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COMMENTARY

Market Opinions And Topics Of Interest
February 23, 2000

Our Take on the Bond Market in 2000 Part 2: How Far Will the Yield Curve Invert?

"[Federal Reserve Chairman Alan Greenspan] strongly hinted that more interest rate increases are on the way to cool things off. Given that hint, investors have priced in an expectation that the Fed will raise its 5.75 percent target for overnight rates by a quarter-percentage point in March, May and early July."—The Washington Post, John Berry's "Basis Point" Column, February 20, 2000

In Part 1 of this commentary, we presented our reasons for the recent yield curve inversion. They were:

- Few leveraged bond traders (i.e., dealers and hedge funds) make bets on the direction of interest rates. Instead, they place their bets on the direction of spreads (i.e., "convergence trade"); the shape of the yield curve (flattening or steepening); or those sectors of the fixed-income market they feel will outperform a benchmark index ("sector bets").
- At the end of 1999, leveraged traders were making a huge bet that the yield curve would steepen. The assumption for such a bet was that the Fed would soon be done tightening, and short-term interest rates would fall. This would cause the yield curve to steepen.
- In early January, the belief that the Fed would soon be done tightening changed dramatically. Consensus opinion concluded that the Fed was going to get aggressive, "Greenspan style." The Fed would hike the funds rate 25 bps at every meeting until the economy appreciably slowed.
- The reduction in supply and the Treasury buyback announcements were not the cause for the dramatic yield curve flattening (and now massive inversion). They were more like "pouring gasoline on an existing fire" than "causing the fire."

In Part 2, we will discuss how far the yield curve can invert.

How aggressive is the Fed going to get?

We singled out the above quote because we believe it accurately captures consensus opinion about Greenspan's Humphrey-Hawkins testimony. It seems the marketplace was surprised about his comments on the stock market, the growth of the economy and the role of productivity. They now conclude that the Fed is "poised" to raise rates assertively.

The idea that the Fed is going to get aggressive in raising rates should come as no surprise. As Chart 1 shows, the fed funds futures market has discounted the likelihood of a Fed tightening at the March and May meetings for months (odds better than 100% mean that these futures contracts are discounting the potential of a 50 basis point hike). Furthermore, the July contract is putting the odds of a 25 basis point hike at the June 28 meeting at 80% and the September contract is putting the odds of an August 22 hike at 60%. **This means that the fed funds futures market, which has the best forecasting record around, is discounting a Fed hike at every FOMC meeting between now and Labor Day.**

Another example that the marketplace senses the new assertiveness of the Fed can be found in chart 2. The move higher in swap rates for the last few weeks has been closely tracking the shifting consensus regarding the Fed's intentions. Since swap rates are merely an exchange of cash flows, this means that one's opinion regarding the direction of interest rates plays heavily into the calculation of swap rates. Now that the marketplace believes that the Fed is getting aggressive, swap rates are feeling the impact.

Conclusion

The marketplace is coming to the realization that the Fed is going to raise rates at every FOMC meeting until the economy slows. As this attitude gains wider acceptance, we believe the yield curve will stay inverted and, in all likelihood, will invert further. The curve inversion will continue as long as the economy stays strong. It will approach its eventual extreme only when the economy slows enough to change the outlook for additional Fed tightening.

We feel it is also important to watch the 5-year to 2-year yield spread. This is shown in chart 3. Should this yield curve invert, it would signal that the entire

coupon yield curve is "properly" inverted. We believe this would confirm our view that more than the Treasury buyback is at play on the yield curve. We fully expect this yield curve to invert in the coming weeks. Such an occurrence will only add credence to our conclusion that the yield curve inversion is the result of an aggressive Fed and a strong economy, and not from a reduction in supply and the Treasury buyback announcements.

In Part 3, we will discuss the effects of reduced supply on the bond market.

