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When Doves Cry

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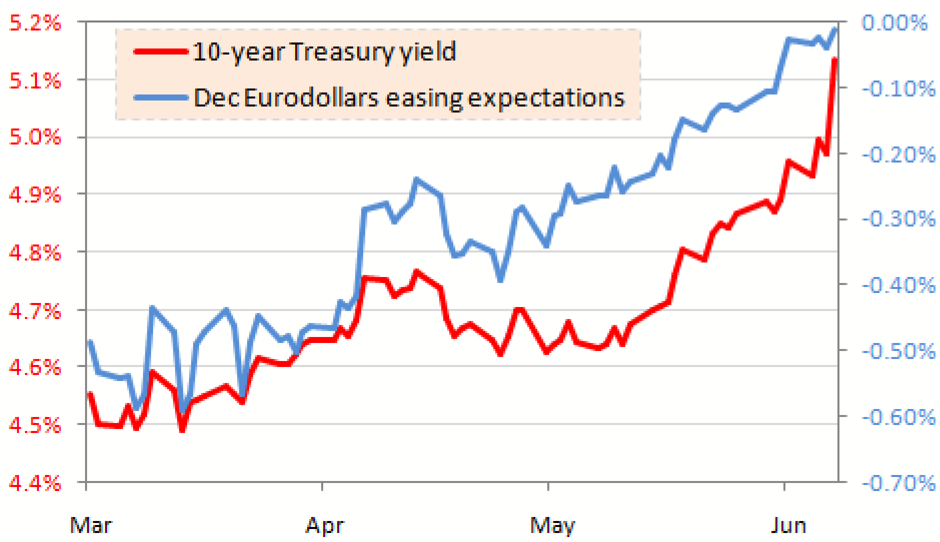
Bill Gross brings up the rear of the capitulation parade. But it's just beginning -- bonds will have to brace for Fed rate hikes.

The capitulation of the bond bulls was rendered complete yesterday when long-time uber-bull Bill Gross abandoned his long bond call, and said he's now a "bear market manager." The PIMCO bond chief's surrender came on the heels of the keepers of conventional economic wisdom at Merrill Lynch, Goldman Sachs and ISI all vacating their forecasts of Fed rate cuts this year (see "Doves Eat Crow" June 6, 2007). With bonds having fallen so far so fast -- at 5.14% the 10-year Treasury yield at yesterday's close was 50 basis points above its levels just one month ago -- a period of some short-run consolidation or retracement might be in store, if for no other reason than to punish the capitulators Any such respite, however, is unlikely to long keep yields from first moving into rough equilibrium with the current 5.25% overnight rate, and likely get pushed up further as the speculative environment turns from ditching any rate cut hopes to placing early bets on the probability of forthcoming rate hikes.

Update to strategic view

US BONDS: After widespread capitulation by bond bulls on prospects for Fed rate cuts, long Treasuries may be due for consolidation or retracement. But with cuts off the table, the 10-year is destined to at least reach parity with the funds rate. As rate hike expectations begin to infiltrate expectations, the curve will steepen and long-term rates will move even higher.

[see Investment Strategy Dashboard]



From our analytical perspective, it's no mere coincidence that this bear market in bonds commenced with the May 9 FOMC meeting (see "Retail No Relief for Economic Bears" May 11, 2007). While yields up to that point had drifted about 15 basis points higher from their March lows

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below 4.50% on signs the economy was not as weak as the bond bulls had hoped, the Fed on that day landed a big blow against the notion of any rate cuts being in prospect. In its post-meeting statement, the Fed reiterated its previous warning that the "predominant policy concern remains the risk that inflation will fail to moderate as expected," failing to give any nod to the crowd contending that soft growth would soon compel the central bank to sanction lower rates. And in the minutes of the meeting released last week, it was clear that policymakers harbor considerable unease about the labor market's failure thus far to show more slack in the face of the reported growth deceleration seen in recent quarters (see "Rodney Revisited" May 29, 2007). In the Fed's archaic demand-based model, an unemployment rate of 4.5% is indicative of a perilous degree of "resource utilization," underscoring its perceptions of heightened inflation risk.

We have fundamental differences with the Fed's formulations about the sources of inflation, and believe the Fed has failed to sufficiently remove the impulses pointing to a rising price level by keeping policy on hold the past year, but it's at least heartening to note the response of various market indicators to signs that the possibility of easing is off the table. The firming of dollar purchasing power seen in the 5% decline in the price of gold and the more modest rise in the dollar's forex value tell us that while inflationary influences remain at work, the expectations shift has had the effect of reducing the market's inflation risk premium. Restoring monetary equilibrium, which would be evident in a sustained reversal of the gold price rally from current levels around $650 toward a range back below $500, and a concomitant appreciation of the dollar in forex markets, likely will require the funds rate rising to a level no lower than 6%.

At this point, the prospect of such an eventuality is nowhere in sight. Currently, the Eurodollar futures curve shows nothing more than a 50% chance of even one rate hike before December 2009. We expect that to change however, and with signs of a resurgence in growth and core inflation remaining at uncomfortable levels for Fed officials, a resumption of rate hikes is likely by the latter part of the year. Expectations for higher rates could begin to show up considerably sooner. Highly speculative futures markets don't stand still for long. Once they have completely priced out any chance of lower rates -- the June '08 Eurodollar contract today is still showing about a 20% chance of a 25 basis point rate cut -- the expectations markets are likely to begin shifting to pricing odds for rate hikes.

One effect of such an expectations shift is likely to be a further steepening of the yield curve. The blowout at the long end has already seen the curve steepen by about 17 bps just this week, with the 2/10 spread jumping to about 13 bps from a 4 bp inversion. This confirms our contention that rather than being a manifestation of tight monetary policy, the slight curve inversion of the past year or so has reflected the rate-cut expectations priced into long maturities. With those expectations now having been almost completely unwound, and likely to be replaced by expectations for rate hikes in fairly short order, the last of the curve inversion for this cycle has in all probability been seen.

BOTTOM LINE: As we have been expecting for months, the resilience of this economy and continued cognizance of inflation risk at the Fed has -- for all practical purposes -- put an end to easing expectations, with the long end of the Treasury yield curve bearing the brunt of this reckoning with reality. Going forward, we see expectations evolving to bring forward what are now far-dated probabilities for rate hikes, with continued bearish implications for bonds. At this point, the realistic scope for additional Fed action should not pose a meaningful threat to the sustainability of the expansion. But we don't rule out the possibility that a more aggressive course of action may be required to root out the inflationary influences embedded by a still-accommodative Fed, in which case the economy could well be a casualty.