What Is the US Bond Market Telling Us?

At the onset of 2014, almost everyone agreed that as the Fed winds down large-scale asset purchases, bond prices would fall and the US dollar would rise. Ignore for a moment that these two ubiquitous themes were somewhat inconsistent. After all, how could the US dollar rise if foreign investment did not buy US assets and plenty of them since the country still runs a current account deficit of $400 billion or so? In any event, both investment themes have been duds so far. US 10-year bonds have rallied sharply and the yield now stands near the low end of the 2-1/2% to 3% trading range that has prevailed since last summer.

It is easy enough to dismiss the strong showing for Treasuries as flight to safety in the midst of rising geopolitical risks in the Ukraine and elsewhere and surely that notion is correct to some extent. Yet not all investors seem so risk averse as they stretch for yield into EM currencies and high-yielding European debt including those of some heavily indebted countries including Turkey, Brazil and Greece – all of whom face their own difficulties. There seems to be a more profound message coming from the bond market, namely that inflation can be too low for comfort, especially among debtors, and will likely determine what happens to long term interest rates when the Fed eventually normalizes its policy rate. If so, the question is whether the Fed is ahead of the curve in exiting QE or is it already too late to keep inflation under wraps.

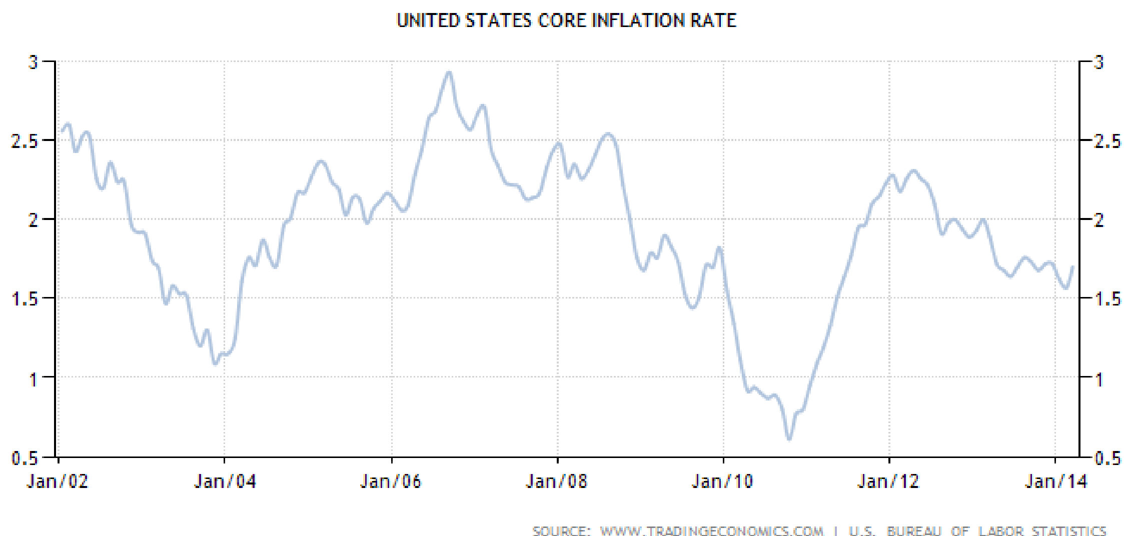
Lessons from the Deflation Scare of 2003-2006. During the early 2000s, the Fed faced the prospect of inflation being 'too low' for the first time since the Volcker Fed established implicit targets for core inflation in the early 1980s. Those initial targets were not plucked out of thin air. Rather, knowing that price indices had certain biases, the Federal Reserve asked government statisticians the question "What is the **measured** inflation rate consistent with price stability?" The answer was the same as the explicit targets cited today: 2% for core CPI (excluding food and energy), 1.75% for the PCE fixed weight price index and 1.5% for the GDP deflator. One could argue that those targets might be different today since the BLS has introduced more quality adjustments, hedonic prices and rental equivalency indices that supposedly reduce former biases. The point, though, remains the same – price stability in the context of operational monetary policy is associated with some positive measured inflation rate, however small. Zero inflation in the national statistics is tantamount to deflation in the eyes of the Fed.

