Agincourt Capital Management, LLC

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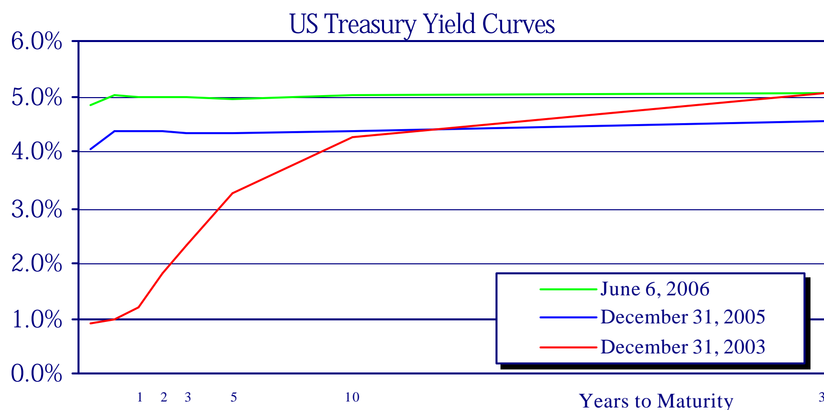
INVESTMENT UPDATE

Let's face it, when it comes to the direction of short rates, US bond investors have had it pretty easy over the past couple of years. Since the first quarter of 2004, we've known that the Fed's Open Market Committee would be raising short term rates after each meeting. They were even kind enough to use the word "measured" to let us know, after each one-quarter percent bump in the overnight Fed funds rate, of their intention not to upset the delicate nature of investors' collective psyches, but to smoothly ease the yield curve into a flatter profile.

Of course, that was an extraordinarily rare period in the history of the Federal Reserve. It is far more typical for the Fed, like the rest of us mere mortals, to be poring over economic indicators, trying to discern just where the economy is, and (even more importantly) where it's heading. Recall that the Fed has two, not always compatible, goals—price stability and "full" employment—and they must find the proper balance in their policy decisions to meet these dual objectives. Complicating matters further, the primary tool that the Fed uses to control the expansion and contraction of the US economy is the overnight rate that banks charge each other for the lending of funds. As Winston Churchill said of golf, it's "a game whose aim is to hit a very small ball…with weapons singularly ill-designed for the purpose."



The result of using clumsy, if not ill-designed, tools is that there are numerous impediments and lags between a change in the Fed funds rate and its desired impact on the economy. In the present case, while the Fed has engineered a radical change in the shape of the US yield curve since 2004 (see chart), we've seen little of its intended impact—the US economy continues to roll merrily along, with the associated whiff of hot-economy inflation—the slowdown that the Fed is trying so hard to pull off remains *pro forma* at this point. And therein lays the problem: The Fed must rely on their forecast of what the economy will be doing over the next few months, based on policy actions that are now in the rear-view mirror.

Investors are used to having to develop their own idea of where the economy is heading in order to fine-tune their investment strategies. But they also depend on the Fed to help out in this respect. As we've seen, over the past few years they've gotten a lot of assistance from the Fed, since they knew every FOMC meeting would mean another 25 basis point hike in the Fed funds rate. Now they're not sure where we're headed. For a while it looked like 5% would be the peak in the funds rate, but now it's wholly dependent on what the Fed sees in their crystal ball.

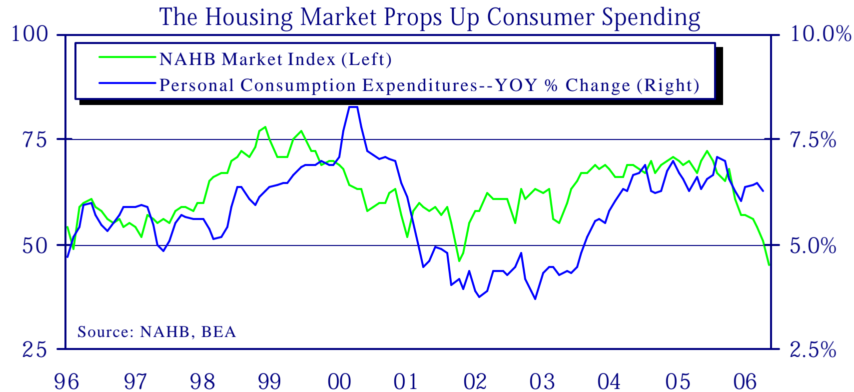
Investors hate uncertainty, and that's what they are now facing for the first time in years. They're just not sure when the economy will show clear signs of responding to the tightening of monetary policy, especially after so much liquidity was pumped into the system in the five year period after the dot-com meltdown. More uncertainty leads to higher volatility in the capital markets. All things equal, higher volatility leads to lower prices for bonds and stocks as the marginal investor waits on the sidelines for the outlook to clear.