Chart 1

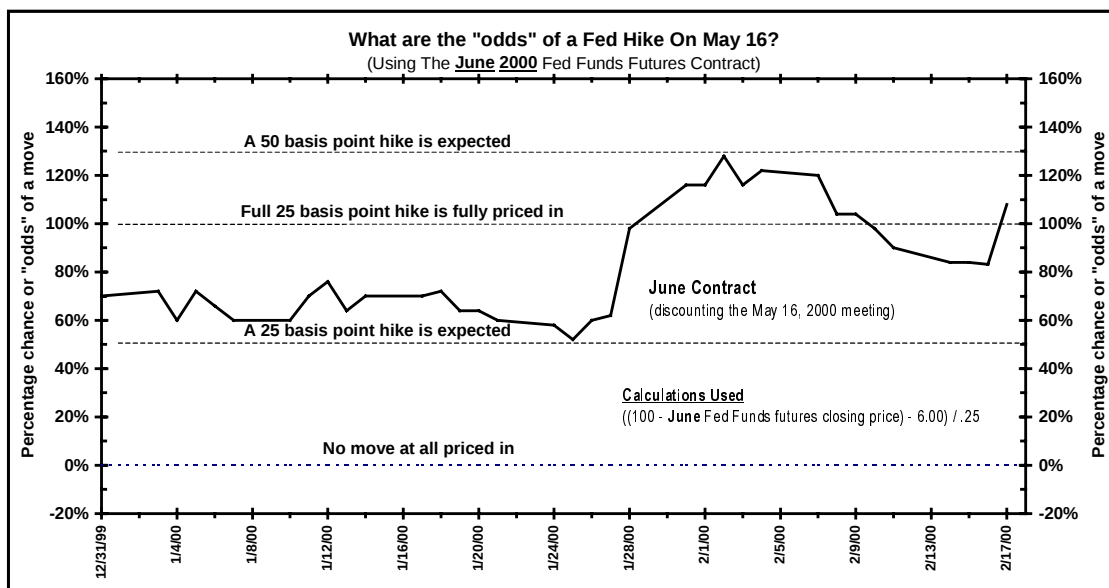
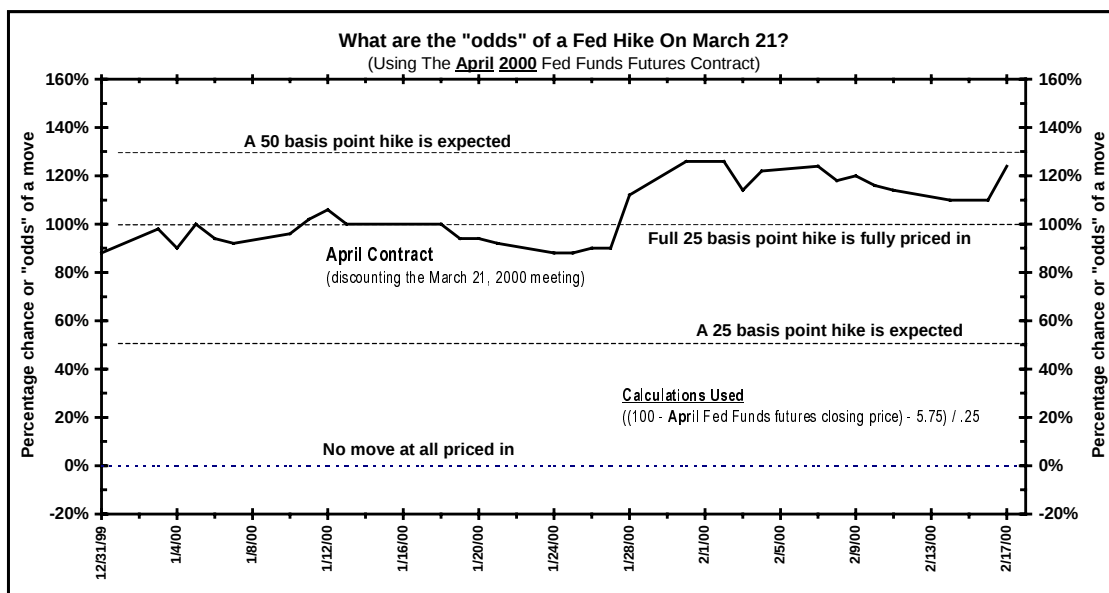