In early 2003, measured inflation fell below those thresholds, as shown on Figure 1 on the next page, and continued to decline steadily until early 2004. The Fed responded by lowering its policy rate to 1% by mid-2003 where it remained until mid-2004, despite an ongoing recovery. With perfect hindsight, the Fed overreacted to low inflation that proved to be transitory and waited too long to normalize rates. To be fair, the revised and re-benchmarked economic data now show a stronger recovery than they did at the time. Nonetheless, the real policy rate had turned negative by late 2002 and stayed

there throughout the next three years until the FOMC belatedly had returned to funds rate to 4% in November 2005. By this backward-looking standard, the Fed often is criticized as having

been too aggressive in combating a perceived deflation that in fact did not materialize and having stayed too long with an overly expansive monetary policy that sowed the seeds of destructive financial excesses. In the vernacular of the bond market, the Fed fell 'behind the curve' in containing inflation which subsequently rose well above target, especially after 2005. Because the economy began to overheat, the FOMC had to move quickly to normalize policy and ultimately was forced to overshoot the neutral funds rate in 2006 and 2007 when it reached 5.25%.

Figure 1



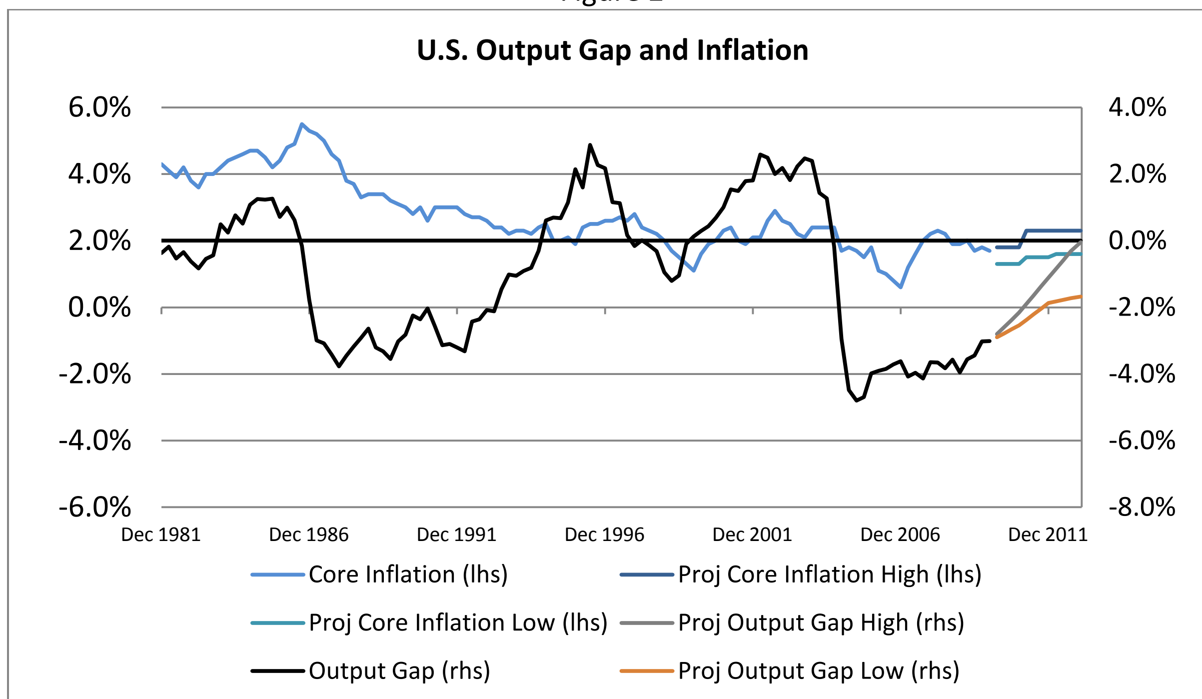
At the heart of the Fed's miscue, however, was not their misreading of the dangers of deflation or of the strength of the recovery but rather their unflagging belief that the economy could expand 3% or more without generating inflation. Chairman Greenspan had inspired that view during the 1990s after software and internet innovations led to a flurry of technology investments and a surge in US productivity growth. Unfortunately, that impetus to potential growth proved to be short-lived, lasting less than a decade. To confound the analytics, a massive infusion of financial leverage masked reality in ways that still are not well understood, thereby exaggerating both measured productivity and estimated potential growth.