Let's look at the world through the Fed's eyes—first, is the economy slowing? The answer to this question is essential, since if we don't get a modest slowdown in economic growth, the small shortages that we're beginning to see in the labor markets, commodities, and other areas of the global economy may cause bigger pricing pressures later. Fortunately, in our estimation, we have some good news here—those areas of the economy that have been driving growth appear to be slowing nicely.

The consumer sector of the economy, which has been the engine of the US economy over the past few years, has cooled a bit. Underpinning strong consumer spending over this period has been the remarkable appreciation of US home prices, which, when combined with low interest rates, has allowed homeowners to pull equity out of their houses without increasing their fixed monthly payments. In fact, the savings rate has fallen to below zero, as monthly measures of personal consumption expenditures have consistently exceeded personal

income measures for more than five years.

The top chart shows the relationship between the housing market and consumer spending. The National Association of Home Builders' Market Index, which looks at present and expected home sales, as well as the current traffic of home buyers, began turning down in the third quarter of last year, and just fell below 50—a reading that indicates "poor" conditions for home sales. You'll notice that last time we had a similar downturn in this Index was in 2000 and 2001, and it led to a significant slowdown in personal consumption expenditures after a lag of a few months.



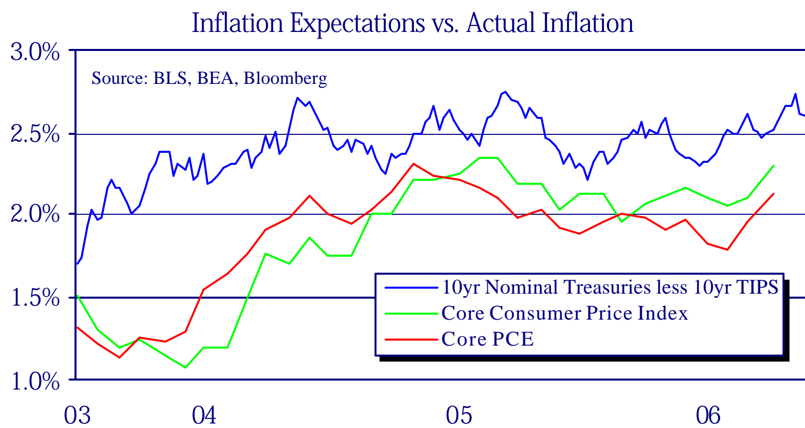
New Fed Chairman Bernanke himself is on record as saying that a slowdown in the US housing market, and the resulting impact on consumer spending, is at the very heart of the Fed's expectation that US economic growth will be moderating in the coming months. The recently-released minutes of the FOMC's May 10th meeting stated that the participants discussed how "slower appreciation of home prices and the effects of the increases in energy prices and interest rates…would likely act to restrain consumption spending somewhat."

But Bernanke made a big miscalculation in his April 27th testimony to Congress' Joint Economic Committee (and in various follow-up comments, private and public) when he came off as "soft" on inflation, saying that a pause in the ratcheting up of the Fed funds rate might be appropriate "in the interest of allowing more time to receive information relevant to the outlook." Investors, already skeptical of Bernanke's inflation-fighting credentials, hammered the bond market, sending yields on inflation-sensitive long maturities up by more than ¼ percent by the middle of May.

Inflation expectations rose as well, both as a result of Bernanke's comments and a third consecutive reading of 0.3% in the monthly change in "core" Consumer Price Index for May. This bumped the 12-month core CPI up to 2.4% and, worse still, the annualized three-month figure to 3.8%.

As the bottom chart on this page shows, the Fed's favored measure, the Core Personal Consumption Expenditures Price Index (Core PCE), has been on the upswing as well, though it remains below the core CPI by a couple of tenths. The Fed Chairman has since tried to take a more "hawkish" tone on inflation; in a June 5th speech to the American Bankers Association, he noted that the recent uptick in inflation was "unwelcome."

Investors are not convinced at this juncture, and many would like to see the Chairman do more than exercise "open mouth operations" on the inflation-fighting front, especially since, by any measure, inflation lies above the Fed's self-imposed 2% ceiling. The bottom chart shows how inflation expectations (measured by the difference in yield between nominal 10-year Treasuries and Treasury Inflation-Protected securities of the same maturity) have moved up since the beginning of the year, and remain well above actual inflation. In other words, investors are betting (by buying inflation protection) that inflation will be moving up from current rates.



A month ago, after raising the funds rate to 5%, it looked as if the Fed was almost certain to pause. But by the first week of June, the futures markets were pricing in an 80% probability that the Fed will bump the rate up to 5.25% when they meet in the last week of June. No doubt this is due, in part, to Bernanke changing his tune. But could it be that the market has it wrong?

There's one more bit of information lurking in the bottom chart on this page: For years now, investors have been overpaying for inflation protection. Core inflation has remained consistently below longer-term inflation expectations in the US. Of course, this time could be different, and inflation could surprise on the upside. Some may even argue that is exactly what we'll get without a tough-acting, and not just tough-talking, Fed Chairman, and have placed their portfolio bets accordingly.