Chart 1 continued

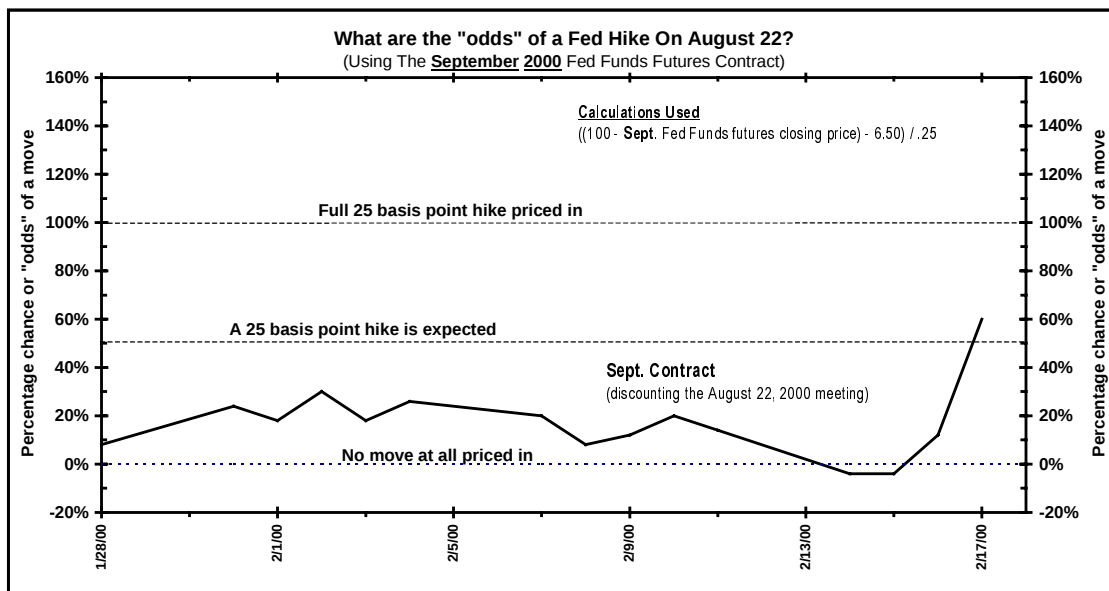
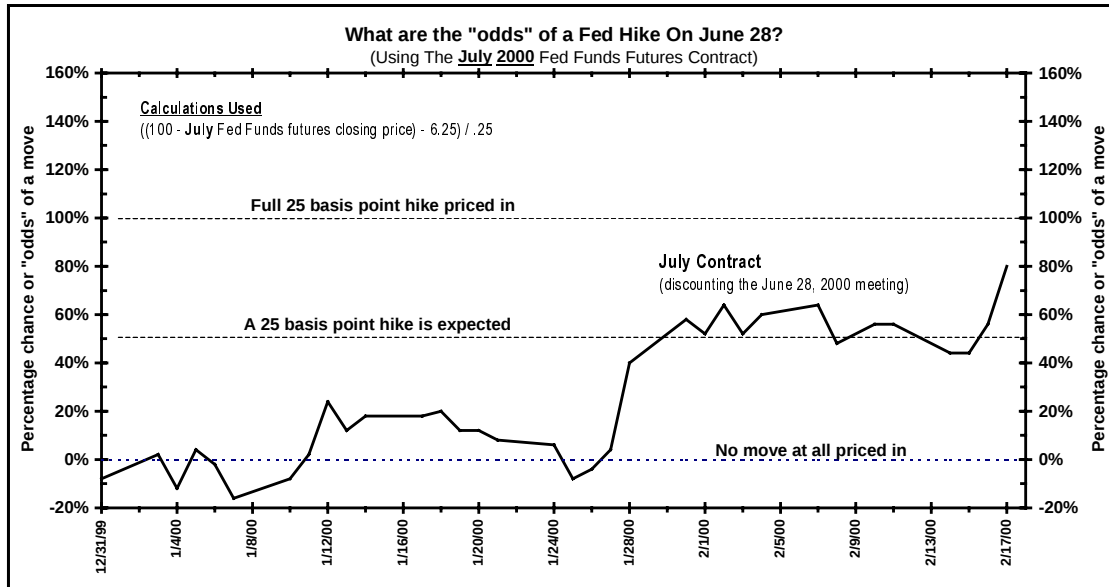


