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Commentary

Market Opinions and Topics of Interest

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The Fed Still Doesn't Get It!

The Committee continues to believe that an accommodative stance of monetary policy, coupled with still-robust underlying growth in productivity, is providing important ongoing support to economic activity. The evidence accumulated over the intermeeting period shows that spending is firming, although labor market indicators are mixed. Business pricing power and increases in core consumer prices remain muted.

The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. In contrast, the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation from its already low level. ***The Committee judges that, on balance, the risk of inflation becoming undesirably low is likely to be the predominant concern for the foreseeable future. In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period***. [our emphasis]

FOMC Statement, August 12, 2003

On June 25, the FOMC cut the targeted federal fund rates 25 basis points to 1.00%. Bonds fell over three points – their worst reaction to an ease in the history of the Greenspan Fed. On July 15, Greenspan spoke about the economy. In his testimony, twice he said:

> *The FOMC stands prepared to maintain a highly accommodative stance of policy for as long as needed to promote satisfactory economic performance.*

That day bonds fell over two points, their worst reaction to any of Greenspan's 171 testimonies since becoming Fed chairman in August 1987.

Tuesday, the Fed re-iterated its dovish talk as highlighted above. Yesterday bonds collapsed over 2 ½ points.

Do you detect a trend? More importantly, does the Fed detect a trend? Right now one has to conclude that the Fed either wants the bond market to collapse (something we find impossible to believe) or they are clueless as to the bond market's message. Clueless seems to be the order of the day.

The tone of some recent news articles is that the Fed must make clear their intentions. We believe the Fed's intentions are crystal clear -- they intend on fighting deflation by creating inflation. The problem is not ambiguity. Rather, we believe the bond market knows exactly what the Fed is doing (conducting a growth strategy at any cost) and doesn't like it at all. The Fed doesn't need more explanation - it needs to change policy more to the liking of the bond market. It had a chance Tuesday and did not elect to do so. Bonds collapsed as the Fed is ignoring its wishes. No one should be surprised.

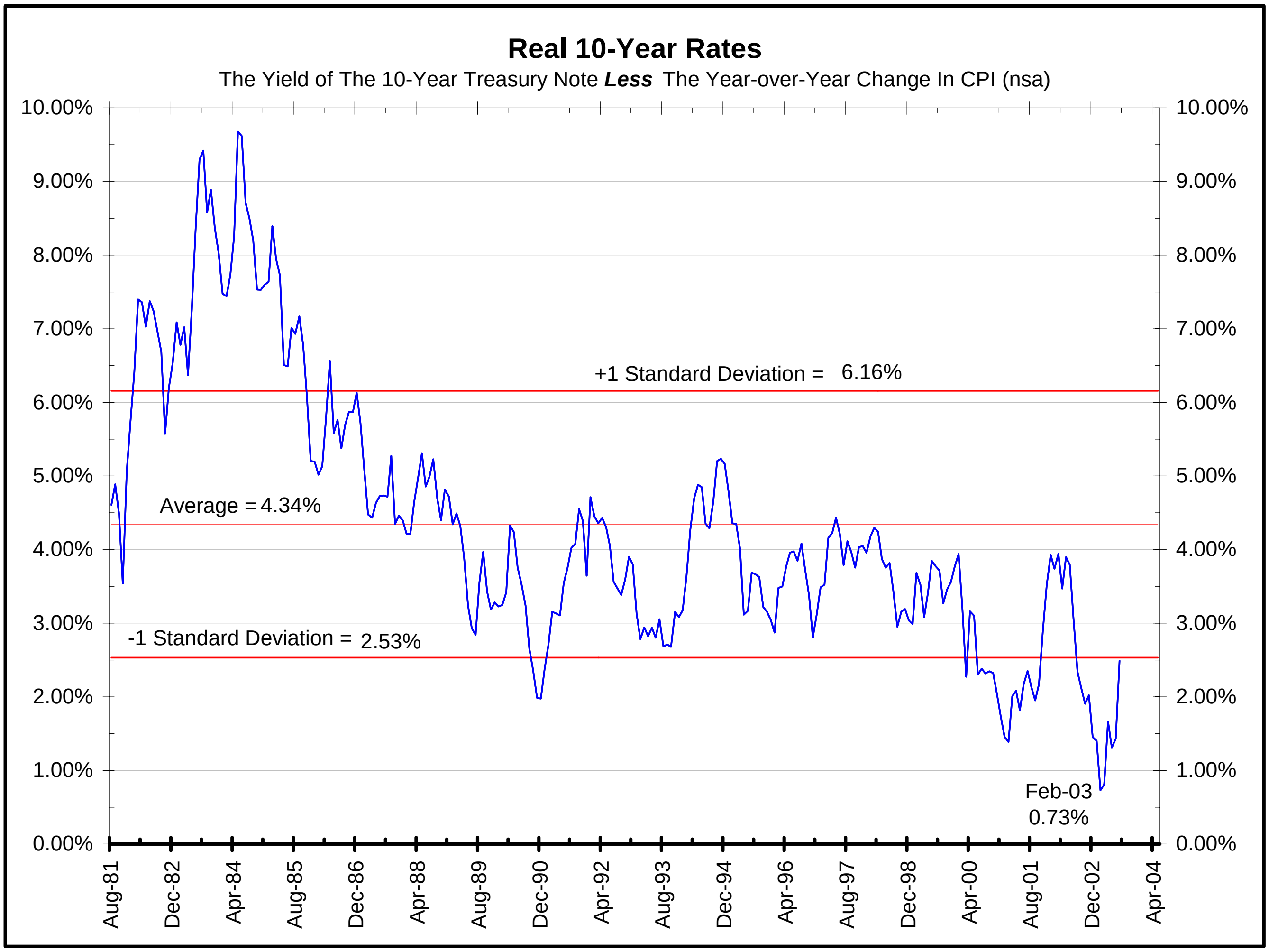
What Doesn't The Bond Market Like?

