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Bond Market Riddle

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Does misplaced economic pessimism explain mispriced bonds?

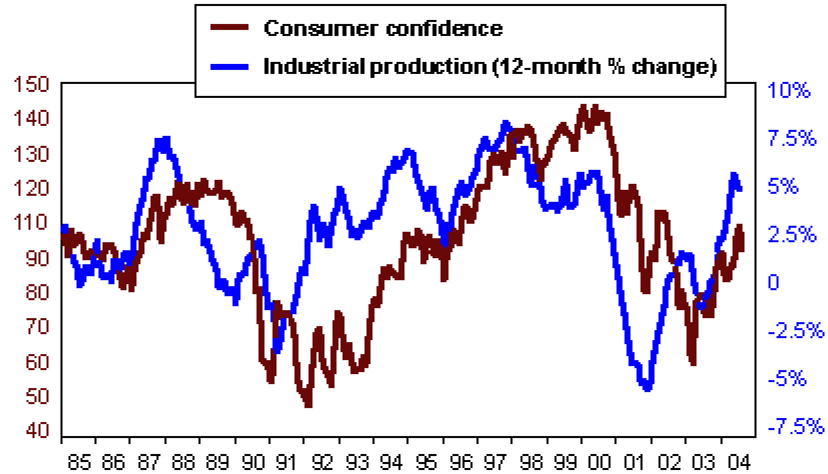
Yesterday's **ISM** survey portrayed a manufacturing sector that remains in vigorous growth mode. This injected a small dose of reality into a bond market that has been sent soaring over the past month on determinedly worst-case interpretations of a host of hardly grim economic indicators. At a yield today around 4.15%, however, the 10-year Treasury is still at levels not seen since unexpectedly strong payroll jobs data in early spring sent shudders through a market priced for **the Fed** to indefinitely maintain its ultra-easy policy stance. While the manufacturing data brought at least a short-lived pause to the rally, with bond traders at the margin positioning for the possibility that it may portend a resumption of brisk payroll growth in the August jobs release tomorrow, it didn't even begin to rectify what we see as a similarly mispriced Treasury market.

We don't entirely exclude the possibility that the market could remain mispriced for some period of time before reality catches up to it. Certainly, given the statistical and methodological vagaries of the establishment payroll survey, it would be unwise to completely rule out the chance of another sub-par jobs number propelling gains that would again see the 10-year breaching the 4% level. At this point, though, the market appears highly vulnerable to the growth signal that would be sent with restoration of solid job growth in tomorrow's employment report. Payroll gains of even 200,000 or so -- though hardly indicating a scorching labor market -- would swiftly send the benchmark yield back to the ranges around 4.5% that it occupied when the pall of economic pessimism descended on the market early last month.

The pervasiveness of that sour mood was reflected in the commentary that initially greeted the ISM release, with one market service characterizing the ISM data as "disappointing, but not disappointing enough" to sustain a rally that brought long-term bondholders a 3.7% total return in August. Disappointing? Well, at a reading of 59, the purchasing managers' index was down slightly from multi-decade highs above 60 recorded the previous several months. The current reading, however, still exceeds the best levels of the late-90s boom, and ISM noted that past relationships suggest a PMI of 59 is consistent with real GDP growth of 5.9%. If that's "disappointing," all we can say is, "bring it on!"

We have puzzled over the bond market's apparent complacency in the face of evidence that the pace of growth is unlikely to stay the Fed's hand from a course of steady, if "measured," rate hikes, as well as unmistakable indications that significantly higher inflation looms. In a report last month, we suggested that the downturn in economic sentiment owed significantly to the media's doggedly gloomy depiction of economic news, and noted that in important respects this characterization seemed politically rooted (see "Risks to Expansion: Reality or Spin?" August 20, 2004.) The bond market has not been insulated from such influences.

The most recent leg of the rally on Tuesday, for example, drove the benchmark yield from about 4.20% to 4.12% on the basis of consumer confidence and **Chicago**-region manufacturing data that were widely, and speciously, reported as weak. "Soft readings on consumer sentiment and regional manufacturing added to evidence of a troubled economy," **Reuters** pronounced. The ***Wall Street Journal's*** on-line edition could not resist the temptation to put **President Bush's** election chances in jeopardy due to the slight downturn in confidence: "Job worries sent consumer confidence tumbling in August, a fresh blow to the Bush presidential re-election campaign." And in the kind of exquisitely circular logic that often figures prominently in such reports, the decline in consumer confidence was broadly regarded as boding ill for the employment release tomorrow, even as the decline was itself supposedly the result of sub-par job growth.



To be clear, in a universe of scores of data series with widely varying degrees of usefulness as substantive indicators of economic performance, consumer confidence is among the least useful. The preoccupation of much conventional economic wisdom with confidence grows out of the demand-based misconception that consumption drives output and growth, rather than being the consequence of, or reward for, production. The chart above plotting consumer confidence against industrial production, a highly accurate coincident indicator of output, helps illustrate the point. Over the past 20 years, confidence has never led, but always lagged, the economic performance trends indicated by industrial production. At this point, as the chart shows, industrial production has returned to late-90s levels.

As for the data, even as the confidence number slipped from its recent high of 105.7 last month, at 98.2 it's still at levels above that of any other month in the last two years. The volatile Chicago PMI, meanwhile, while falling below 60 for the third time in the past eight months, has recorded 16 consecutive months above the breakeven 50 mark, and at 57.3 continues to indicate strong **Midwest** manufacturing growth.

Yesterday, we were struck by the gold market response to the ISM release, with the spot price immediately breaking its upward trek above $410, closing the session just above $408, and falling further today toward the $405 range. Taking its cue from the same stubbornly glum sentiment affecting bonds, the gold market bet has been that the Fed will remain constrained from taking the action required to forestall a potentially damaging inflation breakout. Since late July, as bonds have rallied from around 4.6%, gold on net has popped about $20 higher. Yesterday's view of a still-robust manufacturing sector marginally quieted that concern, although at above $400 gold continues to price for a decline of dollar purchasing power that augurs for a price level rising at a significantly faster pace than consensus expectations now suggest. At the end of the day, of course, an unexpected inflation episode would hit bonds significantly harder than a Fed that takes forceful enough action to avoid it. Either way, though, bonds at these levels appear to offer very little upside for anything beyond the short term. TM