AMERICAN DEBT GARDENS- HIGHER YIELDS
("DESPERATE HOUSEWIVES", EPISODE 7)
© Leo Haviland, 646-295-8385 February 8, 2011

A scene from the 1979 film, "Being There" (Hal Ashby, director):

*US President "Bobby": "Mr. Gardner…do you think that we can stimulate growth through temporary incentives?"
*Chance the Gardener [a well-meaning yet rather simple-minded and uneducated fellow who nevertheless gains a respected position in lofty Washington circles]: "As long as the roots are not severed, all is well. And all will be well in the garden…In the garden, growth has its seasons. First comes spring and summer, but then we have fall and winter. And then we get spring and summer again."
*Benjamin Rand: "I think what our insightful young friend is saying is that we welcome the inevitable seasons of nature, but we're upset by the seasons of our economy."
*Chance the Gardener: "Yes! There will be growth in the spring!"….
*President "Bobby": "…Mr. Gardner, I must admit that it is one of the most refreshing and optimistic statements I've heard in a very, very long time. I admire your good, solid sense. That's precisely what we lack on Capitol Hill."

****

CONCLUSION

The sustained economic rescue and repair efforts by America's resolute yet fearful central bank and politicians and their overseas allies will continue to encourage rising US interest rates. The Federal Reserve's seeds of very low Federal Funds rates and its quantitative easing deluge play crucial roles. As part of its heated quest to propel a recovery and rehabilitate injured consumer net worth, the Fed scrambles to create some inflation. Congress and the President, enamored of stimulus, place fiscal discipline aside in the tool shed for the foreseeable future.

Such US regulatory and political permissiveness erodes the broad real trade-weighted dollar. Rising interest rates and a slipping dollar tend to diminish the appetite of foreigners for US securities in general and debt ones in particular.

Are climbing interest rates a sign of the success of "green shoots" economic policies? Many weathervanes proclaim them as such. Yet over the next several months, higher yields will tend to reflect and encourage economic weakness.

Take the US 10 year government note as a benchmark for rate trends. Yields will test the 400/430 range, probably by end-June 2011 at the latest.

The likelihood of an eventual move in the 10 year Treasury toward 500/550 is higher than many believe. In that regard, inaction regarding the deficit rot and a substantial wilting of the US dollar are key ingredients. Moreover, the Fed's deliberate cultivation of some inflation creates the danger of more than sufficient inflation. The Fed and many other watchdogs display minimal concern about inflation hints from high-flying equity and commodity marketplaces. Signs of more than adequate money floating around trouble them little. Recall the sluggish analysis and action of such guardians in the prelude to and dawn and early afternoon of the economic crisis that emerged in 2007. Will exit strategies to

preclude so-called excessive inflation be rapid or forceful enough to preclude marketplace tragedies?

CREEPING INFLATION…AND THE PARTLY VOODOO RECOVERY

"Well, I stand up next to a mountain
And I chop it down with the edge of my hand
Well, I pick up all the pieces and make an island
Maybe even raise a little sand…
I'm a voodoo child baby
I don't take no for an answer." Jimi Hendrix, "Voodoo Child"

****

Current economic policy making wizardry may not be voodoo economics. Perhaps sustained low policy interest rates (Federal Funds around one quarter of one percent), money printing enthusiasm, huge deficits, and a weak dollar will not breed runaway inflation. Yet in combination, and given the Fed's fevered determination to boost nominal GDP and promote inflation, they probably will produce some.

Such variables of course are not the only ones to consider, and the US is obviously not the only participant in the international playground. But America's allies generally have been married to easy money and deficit spending policies to promote economic recovery (Europe, Japan) or sustain economic growth (as in China).

****

Nominal US corporate profits have blossomed. Share buyback programs support equity prices. Yet heavenly rallies in key equity benchmarks such as the S+P 500 from the March 2009 bottom, and especially from summertime 2011 interim lows, are hints of increasing inflation. These rallies occur in a context, and that context has been very easy money and deficit spending. The S+P 500 has almost doubled since the 3/6/09 valley and is up over twenty-five percent from the 8/27/10 low at 1040. In the commodity realm over the past two years, likewise look at the broad GSCI and the DJ UBS index, as well as at agricultural indices (Food and Agriculture Organization; the Goldman Sachs Ag Index). In regard to inflation, dramatic advances in commodity benchmarks are not scarecrows. They really signal inflation.

