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FED SHADOW

Fed Still On The T-Bond Sidelines

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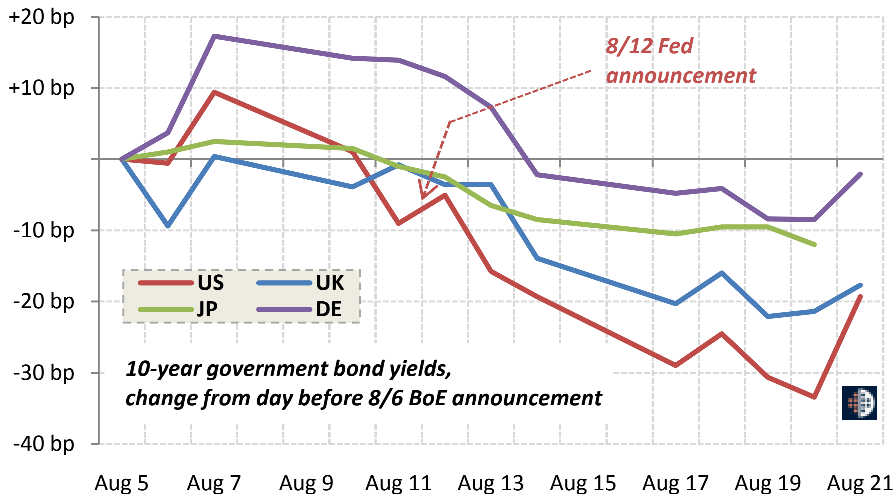
Donald Luskin

Kohn's Jackson Hole remarks don't mean more long-term bond buys are coming.

Update to strategic view
US BONDS: We don't believe that reported remarks by Fed vice chair Kohn signal a probable resumption of the Fed's terminated long-term Treasury buy program. Short-sellers likely remain free of the risk of sudden Fed intervention.
[see Investment Strategy Dashboard]

Our clients who are short long-term Treasury bonds may be concerned by reports over the weekend on Bloomberg and the *Wall Street Journal's* economics blog of remarks by Fed vice chair Donald Kohn. Speaking extemporaneously from the audience at a Saturday panel discussion at the Fed's annual Jackson Hole retreat, Kohn is being portrayed as having put in play the possibility of the Fed buying more bonds -- this after the FOMC at its August 12 meeting voted to let the program expire when it reaches its intended goal of $300 billion, and despite the fact that the program is generally regarded as having been a dangerous failure (see "The Fed's Bond Boo-Boo" July 24, 2009). We strongly doubt that Kohn's remarks signal any important probability of a policy shift back toward Fed bond purchases.

Reportedly, Kohn said he was "struck by the market's reaction" to the Bank of England's August 6 decision to increase its bond purchase program by £50 billion, and that "the markets must perceive that there is an effect there." Reports have interpreted this as Kohn's noting a salutary drop in gilt yields since the BoE's announcement. But 10-year gilt yields were unchanged for a full week after the BoE's announcement (see the chart at left). They only began falling *after the August 12 FOMC meeting*, when the Fed took a policy stance *opposite* that of the BoE -- by *calling an end* to its bond purchase program



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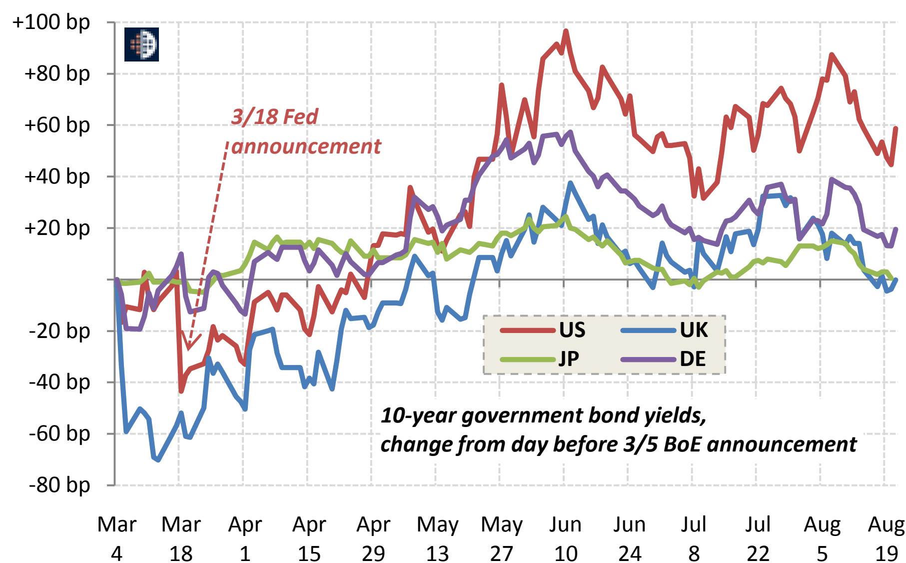
(see "On the August FOMC" August 12, 2009). From that date, government bond yields around the world fell, including gilt yields. If Kohn sees "an effect there," it ought to be that the Fed can lower long-term yields world-wide by announcing it will *not* buy bonds.



A longer-term perspective reinforces this conclusion (see the chart at left). 10-year gilt yields dropped sharply after the BoE first announced its buy program on March 5. Two weeks later, 10-year Treasury yields dropped sharply, too, after the Fed announced its buy program. But from there, government bond yields around the world moved higher. They reached their climax -- so far -- in early June, when markets were abuzz with expectations that the Fed would enlarge its buy program, raising the stakes on the inflationary risk of a vicious cycle of speculative attack (see "No, Mr. Bond, I Expect You to Die" May 22, 2009) and outright debt monetization (see "They Laughed When I Sat Down to Monetize" June 4, 2009). Yields world-wide subsided as it became clear that the Fed would, in fact, *not* intervene to keep long-term yields low. If Kohn wants to be "struck by the market's reaction," he should be struck by the market's reaction to *that*.

Kohn is one of four FOMC members who matter (the others being Bernanke, Yellen and Warsh), so even his off-the-cuff remarks must be taken seriously. In this case, we are tempted to believe that his remarks were misinterpreted, if not downright misreported. Surely Kohn can't look at the historical evidence and conclude that the Fed can keep long-term rates low by committing to buy more long-term government bonds -- the evidence leads to the opposite conclusion. For bond shorts, this is a mixed blessing. The Fed has stepped aside from the risk of a vicious cycle of speculative attack, which could have resulted in a rupture in Treasury markets similar to the one in currency markets when speculators "broke the Bank of England" in 1992. And it has eschewed the most overt form of debt monetization, which could have resulted in a catastrophic loss of confidence in US debt and the dollar. So the prospect of a bonanza for shorts has been lessened. On the other hand, shorts are probably free from the risk of being punished by sudden Fed interventions. Less upside, less risk.

The shorts continue to have the strategic wind at their backs. The Fed still has no exit strategy from its present inflationary policy stance, and even if it did, we doubt it will have the wisdom or the political will to execute it. As the risk of the global economy falling back into deep recession subsides, safe-haven demand for Treasuries will continue to abate, while there's no sign that supply from a funding-hungry federal government will do anything but grow. And when the economy begins to actually expand again -- beyond the horizon of the present bottoming process -- shorts will have their payday.

BOTTOM LINE: We don't believe that reported remarks by Fed vice chair Kohn signal a probable resumption of the Fed's terminated long-term Treasury buy program. Short-sellers likely remain free of the risk of sudden Fed intervention.