Figure 2 on the next page depicts this unfortunate reality with the advantage of re-estimating potential GDP after the full economic cycle has unfolded. The black line shows the output gap – the difference between actual and potential GDP. Readings above zero (right hand scale) indicate that actual GDP has overshot its stable-inflation level, as was the case from mid-1998 until well into 2001. With a delay of about one year, core inflation – the blue line – began to rise. Note that the shallow recession of

2001-2 barely erased the overshooting at the end of previous cycle. As the lackluster recovery proceeded, inflation continued to decline in its usual delayed response to a negative output gap

but unbeknownst to the Fed the economy already was much closer to potential than they thought. With lower estimates of historical potential growth, the entire black line shifts up, the output gap is smaller and inflation itself only flashes a warning sign long after the economy is overheating again.

Figure 2



Sources: Federal Reserve, U.S. Bureau of Labor Statistics and Fenwick Advisers estimates

Is the Fed Repeating Past Mistakes? As powerful as this analytical framework is, it suffers from the challenge of estimating potential growth since the last cyclical peak.
Small miscalculations accumulate into big mistakes over the course of a business cycle. No central bank is immune and consequences of misestimating the inflation-stable **level** of GDP in real time are magnified when potential growth decelerates. With few exceptions, nearly every major country now faces this uncertainty as aging populations, financial deleveraging and slower productivity growth are undermining potential growth almost everywhere.

Could the Fed be repeating the mistake of the early 2000s, which in itself was a repeat of the misguided policy of the 1970s under Chairman Burns? One cannot dismiss that possibility lightly. The current expansion already is entering its fifth year. The weak recovery is no salvation if potential growth is even weaker. What is clear, though, is that the Fed is trying to get ahead of this conundrum before it gets out of hand. In a recent research study, three senior Fed economists re-estimated their models of potential GDP (see http://www.imf.org/external/np/res/seminars/2013/arc/pdf/wilcox.pdf) and downgraded estimates of the output gap to about 3% of GDP. Moreover, FOMC members have lowered their estimates of 'long term growth' to 2.3% annually as can be seen in their recent published

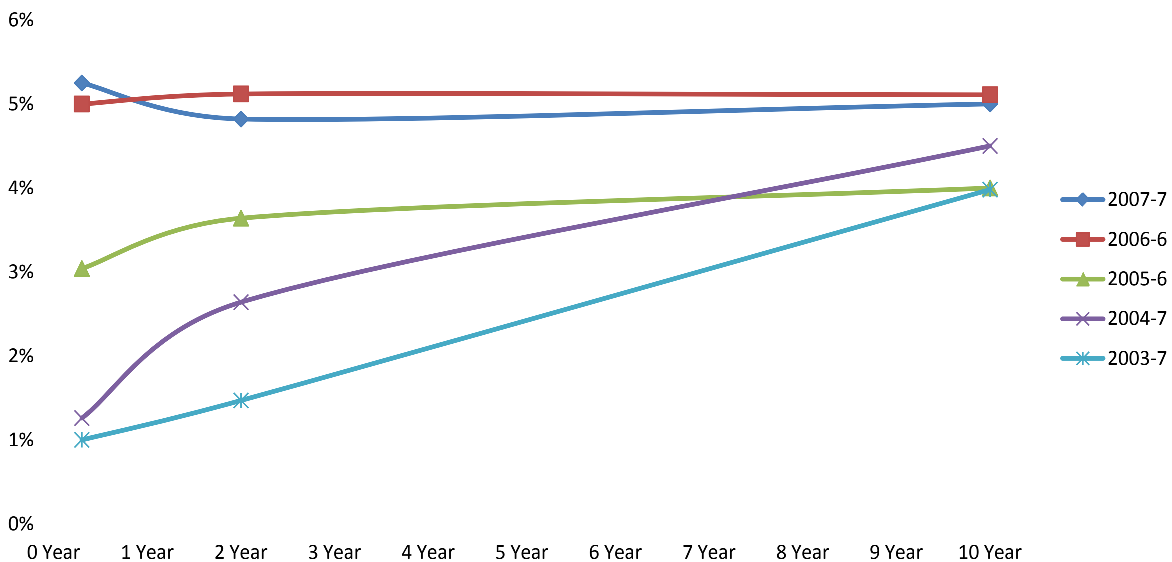
forecasts. The problem, of course, is that potential growth could be even lower and hence the Fed's wiggle room could be yet smaller than that 3% output gap. And inflation itself will not give them a 'heads up' until it is too late.