****

Fears of inflation do not bug most oracles, at least for the near term, in regard to Western (so-called advanced) nations. The IMF predicts consumer prices will edge up only 1.6 percent in advanced economies in 2011 (2010 was 1.5pc). However, that in emerging and developing ones may rise a bothersome 6.0pc (2010 was 6.3pc). "World Economic Outlook Update", Table 1, 1/25/11).
http://www.imf.org/external/pubs/ft/weo/2011/update/01/pdf/0111.pdf

In the intertwined global environment, shouldn't developed countries at least ask if inflation trends in emerging marketplaces could be mirrored in their yards? In the Euro FX area, January 2011 consumer prices crept up 2.4pc year-on-year, higher than the European Central Bank would like.

****

Anyway, the US consumer price index (all items) rose about 1.5pc year-on-year in December 2010 (and 1.6pc for 2010 versus 2010 (Bureau of Labor Statistics). So isn't everything just peachy here? Not all inflation measures are the same in the US, and those in the West may place less emphasis on food and energy than those of many emerging marketplaces. Yet given the rallies in food and energy prices, maybe we should examine a bit more closely America's headline consumer price index indicator (the CPI-U).

Focus on the US Consumer Price Index for All Urban Consumers (CPI-U) for December 2010 (Table 1, p10, 1/14/11).
http://www.bls.gov/news.release/pdf/cpi.pdf

"Housing" makes up almost forty-two percent of this key CPI-U measure. As part of the housing category, the "shelter" element equals 32.3pc of the entire CPI (fuels and utilities make up about 5.1pc, and household furnishings and operations about 4.6pc). Within the 32.3pc, "rent of primary residence" is about six percent, with "owners' equivalent rent of residences" over twenty-five percent. The December 2010 year-on-year increase in this 32.3pc "shelter" category was a mere .4pc. Such a meager rise keeps a key inflation measure down, and thereby helps the Fed to preach their sunny sermons that inflation is low and not a likely substantial danger.

Measured by the equity marketplace rally of nearly 100 percent since the March 2009 depths, the Fed and political effort to boost equity prices has borne luscious fruit. Suppose the battle to revive drooping prices in real estate marketplaces becomes more fruitful, particularly in the home sector. What happens as fewer houses are built, foreclosure rates decline, and home inventories plummet from extreme levels? A real estate sector rally in percentage terms probably will be much less than the gigantic one in equities since March 2009, but it still may translate into higher levels in the CPI "shelter" measure. Thus inflationary consequences in the context of the overall CPI nevertheless eventually may be significant, and consequently surprising to many financial observers.

****

Here's a footnote that some may claim is a bit nutty. But is it really? Suppose US real estate and "shelter" prices do not rise much from present levels. Further assume no notable changes in CPI components outside of the food and energy landscape. Then food and energy prices may need to soar very high in order to spark sufficient inflation (a high enough CPI) to satisfy Fed faith that its policies (and those of noble politicians) have created sufficient inflation. Until that adorable inflation target is achieved, the contented Fed can strut happily on its path of current and supposedly prudent policies. It can declare that there's no reason to worry much about inflation.

Some gurus may grunt that food and energy do not represent core (or real) inflation. Or, they will say it takes quite a bit of time for them to work their way into (really influence) core inflation measures. But in the meantime, those high and rising food and energy prices can eat into the pocketbooks of many Americans (and people elsewhere), especially those who do not own substantial amounts of equities. Note America's increasing poverty rate.

