TrendMacrolytics

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

MARKET CALLS

Bond Bubble Sure To Burst, But When?

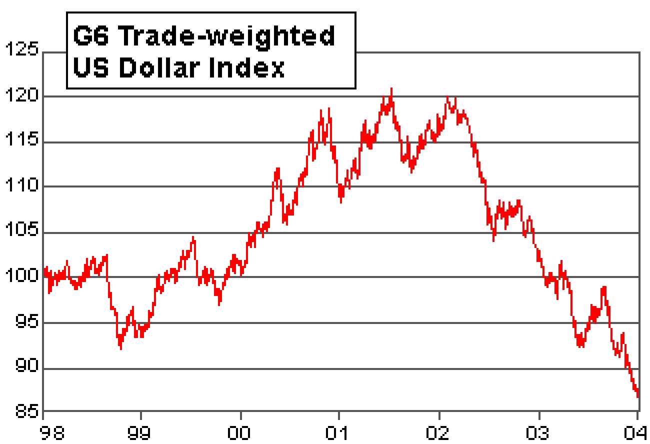
Tuesday, January 13, 2004

David Gitlitz

A questionable jobs number has given the bond market a questionable reprieve.

In the wake of Friday's stunning jobs report that appeared to reaffirm **the Fed's** repeated assurances that it has ample room to maintain its easy money posture for a "considerable period," bonds have faced little resistance pushing yields back to the low end of the 4 to 4.5% range that has prevailed since late last summer. With a 1% funds rate apparently locked in for now, the take-it-while-you-can-get-it carry trade is once again in control, helped along by shorts vacating their positions following the surprisingly small gain to payrolls,

But with the benchmark 10-year Treasury hugging levels around 4.1% last seen in early October, the market has priced in little margin for error to its estimate that a lagging labor market will keep the Fed sidelined indefinitely. The vulnerability of long-term bonds at these rich levels is further underscored by the dollar's seemingly relentless erosion. Gold, the most monetary of all commodities, has breached the $425 plateau for the first time in more than 15 years, and is up some $100 in little over a year. At the same time, the dollar's trade-weighted foreign exchange value against its major-currency counterparts is now at its lowest levels since early 1996.



In fact, a strong case can be made that the Fed's posture is now nearly as extreme in the direction of ease as its stance was excessively tight in 1999-2001. Relative to levels that prevailed during the first half of 1998 and that appeared consistent with essential price stability, the dollar's forex value has *depreciated* by almost as much as it *appreciated* in the earlier deflation).

We're sticking with our bet that bonds will not escape unscathed, although the downturn now seems likely to be delayed for longer than we had anticipated. With the Fed remaining blind to the incipient inflation pressures being transmitted by its hyper-accommodative policy stance, a bond market reckoning for the currency's decline in real purchasing power is inevitable. Sooner or later, the Fed will be compelled to move to correct its excess liquidity posture. The longer it waits, the higher the funds rate ultimately will have to go and the larger will be the back-up in longer-term Treasuries. One way or another, bonds lose -- the only real question is *when*, not if.

Bonds surged in response to the December jobs release because the market -- probably correctly -- read the apparent weakness of the data as likely to put off initiation of Fed rate hikes

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Stamford CT

Phone:
650 429 2112
973 335 5079
203 322 1924

for some as yet unknown period of time. Such official government statistics provide a highly flawed foundation for the conduct of monetary policy, but the potential for error is compounded significantly when the reliability of the data -- and their interpretation -- are open to such serious question. It appears, for one thing, that seasonal adjustment factors contributed to a downward skewing of job totals in Friday's report showing an addition to payrolls of just 1,000. The seasonally adjusted data, for example, showed retail positions declining by 30,000 in December, normally a big month for retail hiring. Unadjusted, however, there was actually a net *gain* of 174,000 retail jobs, so the biggest negative in the report may have been a statistical quirk.

Conventional wisdom has been trained to treat the payroll totals as an inviolate indicator of job market health, but there is good reason to question whether the **Department of Labor's** establishment survey is accurately capturing current market dynamics. If the weak payroll data are "right," then a host of other indicators consistent with job creation must be "wrong." Unemployment claims are now at multi-year lows and **ISM** purchasing manager surveys show that hiring is rebounding strongly. Moreover, the Labor Department's own household survey, which accompanies the payroll release, portrays a vastly more upbeat employment scene. Over the 12 months ended in December, the household survey recorded creation of some 2 million jobs, while the establishment survey has payrolls contracting by 74 thousand. As we have noted previously, the household survey has traditionally been a more accurate indicator early in labor market upturns because it is more sensitive to small business hiring and gains in self employment, which the establishment survey excludes. While the difference between the two has never been this great, it's significantly more likely that the establishment survey will eventually be revised to narrow the gap. In the last "jobless" recovery in the early 1990s, subsequent revisions of the payroll data identified some half million new jobs that initially went unreported.

Beyond that, though, one must wonder whether the Fed is prepared to risk its credibility by remaining on hold until it has solid evidence of a payroll recovery, notwithstanding the myriad other indicators of broad-based economic strength. Is the Fed, in other words, using job creation as its main indicator of its objective for sustainable "aggregate demand" growth, or is job growth *itself* the Fed's policy objective? Neither choice represents policy optimality, inasmuch as labor market conditions are notoriously misleading as guideposts of inflation/deflation risk. But if payroll growth has become the Fed's single-variable objective, as the market seems to assume, the 1% funds rate target could conceivably be left in place until the inflationary consequences become too obvious for the Fed to ignore, which might not occur until late this year or early in 2005.

Our hunch, however, is that a few key players at the central bank, including **Alan Greenspan**, are not quite as oblivious as they might currently seem. Greenspan has always taken a less doctrinaire view of the Phillips Curve/output gap paradigm which puts employment at the center of the Fed's policy universe. Of course, our willingness to rely on Greenspan's ultimate wisdom is not unrestrained -- too many have lost too much making that bet. Still, Greenspan & Company are aware that policy changes work their way through the system with long and variable lags. And although the Fed chief no longer acknowledges gold and the other market price indicators as integral to his policy perspective, it can safely be assumed that he monitors their movements and knows the implications of their recent behavior. At some point sooner than the market now expects, Greenspan is likely to begin prepping the market for the inevitable shift. Our **Model Position short June Eurodollar futures** has taken somewhat of a beating, with the contract now priced for just a 60% chance of one 25 bp hike. However, we see the market as having gotten somewhat extended, taking the Fed at its word that it will remain on hold for as far as the eye can see. We are maintaining the short position in June EDs.