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

MACROCOSM

Catch Up

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David Gitlitz

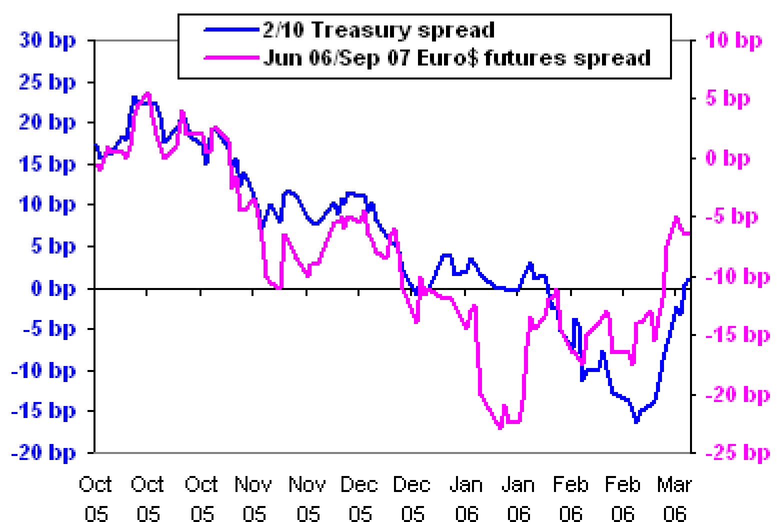
The big move down in bonds reflects both shifting Fed expectations and growing inflation worries.

Having already gone some way in recent trading toward catching up with a more plausible economic and policy outlook, the damage suffered by **bonds** on today's somewhat upwardly surprising **jobs data** was fairly limited, the **10-year Treasury** falling about a quarter point to **yield** 4.76%.

For our purposes, the more telling market response to the 240 thousand gain in **payroll jobs** last month came in the **gold** pits. After initially falling by about $10 to below $536, the gold price quickly recovered nearly half the loss to close at just below $540. The initial response probably reflected the assumption that chances of **the Fed** sustaining this **rate hiking cycle** until it reaches **monetary equilibrium** are enhanced by such a robust **labor market**. But the move in the most sensitive gauge of **real dollar strength** could not be fully sustained in the face of other indicators, including **interest rate futures**, showing the market continuing to price for a policy environment that is expected to remain **accommodative**. However, we see continued vulnerability for **longer maturity** issues as **expectations** inevitably shift toward a higher end-point for the **funds rate target** than is currently priced. At the same time, the market is showing some signs of awakening to the **inflation risk** that it has so readily ignored to this point.

Our supposition that bond yields were being held in check and the **yield curve** pushed into **inversion** on a misplaced bet that the Fed would be moving to **cut rates** fairly soon after concluding this **tightening exercise** has been borne out by recent events (see "Return of the Long Bond" February 10, 2006). The 10-year Treasury yield has popped to two-year highs and the curve inversion completely unwound as expectations for rate cutting reflected in longer-dated futures have been trimmed considerably.

In late February, as the curve inversion peaked at about 15 basis points, September '07 **Eurodollar futures** were priced for a 70% chance of a 25 bp rate cut relative to the yield reflected in the June '06 contract, which implied a 5% funds rate. In the interim, chances of a rate cut were reduced to about 25%, while the curve inversion reversed and the 10-year yield jumped some 25 bps. The chart at right, plotting the 2/10 yield



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

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

curve against the rate expectations captured in the spread between June '06 and September '07 Eurodollar futures, captures the sensitivity of the curve to those expectations since last fall.

We note as well that this bond sell-off has corresponded with marginal moves higher in expectations for the **peak funds rate** this year, although they remain in a range consistent with the rate topping out at 5%. That, we believe, is unlikely to hold up. Comments by **Fed officials** suggest that, if anything, the central bank is becoming more watchful regarding the economy's current strength. Some of the remarks appear aimed at signaling that current market expectations might not be entirely in tune with the developing policy consensus.

St. Louis Reserve Bank president William Poole gave a speech this week warning that "there is a great deal of momentum in the economy." He added that it was probably not "momentum of the sort that is going to run us off the rails. But I think it is momentum of the sort that says we're going to keep rolling down the expansion here, and you're not going to stop this freight train easily." Indicating that he is prepared to move policy beyond "neutral" if required, Poole said, "Should we get data in the coming months that are consistently strong, particularly if there are substantial upside surprises, then that says we're going to have to step a little harder on the brake." Given that key **macro indicators** are likely to run stronger than **the "central tendency"** of the FOMC outlined just last month in the Fed's **monetary policy report to Congress**, which called for "about" 3.5% GDP growth and 4.75% to 5% **unemployment** for the full year, chances that incoming data will be viewed as **"upside surprises"** seem fairly good.

Such **demand management** criteria are at the core of the Fed's policy development function, but policymakers to varying degrees are known to keep an eye on a few market-based indicators as a feedback loop. One is the spread between **inflation-indexed Treasuries** and **nominal bonds** -- the so-called **TIPS spread** -- which can be seen as a rough proxy for shifts in the market's inflation expectations. While late last year the 10-year TIPS spread was below 230 bps, its has since widened out to about 255 bps. That indicates that of the 40 bps in yield tacked on to the 10-year Treasury so far this year, fully 25 bps -- or more than 60% -- can be explained as a **higher inflation premium**. At one level, the higher premium can be seen as an inkling of the market's nascent inflation cognizance. At the same time, to the extent the spread is considered salient by the Fed, at this point it is certainly not signaling that the **policy normalization** task is near completion.

Bottom line: Bonds have taken a hit on growing recognition that the Fed is not likely to move into rate-cutting mode soon after it concludes its rate-hiking exercise, a reality that also has been reflected in a reversal of the yield curve inversion. Still, even as the market moves toward a more rational expectations setting, it continues to price for an end-point in the process that would see policy remain accommodative. But we see those expectations as vulnerable to further significant repricing, which implies additional considerable downside risk for fixed income assets. TM