 0.3% in four of the last five months, OER dropped to 0.2% in April, and below 4% on a year-on-year basis for the first time since last August. Until the surplus supply of homes clears the market, this is likely to be a factor restraining the core inflation readings. However, this is more of a transitory statistical distortion than a factor reflecting a real suppression of inflationary influences.



"CORE" INFLATION INDICES ARBITRARILY FILTER OUT THIS MEGATREND

We also do not believe it would be advisable in the current context to completely discard the significantly more troublesome inflation signals coming from the "headline" CPI, now running at nearly 6% on a three-month annualized basis. The core rate is an analytical convenience intended to get at underlying inflation conditions by excluding food and energy, which have historically been among the more volatile components of the index. But the energy price increases had their origins in 2002 at about the same time that highly inflation-sensitive commodities such as gold began to rally from long-depressed levels. In the years since, the broad congruence in movements of gold and crude oil have been clear (see the chart at left). If gold, as we maintain, has reflected that the Fed's surplus liquidity posture has eroded the real purchasing power of the currency, so has oil.

Moreover, the purpose of excluding high-volatility components from a core index is to filter out items that have a tendency to show sharp movements both up and down. In that way, the thinking goes, a core index provides a better filter separating signal from noise. But if the prices being filtered out are primarily moving unidirectionally, they aren't really noise, they're signal. Since mid-2002, the energy price component of the index is up by 67% and food by more than 14%. And while the Fed itself focuses on core measures of inflation for policy purposes, it has acknowledged concern about potential "pass through" of food and energy into the broader price universe.

BOTTOM LINE: Today's sell-off puts the 10-year Treasury yield at a one-month high above 4.75%, and there may not be any lifelines available to throw to this market for quite some time. Another week of upbeat jobless claims data and a solid pickup in the Philly Fed manufacturing survey are further diminishing the prospect of any Fed rate cuts for the foreseeable future, and we have no reason to think that's likely to change any time soon. For now, core inflation is being restrained by effects of the housing downturn, but that’s unlikely to provide long-term relief from the inflationary influences embedded by a Fed that has now been on hold for nearly one year in a posture that has failed to reach equilibrium.