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Bonds: Is This the Turn?

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Bonds may have finally passed their apogee of irrationality.

Could yesterday's abrupt fixed income downdraft -- with the 10-year benchmark tumbling three-quarters of a point and its yield jumping 10 basis points to 4.08% -- mark the onset of the long-awaited unwinding of a massively overbought Treasury market? While it's still too soon to say for sure, the forces at work in yesterday's sell off are certainly consistent with our analysis that bond buyers have inhabited a world of wildly unrealistic expectations. The sight of investors balking at a new issue of 10-year notes priced to yield barely 4% as weekly initial unemployment claims came in well below forecasts at a four-year low of 303,000 suggests the chickens could finally be coming home to roost. In the face of healthy growth, moderately higher inflation, and a **Fed** that more likely than not will continue pushing short rates higher, bonds have been pricing for some combination of a faltering economy, quiescent inflation and short-term rates being nudged up only slightly from current levels. While our bearish take on bonds up to this point has yet to bear fruit, we continue to see longer maturity Treasuries presenting one of the more compelling asymmetric bets now available in the capital markets, with whatever upside potential remains dwarfed by downside risk.

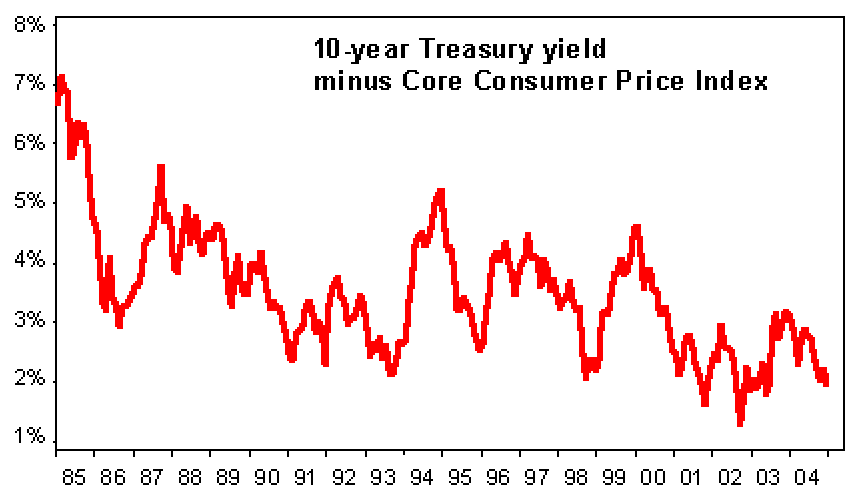
Yesterday's blow-back came in the wake of gains Wednesday that pushed the 10-year yield back below the 4% level, an event which bond analysts may at some point look back on as the apogee of a market that made remarkable strides by telling itself what it wanted to hear. The rally was sparked when **Atlanta Fed president Jack Guynn** was widely interpreted as suggesting in a published interview that a pause in the rate-hiking cycle might be forthcoming. Guynn told the ***Wall Street Journal*** that references to "measured" action and "accommodative" policy in the post-**FOMC** statements could soon need to be dropped. One wag seemed to capture the exhilaration touched off by the news, maintaining that "any change in language is more likely to generate a slower pace…than a speeding up" of rate increases. Why that would necessarily be the case wasn't explained.

In fact, were the Fed to jettison the "measured pace" assurance, it would likely signal that a more aggressive policy course is in the offing. Dropping "accommodative" would indicate that the Fed had attained its immediate objective of policy "neutrality." But that wouldn't preclude the possibility that the Fed would want to continue the process and move toward a tighter posture in order to continue rooting out the inflationary impulses that became embedded over the past two years of extraordinary policy ease. Somehow the market chose to ignore the fact that Guynn also told the *Journal*: "If my expectations about the path of the real economy over the next year or so are [met], we still have a ways to go." Those don't strike us as the thoughts of a policymaker contemplating a near term break in the policy normalization process.

The market's eagerness to latch on to the most favorable interpretation of the outlook for rates fit hand in glove with the reach for yield manifest in the curve-flattening trade. As long as confidence was maintained that short rates were unlikely to go much above the 3.25% reflected in the two-year note, borrowing short to extend exposure to longer-term maturities has been a good bet. In the sell off yesterday, however, we spotted what could be an early sign of that trade coming unhinged, with the curve steepening by five basis points, and now standing at about 80 bps.