****

The Federal Reserve Chairman only a few days ago chirped that "overall inflation remains quite low" from the perspective of both prices and wages. He admittedly is awake to the fact that "prices of many commodities have risen lately". However, he attributes this primarily to strong demand from "fast-growing emerging market economies", with some rallies aided via low supplies. ("The Economic Outlook and Macroeconomic Policy", 2/3/11). Thus the Fed does not seem to want to take any responsibility for higher agricultural, energy, and base metals prices. In regard to that, the Financial Times headlines (2/4/11, p1) that the Fed denies its monetary policy is driving up food prices in emerging markets. Bernanke squeaked: "I think it's entirely unfair to attribute excess demand pressures in emerging markets to US monetary policy because emerging markets have all the tools they need to address excess demand in those countries."

Commodity marketplaces are not islands apart from equity, debt, and foreign exchange lands. Interest rates and money supply (and many other considerations like currency trends) affect commodity levels and trends. But doesn't the Fed influence interest rates and money growth? Despite the Fed's viewpoint, commodities are tied to the famed "real economy". Don't the Fed and other central bankers attempt to influence that economy? And after all, that economy and its members use commodities. Construction employs copper. Prosperity boosts demand for protein. And in a global economy, economic policies interrelate.

The extent of influence by the Fed (and other central bankers, regulators, politicians, and so forth) on commodities may be debated, but that does not make it nonexistent or insignificant. Besides, many people- both inside and outside the commodity "space"- call commodities an asset class, diversify into them, call them alternative investments, and compare returns from them with those of stocks, interest rate instruments, and currencies.

We all know that many players in stocks, bonds, and currencies monitor commodity prices. If commodities don't influence interest rate levels (inflation) at all, why do so many bond traders pay attention to commodities?

****

Money measures offer grounds to look for further interest rate rises. Noteworthy growth in money measures may not translate into real inflation soon, if at all. Besides, inflation and deflation reflect numerous variables. The United States of course is not alone in the economic pasture. However, US money statistics hint that inflation and thus higher US interest rate yields are on the way.

The US monetary base (seasonally adjusted) was about 844 billion dollars in August 2008. It rose to about $2.11 trillion by February 2010. A 150 percent leap may not spark appreciable inflation, but it should make players consider its genesis. Though the monetary base slipped slightly to about $1.96tr in October 2010, it has grown to about $2.05tr for the two weeks ending 1/26/11 (Federal Reserve, H.3). Continued high base levels- and especially a hop over the February 2010 level- may further encourage inflationary fears and outcomes.

Note that US money supply M2 increased at a 5.0pc annual rate in the three months from September 2010 to December 2010 (and 5.1pc from June 2010 to December 2010). The 13 weeks ending 1/24/11 were up 5.0pc against the 13 weeks ending 10/25/10 (H.6). Such M2 annual rates of increase are well above current benchmark inflation measures (whether via the CPI, Personal Consumption Expenditures, or otherwise) and breezy forecasts of two percent or less. Glance also at currency in circulation (H.4.1). For the week ending 2/2/11 (averages of daily figures), it's up 6.3pc year-on-year.

****

Remember the dusty ancient times of the Goldilocks economy, venture back to around 2007 and the few preceding years. Many experts placed great faith in the sustainability of housing (and commercial real estate) prices and the ratings of mortgage debt, even in the subprime corner. The ability of financial sheriffs and marketplace dwellers to perceive and manage risks was little questioned. Yet ratings were slashed, real estate prices withered, mortgage securities were crushed, and so on. Government inflation measures probably are more "neutral" than mortgage securities ratings and housing perspectives developed by players with stakes in real estate development, trading, and banking. Yet might there be analogous complacency nowadays, evidenced by devoted belief that consumer prices and similar inflation indicators will not exceed blissfully low to moderate levels? Surely the agile and astute Fed will act at the right time with the proper exit strategy!