This uncertainty, more so than the plethora of others, will dictate the Fed's tapering of asset purchases (see *The Fed Is Preparing the Markets for a Policy Change,* Fenwick Advisers, November 11, 2013). Namely, there simply isn't enough time to dawdle in exiting QE before the chance of reaching full potential becomes a serious risk and the Fed would be faced with the same predicament as it was from mid-2004 to mid-2006 when it was force to raise rates 425 basis points to get ahead of the curve on inflation.

What Do Bond Markets Tell Us? Institutional investors continue to express antipathy toward long-dated Treasuries likely reflects the legacy of the Greenspan Fed that tended to err on the side of easing monetary policy during unsettled times. By lingering too long, the Fed clearly fell behind the curve on inflation -- namely during the S&L crisis of the early 1990s, post Russia's default in 1998 and during the deflation scare of the early 2000s -- and was forced to reassert its credibility.

Figure 3 shows the typical evolution of the yield curve when markets sense a belated reversal of policy, as was the case in 2004-5. The UST curve actually was steepest – with the 10-year bond yield about 300 basis points above the fed funds rate – while the policy rate was at its low ebb of 1% from mid-2003 through mid-2004. By early 2004, though, core inflation had begun to rise and by mid-year was above target at 2.9% yoy compared with 1.9% a year earlier.

Figure 3
Evolution of the UST Yield Curve: 2003 to 2007



Source: www.tradingeconomics .com

Markets already were anticipating the first rate hike as evidenced in Eurodollar futures and the associated sharp rise in the 2-year yield to 2.64%. Notwithstanding the jump in inflation, the yield on 10-year bonds increased only 50 basis points to 4.5%.

The most telltale point in the tightening cycle, though, was mid-2005 when the Fed had raised rate 200 basis points to 3%. Yields on 2-year notes continued to anticipate more rate hikes yet long rates actually fell back to 4% as inflation had stabilized around 2-1/2% - within striking distance of the Fed's target. Unfortunately, the economy already was operating above its potential and the feeding frenzy for leveraged finance hit a crescendo in 2006 and inflation ratcheted up another notch to 4.2%. The tightening episode culminated with the policy rate at 5-1/4% and the rest of the yield curve hovering around 5%. The 2-year yield had climbed 375 basis points while the 10-year yield had increased only 100 basis points, roughly in line with inflation expectations.

Implications. The bottom line is that inflation, not Fed tightening per se, is the key driver of yields on long-dated bonds. To stay ahead of the inflation curve, the Federal Reserve will need to normalize rates long before inflation pressures begin to build. So far, the bond market is telling us the Fed still has time. We expect the 10-year yield to remain in the current trading range of 2.6% to 3% until yearend 2014 on the basis of our belief that inflation will remain below target well into 2015. History indicates that this favorable scenario can slip away if the Fed dawdles in normalizing. Belated tightening ultimately is worse for financial markets than preemptive action as the economy approaches full potential. The US economy has at least one or two years of continued recovery before reaching that threshold, even if US potential growth is considerably less than the Fed presumes.

On the flip side, the US economy no longer faces the deflation that now threatens Europe. The latest statistics are showing signs of normality. Rents are rising as are real wages, and rising real incomes provide the momentum for the next phase of a sustained recovery. Expansions rarely just wither and fade away, especially for a largely self-sufficient economy like the US. If the Fed wishes to retain the enviable position of being ahead of curve, it best drop the rhetoric on keeping rates low for a long time and stay the course on normalizing policy.

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