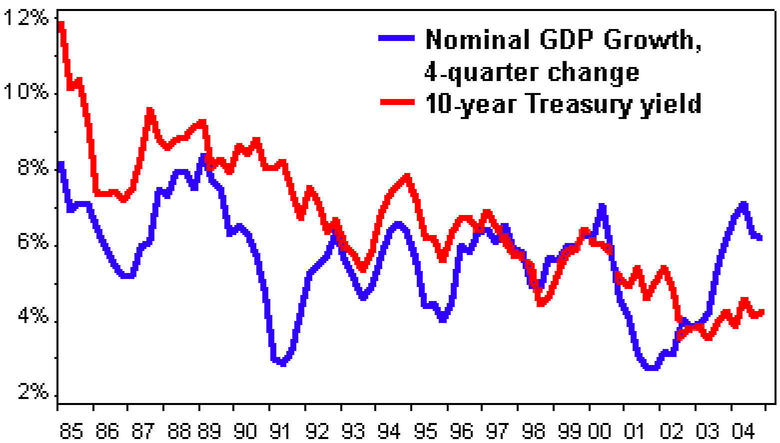
Part and parcel of the rationale keeping the curve-flatteners in play has also been the faith that inflation is unlikely to become much of a factor. But this conviction appears to overlook not only the forward-looking market-based gauges of likely price-level change but recent trends in current statistical inflation as well. Core CPI is now running at a rate of nearly 2.3%, up from 1.1% a year ago. Obviously, 2.3% core inflation is nothing to get terribly alarmed about in an absolute sense, but there is little reason to think the uptrend is close to running its course. The doubling of the core rate in the past year was the inevitable feed-through of the decline in dollar purchasing power indicated by gold and foreign exchange beginning three years ago. Over the past two years, on net, the dollar has lost some 25% of its value relative to gold, while the monetary metal has been trading more than 20% above its 10-year moving average for most of the past year. The last time gold maintained elevated levels for such an extended period was in the late 1980s, presaging an uptick in core inflation from 3.5% to more than 5.5%, and we expect a similarly sized bump in this case, from 1% to at least 3%.

Although there is little the Fed can do now to forestall the inflation created by its excessively easy policy stance from surfacing eventually, we have been encouraged by gold's roll-back and the dollar's strengthening since late last year. As we have noted, the reversal of the dollar's weakening trend accompanied indications that the central bank was becoming more cognizant of the inflation-risk environment, and thus less likely to call a too early end to this exercise. That would ensure that any inflation uptick remains fairly short-lived and does not become entrenched. We note, though, that on the heels of Wednesday's news giving rise to hope for less extensive Fed action, gold has popped about $8 higher to just below $420, and the dollar has weakened against its major-currency counterparts. The bet on the likely course of Fed action barely budged in yesterday's bond market blow-off, with the Eurodollar futures curve now leaning toward a year-end funds rate of 3.25%, up just 75 bps from the current level, after fully pricing for a 3.5% rate prior to the report of a "disappointing" gain of 146,000 payroll jobs last Friday.



One way or another, though, there appears almost no way out for long-dated issues at these levels. Even if one assumes core inflation stays near present levels, current yields offer an historically low risk premium. In fact, the nearby chart of the 10-year yield adjusted for year-on-year core CPI shows that when "real" yields reach levels below 2%, as they are now, a sharp reversal is virtually assured. It's true that bonds discount not only for current inflation but also expected and the risk of unexpected future inflation. Theoretically, the case could be made that if one expects inflation to fall from current levels, the real yield doesn't appear to be quite so low. Over the past 20 years, though, the core CPI-adjusted 10-year yield has averaged about 3.2%. Restoring that level while holding current nominal yields constant would imply a core-inflation assumption of less than 1%, which seems highly implausible. The greater likelihood is that if current expectations prove correct and the Fed is reticent about tightening policy to the extent required to quell incipient inflation pressures, the inflation breakout will be considerably worse than we currently expect, with potentially devastating implications for bonds. Indeed, the bond market's longer-run health will be better safeguarded by the Fed doing more, rather than less, in this policy cycle.

Then there is the argument that yields have been held down by a dampening of expected returns in a supposedly down-shifting economy. We find an absolute dearth of empirical support for this view. The indicators of capital formation and risk-bearing that we monitor to gauge the economy's engines of wealth creation and expansion show no signs of faltering. High-risk credit spreads, while up marginally from their best levels in more than six years at the beginning of the year, remain in highly positive territory, suggesting default risk is minimal and entrepreneurs have access to the capital they need to build high-growth enterprises. The IPO market just completed its best January in five years, with 10 new offerings coming to market raising $2.12 billion in capital. Such indicators of risk tolerance would be among the first to reflect a pulling back if the sustainability of the expansion were actually at risk.



The chart at left provides some perspective illustrating how unusual the bond market's recent performance has been relative to aggregate available returns. We use nominal GDP as a proxy for such economy-wide returns, and as can be seen, over the bulk of the past 20 years, the 10-year yield has shown more than a casual link with the pace of nominal growth. Until this most recent episode, the only exceptions to a fairly clear-cut relationship have come during periods such as 1989-91 and 2000-02 when the economy was weakening but the Fed was holding yields higher by keeping short rates up. The current situation is exactly the opposite, with bond yields being held well below levels indicated by economy-wide returns due to the Fed maintaining below-equilibrium overnight rates.

Bottom Line: The Treasury sell off yesterday could be the opening salvo of a long overdue reversal for a badly overbought market. The unrealistic expectations embedded in bond prices were highlighted by circumstances surrounding the downdraft, with auction participants balking at 10-year yields barely above 4% even as weekly initial unemployment claims printed at a new four-year low. The market's vulnerability at current levels is underscored by yields which fail to provide a normal premium reflecting both current and likely future inflation as well as by offering well below economy-wide returns. TM