The Fed's turnabout from inflation fighter to deflation fighter marks one of the most significant shifts in monetary policy over the last 25 years. At least, this is the way the bond market views it.

The problem is the bond market was not at all prepared for this shift. The marketplace, like the Federal Reserve, believed inflation was dead. So, it removed most of the inflation premium it had built into interest rates. Now that the Fed is trying to create inflation, the market is trying to build an inflation premium back into bonds. Couple this with the volatility-enhancing convexity trade, and this major policy shift is having a huge effect on the bond market.

The chart below shows the "real" 10-year interest rate (10-year yields less the year-over-year change in CPI), beginning on September 1981 (the start of the secular bull market). Earlier this year, before the

May 6 FOMC announcement that the Fed was abandoning the inflation fight to take on the deflation fight (or, adopting "the Bernanke view"), real interest rates had slumped to their lowest levels since the secular bull market began. At that point, the bond market thought everything was fine – the Fed was ever vigilant about inflation and, since it was nowhere in sight, real interest rates could slump to record bull market lows.



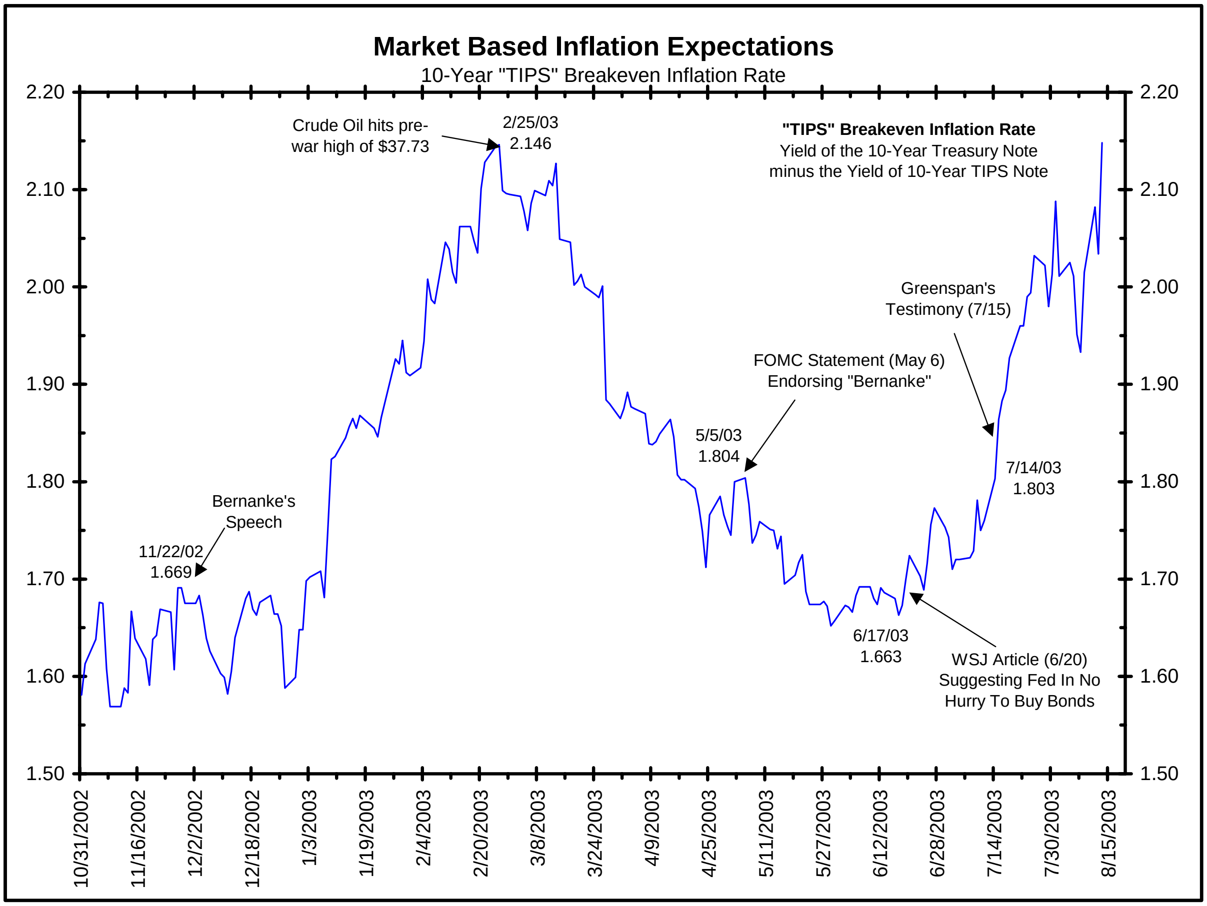
When the Fed "switched gears," the bond market feared that inflation would rise – even if it were slight. But with the smallest inflation premium in over 22 years, the bond market needed to build more of an inflation premium back into interest rates. So, 10-year yields have been moving higher.

