Trend Macro

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FED SHADOW

Thrown A Curve

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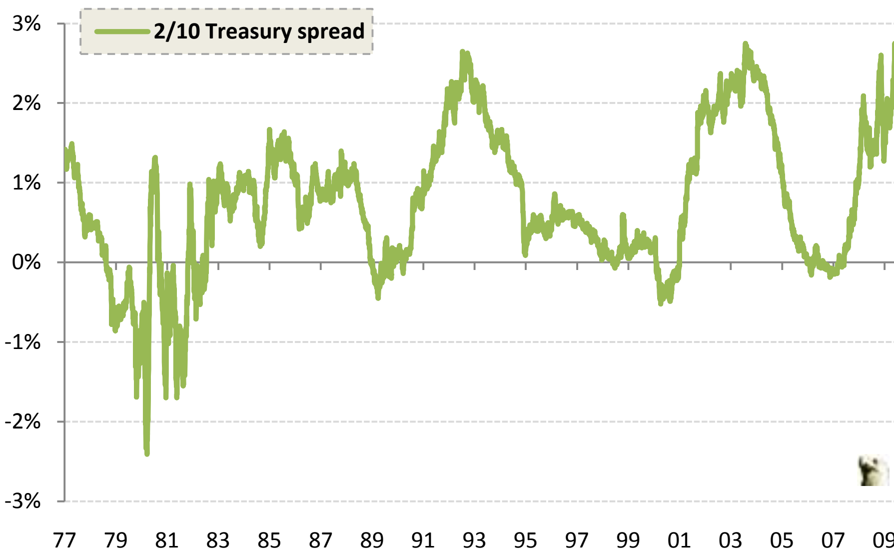
A record 2-10 Treasury spread shouts "inflation," but the Fed can't hear it.

Update to strategic view

US BONDS: The sharp steepening of the yield curve is a classic indicator of a rising inflation premium at the long end. We expect that the Fed will at some point ramp up its Treasury purchases to keep the long end in check. That may be a short-term palliative, but by extending its monetization of the national debt, on top of its other asset-purchase programs, the Fed will further aggravate the inflation outlook, implying an even steeper curve going forward.

[see Investment Strategy Dashboard]

Notwithstanding the snap-back rally in long-dated Treasuries late last week from their shellacking at mid-week, the bond-market has endured a head-spinning downturn in recent weeks, with the 10-year yield now up some 80 bp on net over the past six weeks. To be sure, this has to a notable extent been a process of normalization from the safe-haven demand and deflation fears which had dominated a crisis-wracked market (see "Green Overshoots" May 29, 2009). And in absolute terms, a 10-year yield around 3.5% is still more than 100 bp below average for the last decade. But the pop higher in yields has been nearly matched by a widening of the yield curve, which points to something more at work than simply a calming of the market's worst fears.



At last Wednesday's peak of 275 bp, the 2-10 Treasury spread is the steepest on record -- since the Fed started keeping constant maturity data in 1976, thus capturing the worst of the high inflation years -- and even with its narrowing as of this writing to 265 bp, the curve has rarely been this steep. What is notable about this sudden steepening -- the

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curve was at 149 bp at year-end -- is that it is almost entirely explained by the long end of the curve. Previous sharp steepenings were led by a reduction in short-term rates in response to Fed easing. But this time, the short end of the curve has pretty much been flat since late last year, with the Fed already cut as much as it can with the Fed funds rate set at zero.

The rising premium in long maturities is the market's message that inflation is increasingly becoming a pressing concern. Were inflation not a factor, the 2-10 spread would likely have widened out modestly to below 200 bp, the level seen last year before the outbreak of the worst of the crisis. With the intensification of the panic and mounting deflation anxieties, the curve contracted to below 125 bp at its lows late last year. The most intense phase of the current curve widening has come since mid-April, when the spread was still below 200 bp, a period during which our leading inflation indicator, the price of gold, has also rallied by more than $100 to above $975.

This period has also coincided with a sting of pronouncements by various Fed officials that, while acknowledging the huge expansion of the Fed's balance sheet will require an expeditious unwinding at some point to maintain price stability, at the same time express considerable ambivalence about confronting the task. Typically, in a speech last month, Fed chairman Ben Bernanke said that while policymakers are "committed to removing accommodation" in a timely way, he also said the Fed faces tough decisions when that time comes. And whenever that may be, we believe it's unlikely to be anytime soon. At the same event, Bernanke said that while he sees the risk of deflation "receding," the Fed must remain "very aggressive" to guard against it.

The most immediate question raised by the contretemps at the long end is to what extent the Fed will feel compelled to up its Treasury purchases and attempt to restrain the rise in yields. The Fed has used nearly half the $300 billion it has so far committed to acquiring Treasuries, but has left the door open to purchasing more. According to a story in Friday's *Wall Street Journal*, Fed officials "believe the recent sharp rise in yields on U.S. Treasury bonds could reflect a mending economy and a receding risk of financial catastrophe, suggesting the central bank won't rush to react." But, according to the same story, "Fed officials could see the bond market as endangering the economy by prematurely pushing up yields because of market dysfunction or unfounded fears of inflation." If that's the case, the Fed could expand its Treasury buying program. But if this story is accurate, it offers disconcerting insight into the mindset at the Fed. It indicates that Fed officials are dismissing any possibility that bonds are pricing for higher inflation; they're only entertaining the possibility that the market may be showing "unfounded fears" of inflation. That's particularly ironic, because if the Fed increases its purchases on that basis, it will only even more deeply entrench the long-run inflationary impulses. This *Journal* story was likely a key factor in Friday's $20 rally in the price of gold.

There are voices within the Fed calling for even more aggressive action and suggesting the ultra-easy posture should be maintained indefinitely. Glenn Rudebusch, senior vice president of the San Francisco Fed, writes of a "funds rate shortfall" which implies that "the funds rate should be near its zero lower bound not just for the next six or nine months but for several years." This "shortfall" is based on Rudebusch's calculation that under current circumstances the Taylor rule would posit that the funds rate be set at -5.0% -- to be clear, a *negative* rate. But since the nominal rate cannot be set below zero, there is a 5% "monetary policy funds rate shortfall," and any recovery is likely to be a slow one, unlikely to absorb the economy's "slack" for many months. Actually, John Taylor himself, the Stanford professor who invented the rule, says his current reading would put the funds rate at a positive 0.5%. In any case, Rudebusch's thinking is likely not outside the mainstream within the Fed. He contends that the Fed's balance sheet expansion has "only partially offset the funds rate shortfall," implying that the growth in assets

since last September -- from less than $900 billion to more than $2 trillion -- has not been forceful enough.

BOTTOM LINE: The sharp steepening of the yield curve is a classic indicator of a rising inflation premium at the long end. We expect that the Fed will at some point ramp up its Treasury purchases in attempting to keep the long end in check. That may be a short-term palliative, but by extending its monetization of the national debt, on top of its other asset-purchase programs, the Fed will further aggravate the inflation outlook, implying an even steeper curve going forward.