TrendMacrolytics

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Racing to the Cliff's Edge

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Now more than ever, bonds are riding for a fall -- the economy isn't weakening and the Fed's not going to ease.

Update to strategic view
US BONDS: Rallying bonds are making two mistaken bets: on a near-term slowdown that isn't really happening, and on rate cuts from a Fed that is signaling it's not ready to ease. The case for shorting bonds is stronger than ever.
[see Investment Strategy Dashboard]

Among those hoping the Fed would show more concern about growth than inflation, yesterday's FOMC statement briefly registered as marginally hawkish. Immediately after the statement's release, the small gains that had been seen at the long end of the curve were erased. But despite the lack of any encouragement from policymakers, fixed income markets are today upping their bet that the Fed's next move will be to cut rates, extending to 60 basis points the inversion of the curve between the fed funds target and the 10-year Treasury. This rate cut bet represents the first order of vulnerability for a deeply overbought bond market. A major whipsawing of the market figures to come when expectations shift again from rate-cutting to rate-hiking, which could happen as early as the run-up to the next FOMC session on October 24.

While yesterday's statement evinced no major shift in the policy setting, it was noteworthy that in probably its most significant modification, the central bank essentially upgraded its growth outlook by removing references to energy prices and interest rates as factors restraining growth. Following the first rate-hiking pause in 18 meetings on August 8, the post-meeting statement said, "Economic growth has moderated from its quite strong pace earlier this year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in energy prices and interest rates." In yesterday's statement, the Fed asserted simply that the "moderation in economic growth appears to be continuing, partly reflecting a cooling of the housing market." As we have noted, the oil price decline presents conflicting policy signals -- reducing cost-push inflation pressures on one hand but boosting growth on the other, feeding into what the Fed considers inflationary rates of "resource utilization" (see "Immaculate Consumption" September 20, 2006). Yesterday's statement also noted the "reduced impetus from energy prices" on inflation pressures, but given that the rationale for the current pause rests primarily on the Fed's anticipation of a marked near-term growth slowdown -- which it expects will reduce inflation over time -- the growth effect of the energy price decline is probably more significant at this point.

As for interest rates, it could well be that the Fed now sees the decline in market rates over the past three months as an enhancement to aggregate demand growth, which hardly fits with its program. In fact, the recent decline in mortgage rates -- with 30-year fixed rates down nearly 40 bps to below 5.9% -- could also significantly ease the housing slump upon which rests so much of the bond market's hopes for broader economic deterioration. But the market is also feeding back on itself, continuing to push prices higher and yields lower on the notion that the curve

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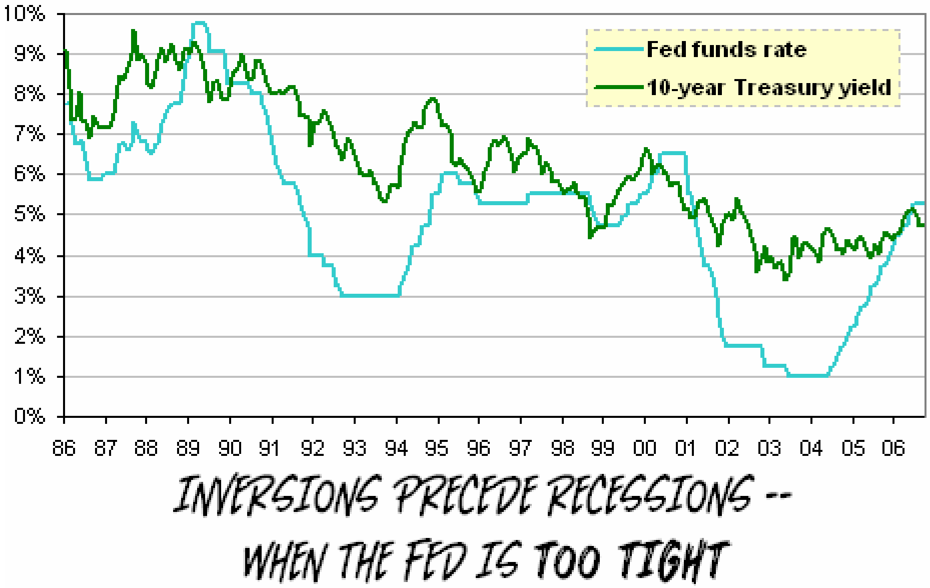

inversion must reflect a tight Fed which is sure to bring rate cuts as growth slows. It's true that significant inversions over the past two decades have correctly anticipated subsequent Fed rate cuts (see chart at left). But it's also true that on those occasions policy was far tighter than it is now. The 2000 inversion came when the Fed pushed the real funds rate to 4%, with a 6.5% nominal rate against core inflation running at about 2.5% year-on-year. In 1989, the real rate got as high as 5%, with the Fed's hikes topping out at 9.75%. By contrast, the current 5.25% funds rate amounts to a real rate of less than 2.5%. Rather than being tight, the Fed remains accommodative.

The recent roll-over of certain commodity prices -- particularly gold and oil -- is also contributing to a sense among some observers that the Fed has done enough, and perhaps is on the cusp of doing too much. From our perspective, these price moves appear more as corrections in a general uptrend than the outbreak of a bear market. At about $580, gold is back to where it was in late March, after rallying more than $100 from last fall. Gold at those levels was hardly giving us comfort about the inflation implications then, and is not doing so now. Were the lower prices a reflection of the Fed restoring monetary equilibrium, we'd see a steady decline in gold back toward the sub-$400 levels prevailing prior to adoption of an excessively easy posture three years ago. Moreover, we hardly are witnessing a generalized trend of lower commodity prices. The CRB Spot index, which does not include oil or gold, is down only 1% from its record highs earlier this month, and is up more than 16% year-on-year.

BOTTOM LINE: Bonds are off to the races again today, as a weak-looking Philadelphia Fed manufacturing index at -0.4 powers up expectations that the Fed will be moving to cut rates starting in the first quarter next year. The Philly index was last negative in June 2005, which didn't herald a manufacturing slump then, and in all probability won't now. Core capital goods orders are growing year-on-year by 13%, and manufacturing output is up more than 5%. But the market, it seems, is growing adept at telling itself only what it wants to hear. A clear-eyed look at yesterday's FOMC statement, for example, suggests policymakers were intent on not signaling a growing possibility of near-term rate cuts, eliminating references to energy prices and interest rates as growth-inhibiting. We don't believe the Fed will ease without a precipitous growth slump, and we see no indication that such a slowdown is in the works. Much more likely than not, the Fed's output gap models will be taken aback by the "surprising" growth reacceleration we see as now in the works, and the central bank is likely to be raising rates again, potentially by next month. Bonds are toast. TM