Has enough inflation premium been built back in? Also shown above is the average real interest rate for the history of the bull market (4.34%) and the one standard deviation levels ("+1" of 6.16% and "-1" of 2.53%). If the Fed is no longer fighting inflation, should real interest rates be trading below their bull market average of 4.34%? Should they be trading below their "-1 standard deviation" level of 2.53%? **We would suggest no!**

What About Inflation?

Compounding the real interest rate premium expansion is the fact that inflation expectations are soaring as well. As the chart below shows, the 10-year TIPS breakeven inflation rate has soared in recent days – reflecting the marketplace's belief that the Fed will be successful in creating inflation. The current breakeven inflation rate is now 2.14%. Add this to the average real rate since 1981 of 4.34% and it suggests 10-year yield could move as high as 6.48%! Even a "-1 standard deviation" real rate of 2.53% on top of a 2.14% breakeven inflation rate implies a 10-year yield of 4.67% - above the 10-year note's current yield of 4.56%. **Anyway you cut it, yields appear to be too low if the Fed is intent on creating inflation.**

(Some have argued that using 22 years of real interest rates is too long a period. If we used only the last 10-years, the average real rate is 3.26% and the "–1 standard deviation" level is 2.30%. Again using a 2.14% breakeven inflation rate, these "generous" real interest rate levels suggest that yields could rise to 5.40% and the "too low" level of "-1 standard deviation" level is 4.44% - just below current levels. So, even here, one could argue that interest rates have a long way to rise get to an "average" real interest rate given soaring inflation expectations and a new Fed policy of creating inflation.)



Conclusion

The bond market perfectly understands what the Fed is trying to do. It is trying to prevent deflation by creating inflation. Or, the Fed is conducting a "growth at any cost" or a "stock market earnings enhancement" monetary policy. The bond market correctly believes that inflation is going up, as seen by the soaring 10-year TIPS breakeven inflation rate in recent days.

The bond market did not anticipate this major shift in monetary policy, so earlier this year it was content with real interest rates at the lowest levels in a generation. When the Fed changed policy on May 6 (and the bond market finally understood by late June that this did not mean they were going to buy bonds), market players realized they had the bond market priced incorrectly for this new policy. Add to this the market problems associated with the mortgage convexity trade, and the bond market rout was on.

We believe that Federal Reserve officials understand none of this. They are clueless. As late as a couple days ago, they had an opportunity to "calm" the bond market by moderating their deflation fighting view. They either did not get it, or decided they don't mind higher interest rates. **Either way this is bad news for the bond market.**

When will this end? When either market-based yields are high enough to offset the Fed's inflation creation policy (6.48% 10-year notes?) or they go high enough to get the Fed to "re-think" this policy. The Fed "re-thunk" this policy Tuesday and decided it was happy with it. So, don't look for another "re-think" anytime soon.

These are not good days in the bond market and we have Alan Greenspan's biggest miscalculation of his Chairmanship to thank. If only Ben Bernanke was still a little known Princeton professor.

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