Chart 2

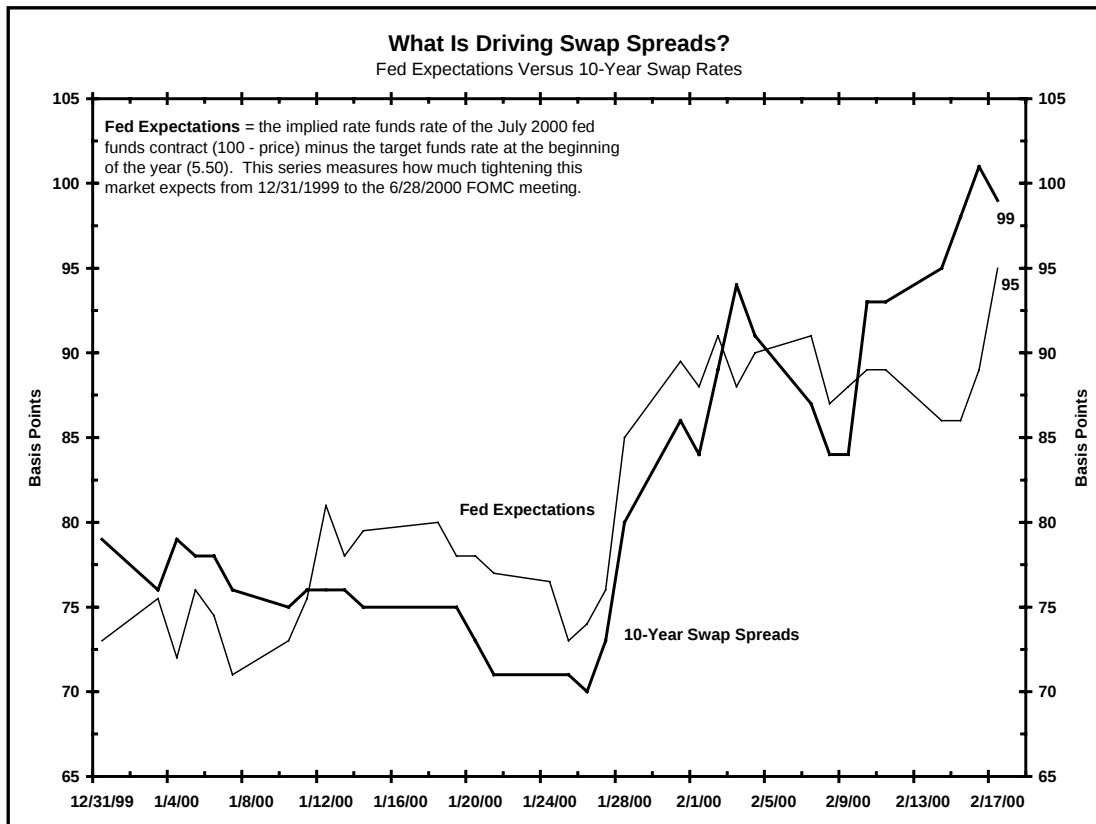


Chart 3

