TrendMacrolytics

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Hearing Impaired?

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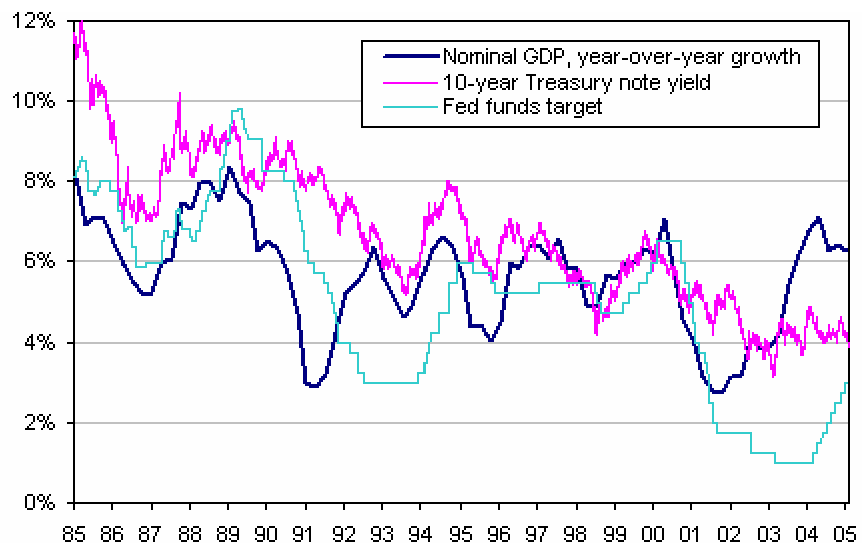
When Greenspan talks, bonds don't listen. Perhaps tomorrow he'll raise his voice.

Yesterday's half-point rally in **long-term Treasuries**, sending the **10-year yield** to 3.9%, was perhaps the clearest demonstration yet of the **bond market's** extraordinary penchant for telling itself what it wants to hear. Catalyst for this most recent buying binge was **Alan Greenspan**, in remarks Monday evening delivered via satellite to a conference in **Beijing**, noting that one "credible" hypothesis for long yields falling in the face of **Fed** rate hikes is that the "markets are signaling economic weakness."

In isolation, and without further elaboration, that *might* support an interpretation that Greenspan was contemplating a pause in the Fed's policy normalization process to mitigate any possible rate-induced **slowdown**. But the comment came in the context of a speech in which the Fed chief mused broadly on several possible explanations for the "unusual behavior" of **long-term rates**, none of which he found particularly compelling. In his next breath, in fact, he as much as dismissed the notion of bonds sending a slowdown signal, observing that the decline in yields has been a global phenomenon, and that "signs of buoyancy in some areas of the global economy have not arrested the fall in rates."

Most amazing, though, the market chose to entirely disregard comments by Greenspan which could have far more significance for the policy outlook. With the **10-2 yield curve** having flattened to30 basis points, a number of analysts have raised the prospect of the **curve inverting** with further Fed rate hikes, suggesting that such an event could foreshadow significant economic weakening. Greenspan, however, doesn't buy it. "I'm not sure what such a configuration, should it occur, would mean," he said in response to a question. "I'm reasonably certain we would not automatically assume that it would mean what it meant in the past." If Greenspan, then, is unpersuaded that a possible curve inversion is the economic risk perceived by some, he is unlikely to be constrained in further raising rates by fear of that inverted curve.



From our perspective, both the low level of yields and the flat curve are primarily due to the Fed maintaining

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below-equilibrium overnight rates. The market has become convinced that the Fed's still-accommodative stance is in itself indicative of a benign **inflation** perspective, which is helping dampen rate hike expectations, encouraging the curve-flattening. The chart on the previous page, plotting the funds rate and 10-year yield against **nominal GDP growth**, shows the degree to which rates have been held below normal economy-wide returns indicated by "money" GDP. The act of holding the funds rate so far below equilibrium for the past two-plus years has required the Fed to continue feeding surplus liquidity into the system, the consequence of which has only begun to appear in the badly lagging, backward-looking inflation indexes. As it becomes clear not only that an important part of the Fed's task remains undone, but also that the near-term inflation reality is being widely underestimated, we continue to expect a significant reversal both for bonds and the yield curve.

Greenspan has a good chance to begin clearing up some of these misconceptions when he appears before the **Joint Economic Committee** tomorrow, and we think he's likely to do so. For one thing, he figures to take a much more positive view of the sustainability of this expansion than is now priced into bonds. He's also likely to note the recent acceleration in **labor costs**, indicating that this has become more of a concern for policymakers, while also acknowledging that contemporaneous inflation data has turned somewhat higher. In apparent positioning for tomorrow's hearing, by mid-afternoon the bond market had given up nearly half of yesterday's gains. Bond holders, however, remain badly positioned for the kind of reality check that seems sure to come their way over the coming weeks and months.

Bottom Line: Yesterday's rally in long-term bonds on the misconstrued comments of Alan Greenspan was another indication of the market's stark mispricing for the current policy environment. Completely lost in the shuffle were clear indications that the Fed is unlikely to be constrained from raising rates further by fears of an inverted yield curve. Tomorrow's testimony by Greenspan before the Joint Economic Committee could be pivotal in compelling fixed income market players to begin realigning their expectations with reality. TM