TrendMacrolytics

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Brave New World?

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Bonds have mistakenly given up on growth -- but the Fed won't give up on rate hikes.

If **bonds** are rallying to eye-popping sub-4% levels on the supposition that a weakening economy will soon intervene to put an end to **the Fed's** rate-hiking cycle, it must also be the case that **equities** relish the prospect of a sharp **slowdown**. Today's trading offered a good snapshot of the past several weeks' dichotomy, as bonds soared on the softer than expected **ISM** survey, powered by a ratcheting lower of out-month rate expectations, and stocks rallied in train.

It's true, of course, that lower rates translate into higher discounted present value of expected earnings, so up to a point coinciding credit and equity market rallies make perfect sense. But only up to a point. At these yields, bonds are pricing for a real return tantamount to **recession**, which obviously would hardly be positive for future income streams. If the bond market is right, in other words, stocks are wrong. But we don't think the bond market is right. Available evidence strongly suggests that while the expansion may be slowing a bit to **growth** rates consistent with longer-run trends in the range of 3% to 3.5%, indications of a significantly deeper deceleration are lacking. Bonds, moreover, appear badly mispriced not only for sustained growth but for the still emerging **inflationary** consequences of the Fed's remaining too long in an ultra-accommodative policy mode.

Given the Fed's deeply flawed **output gap model**, under which it treats growth and inflation risks as virtually synonymous, we don't entirely rule out the possibility of a too early end to the policy normalization cycle due to concern about the economic outlook. At this point, though, our analysis finds scant support for the developing consensus that the Fed will be limited to just 50 basis points in additional rate hikes this year, leaving the **fed funds** rate at 3.5%. To the contrary, we continue to see the Fed remaining on its "measured" 25 basis point per meeting course, putting the funds rate at 4.25% by year end.

In our model, growth is the outcome of the **wealth creation** and **capital formation** processes that are rooted in **risk-bearing** activity. To gauge the economy's prospects for continued healthy expansion, we keep a close watch on various indicators of the proclivity of market participants to put capital at risk. By those measures, the economy appears poised to remain on a strong growth track. High yield debt, one of the more popular indicators of the market's appetite for risk, has had a somewhat bumpy course over the past few months. After bottoming out below 300 basis points in the "quest for yield" frenzy that peaked earlier this year, the **Merrill Lynch high-yield spread** widened out by late April to about 400 bps, a level still consistent with solid growth. Then, in the **hedge fund** panic several weeks ago, the spread jumped nearly 60 bps, as junk debt bore a disproportionate share of the selling. Since that fear has ebbed, however, the junk spread has come back to levels around 400 bps.

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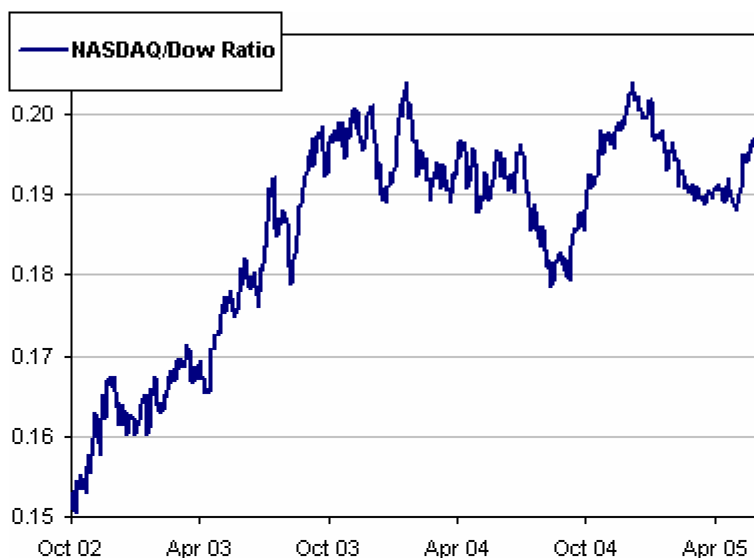

As another rough and ready gauge of the market's risk preference and growth expectations, we also monitor the performance of the higher risk **NASDAQ Composite** against the relatively less risky **Dow Jones Industrial Average.** The NASDAQ/Dow ratio recovered from 12-year lows in late 2002, presaging the impressive growth performance of the last couple years, before slumping again through the first several months of this year in accord with uncertainty over growth prospects. In the past month, however, the ratio has bounced back strongly, as higher risk market segments that were among the worst performers in the downturn have led the rebound. That also suggests the return of a healthy degree of economic optimism.

In speculation over the Fed's likely course, meanwhile, we are struck by what seems a nearly willful resistance to absorbing messages at odds with the story the market appears intent on telling itself. In recent weeks, no fewer than three Fed officials, including two voting **FOMC** members, have made comments suggesting that they see inflation risks tilting higher, requiring that rates continue to rise. In perhaps the clearest expression of this view, Fed governor **Donald Kohn** told a group last month that he expected inflation to remain "contained" as long as the central bank continued to raise rates. Kohn didn't specify the level that he would consider adequate to the task, but one measure helps to define the degree to which the Fed's job remains incomplete. In real terms, the current 3% funds rate target amounts to just 1.4%, using "**Greenspan's** favorite" inflation index, the **core PCE deflator**. Over the past 20 years, that real rate has averaged 2.5%, which suggests at least another 100 basis points in rate hikes, assuming that the year-over-year change in core PCE flattens out at current levels (it was below 1% as recently as late 2003).

The only remarks at odds with the apparent consensus came today when the new **Dallas Fed** president, **Richard Fisher**, told **CNBC** that the Fed is in "the eighth inning" of its tightening cycle, and entering the ninth. To extend the baseball analogy, however, Fisher is a rookie, and he's still feeling his way around the clubhouse. Among the Fed's regional banks, Dallas has long been at the dovish end of the spectrum. In any case, if the Fed wanted to send the markets a new message about its policy perspective, it's highly doubtful that Fisher would be the one to deliver it, especially with Greenspan due to testify before **Congress** next week.

Bottom Line: At current yields, long term bonds reflect a bet that economic growth will slow to recession-like levels, cutting short the Fed's rate-hiking cycle, while recent core inflation trends reverse course and return to sub-1% levels. All of that remains highly unlikely. By the indicators of risk preference we watch most closely, growth prospects remain solid. The Fed, moreover, acknowledges that inflation risks have risen, and the lagging, backward-looking inflation indexes have only begun to register the results of the Fed having remained too easy for too long. Bonds currently represent an asymmetric risk opportunity without recent precedent. TM