TrendMacrolytics

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Here We Go Again

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Bonds are making yet another bad bet that the economy is slowing, and that the Fed is done.

Update to strategic view
BONDS: The rally at the long end of the curve is a misplaced bet on a slowing economy and a Fed that will soon end the present rate-hiking cycle. We forecast no economic slowing, and expect the Fed to keep hiking rates without pause. **FED FUNDS:** No pause in rate hikes for at least two more FOMC meetings.

Fixed income markets are today continuing to unwind some of the manic trading of the past several days that at its height yesterday briefly drove the 10-year Treasury yield back below 5% intraday. Certainly, the possibility of another foray to those levels, or lower, can't be excluded given the intense volatility that has infected the market. However, the bullish case for bonds is essentially built on the same flawed logic that drove the short-lived yield curve inversion earlier this year, and we expect this episode to end no better for the bulls.

The story being peddled to rationalize this latest bond rally has an all-too-familiar ring: despite a dearth of evidence available to support the notion, the economy is living on borrowed time, and should start showing clear signs of faltering any day now. The cooling housing market, high gasoline prices and the effect of the Fed's rate hikes to date are all converging to take the starch out of an economy that registered growth of 4.8% in the first quarter. The fact that there is nary a trace anywhere of confirmation for this dour view matters not. What matters is getting enough players in the market, supported by faulty conventional economic wisdom and an ever-helpful media, to buy into the tale of economic woe -- and it's off to the races.

Cutting through all the cross-talk and punditry, what it comes down to is a bet that the Fed will not only be precluded from raising rates beyond potentially one more 25 basis point move, but will soon be compelled to begin cutting rates to head off the weakness. Much like the rally in long-term debt that culminated in the yield curve inversion last winter, this most recent decline of yields at the long end of the curve has corresponded with out-month futures beginning to price for rate cuts next year. And in a peculiar -- some would say perverse -- twist, much of this bet has been placed since the consumer price data last week provided fresh evidence of the inflationary consequences of the Fed's long-standing easy-money posture (see "Coming Home to Roost" May 18, 2006). The Euro-dollar futures curve is today discounting for an overnight rate between 5% and 5.25% by this fall, and shows about a 40% chance of a cut in the rate by September '07. As of May 15, two days prior to the CPI release, the '06/'07 futures curve showed a slight chance of a rate hike. The thinking seems to be that if the Fed responds to the indications of rising inflation with higher rates, it will further weaken the economy, forcing it to cuts rates.

The recent price break in commodity markets has also played into the rationale for an obliging Fed, seen as an indication of slower growth to come as well as a sign that inflation concerns have been overdone. It's more likely, though, that after an extraordinary run, the commodity rollover simply reflects the inevitable blow-off of speculative forces. As for the notion that the price pull-back might reflect a slackening of inflationary pressures, we'd note that gold, the most inflation-sensitive of all commodities, is still trading at nearly double its 10-year moving average of $340 even after falling from its peak around $720 earlier this month. It's worth noting as well that gold and other sensitive commodities have come well off their recent lows in the midst of mounting speculation that monetary policy might be forestalled from doing what still needs to be done.

BOTTOM LINE: The 10-year Treasury today is yielding slightly above 5.05%, having rallied from a four-year high of 5.20% in just over the past week on the notion that a slowing economy will soon see the Fed ending its rate-hiking exercise, and possibly move to cut rates by sometime next year. In essence, the speculation represents a bet that the Fed will face a choice of whether to squelch inflation or support growth, and will opt for growth. We don't see it that way. An avowedly "data dependent" Fed, we think, will remain in rate-hiking mode for at least the next few meetings as the data will give very little support to the economic bears. We continue to see policy equilibrium in the current economic environment being in a range of 5.5% to 6%, and see the Fed risking significant inflationary error if it stops short of that level. In the longer run, the worst thing the Fed could do from the perspective of sustaining growth would be to end this policy cycle prematurely, sanctioning a sharp price-level run up which would then have to be met by an aggressive tightening response. TM