TrendMacrolytics

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MARKET CALLS

Bond Market Blow-Off

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Treasuries are finally starting to get real about growth prospects and inflation risk.

Taken in isolation, this week's abrupt bond market back-up, with the 10-year note tacking on some 35 basis points in yield from its lows early Monday around 3.07%, might seem to rate as no big deal. After all, as of this writing, the benchmark Treasury remains nearly 50 bps below its levels prior to **the FOMC's** May 6 statement indicating that combating the risk of deflation -- not inflation -- was its major preoccupation, and signaling that no rise in short-term rates was likely for the foreseeable future. Today's ***Wall Street Journal***, in fact, cites **Fed** officials as being quite contented with their handiwork in using "open-mouth operations" to pull down the long end of the curve.

Our reading, however, is that this week's sell-off offers compelling clues to a changing environment, and suggests the limits of the Fed attempting to use its control of overnight rates -- and expectations about future overnight rates -- to manipulate long-maturity issues. Indeed, the fact that bonds are suddenly showing significant resistance to simply tracking Fed rate-cut expectations suggests the credit market is becoming more closely attuned to prospects for a significant growth pickup, a risk of somewhat higher inflation, or perhaps both.

Bonds can be seen as providing a reality check as we witness the battle of leaks over whether policymakers next week are more likely to produce a 50 bps or 25 bps reduction in the funds rate target. **John Berry** in yesterday's ***Washington Post*** strongly favored the former; **Greg Ip** in today's *Journal* says it could well be the latter. The pretense of this duel of journalistic egos is that the fate of the world -- or at least the US economy -- somehow hangs in the balance between whether the Fed sets its rate target at 1% or 0.75%. Not likely. The fact is -- as we have detailed over the past several months, and as is reflected in the dollar's reflation against foreign exchange, gold and broader commodity indexes -- the deflationary risks now preoccupying the central bank have been decisively rooted out. The final dousing of those deflationary impulses has brought about a welcome easing of what had been a paralyzing risk aversion, setting the stage for a marked acceleration in the pace of economic expansion in the months ahead. Absent any now-unforeseeable exogenous shocks, real growth rates in the range of 3.5 to 4% in the second half of this year appear entirely plausible.

That, more than anything, is the message of the bond-yield bounce this week. In addition to a smattering of relatively more upbeat economic releases, the week has also seen what appears to be a positive public mood shift, with several articles in major press outlets pointing toward a potential economic bounce-back in the offing. While the Fed successfully engineered a compression of real long-term yields -- the "real" yield on 10-year CPI-indexed TIPS fell some 70 bps to about 1.4% between May 5 and the end of last week -- that strategy is not likely to survive a significant economic revival. In an economic environment of rising expected real returns, Treasury yields must rise to provide a competitive return in a global capital market. Already this week, TIPS yields have risen by some 25 bps to more than 1.65%. At some point, provided real growth rates recover and stabilize around long-term trends, 10-year TIPS yields are also likely to "normalize" in a range above 3%. That also suggests the continuing vulnerability of nominal long-term Treasuries at current levels. Provided long-term CPI expectations remain in the 1.7 to 2% range that has largely held over the past few years, as reflected in the spread between nominal and inflation-protected Treasuries, that implies the 10-year note eventually returning to yields around 5%.

The bulk of that move, however, is probably not imminent. As long as the Fed remains willing to keep the short end of the curve anchored to a funds rate no higher than 1%, the downside risk in long maturities from current levels appears somewhat limited. Following the blow-off of the excesses of the previous few weeks, we would expect to see the benchmark Treasury settling into a fairly broad trading range of around 3.5 to 3.75%.

We also think it probable that at least a marginal factor in this week's Treasury rout has been some recalibration of the market's inflation forecast. Although it is not yet showing up in indicators such as the TIPS spread, the Fed has made no secret of its considerable concern with core statistical inflation rates currently around 1%. The thinking is that the monetary masters would be significantly more comfortable with a core rate closer to 2%. But just as it never conceived that its earlier excessively restrictive stance would wreak the deflationary havoc that it did, neither can we ignore the risk that in seeking to moderate the effects of its "disinflation," the Fed will overcorrect and engender an unexpected acceleration of the price level. TM