THAT PESTILENTIAL DEFICIT

"Whoever you are- I have always depended on the kindness of strangers." Blanche DuBois, in Tennessee Williams's "A Streetcar Named Desire" (Scene 11)

****

Recent essays explored the gloomy US fiscal situation. For example, see "Keeping It Real- The Dolorous Dollar ("Desperate Housewives", Episode 6)" (pp4-6; 1/9/11) and "Desperate Housewives (Episode 5)- Let's Get Fiscal!" (12/13/10). Regardless of how and over what time horizon one assesses America's gaping deficit hole, no genuine fiscal progress has been made in recent weeks. See the US Congressional Budget Office's "The Budget and Economic Outlook: Fiscal Years 2011 to 2021" (1/26/11; Ch.1, Table 1, p2). The US federal deficit is $1.3 trillion in 2010 (8.9pc of GDP), $1.5tr in 2011 (9.8pc of GDP), and $1.1tr in 2012 (7.0pc of GDP). "The United States faces a daunting fiscal outlook, both for the next few years and for the long term." (Ch.1, p1).
http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26_FY2011Outlook.pdf

In its survey of the global fiscal scene, the International Monetary Fund's "Fiscal Monitor Update" similarly depicts the US vista (1/27/11; Table, 1, p2). According to the IMF, the US overall fiscal deficit as a percent of GDP was 12.7pc in 2009. It stayed very elevated at 10.6pc in 2010. At 10.8pc in 2011, it remains so. US deficit problems are not the only ones around, either.
http://www.imf.org/external/pubs/ft/fm/2011/01/update/fmindex.pdf

Flocks of Washington politicians squawk loudly about the need to slash the federal deficit. Many Republicans have been especially noisy. Yet despite cries about their desire for $100 billion in budget cuts (which itself is not huge in comparison to the problem), House Republicans proposed a slender $32bb one (Budget Committee; NYTimes, 2/4/11, pA13). Such feeble deficit cut proposals by the band supposedly especially hostile to deficits does not promise near term progress.

Suppose not only that US interest rate yields keep going up a moderate amount. How pleased will overseas owners of US government instruments be? What if around the time of these rate rises, the broad real trade-weighted dollar breaks down further, falling below major support around 84.0? Will foreigners see US interest rate marketplaces as fertile investment soil? Will they be eager and substantial (and sufficient) net buyers of US debt obligations?

POLICY HARVEST + TECHNICAL BUZZ

In William Shakespeare's "Macbeth", Banquo demands of the three witches:

"If you can look into the seeds of time,
And say which grain will grow and which will not,

Speak, then, to me…" (Act I, Scene III).

****

On 8/10/10, the Fed announced it would maintain its amount of securities holdings by reinvesting principal payments from agencies and mortgage-backed instruments in longer term US Treasuries. On 11/3/10, it declared it would buy an additional $600 billion of Treasury securities by the end of 2Q11. The gatekeepers sweetly sing that they not only want to promote a stronger pace of economic recovery, but also to insure inflation over time is at a level consistent with their mandate.

In this context, remark the timing of the increase in US government note yields since around the midpoint of those policy actions. Though the 10 year note made a crucial initial low around two percent in the "flight to quality" panic of late 2008 (204 on 12/18/08), the 10/8/10 bottom around 233 occurred right in between these 2010 Fed policy decisions. Not only does this underline that the October 2010 note yield probably represents a final low in the Treasury note bull move (higher note prices are bullish) that commenced no later than 6/13/07 at 532. The yield spike since then has derived in part from inflation-oriented policies (more quantitative easing) and US deficit deterioration.

In regard to these further rounds of and consequences from Fed policy easing and the October 2010 Treasury note bottom, underline the timing of and sharp rallies from lows in equities and commodities. There's been quite a rally in the S+P 500 since its trough at 1040 on 8/27/10. Note the low in the broad GSCI in late August- 8/25/10 at 490, the same day as the bottom in NYMEX nearest futures crude oil at 7076. Admittedly some agricultural marketplaces have tight supply/demand pictures. Food crisis worries have flowered. But view the explosive rally in the GS Agricultural Commodity Index in recent months. The 281 on 6/7/10 was noteworthy, but note the march up from the 380 point on 10/4/10.

Also note US dollar levels and trends before and then alongside these August and November quantitative easing (money printing) decisions (and subsequent Fed rhetoric). The broad real trade-weighted dollar made an interim high in March 2009 at about 96.7 (monthly average). This was around the time of the S+P 500's major low at 667 on 3/6/09 and the broad GSCI's at 306 on 2/19/09. The dollar's dive resumed, from June 2010's 89.8 and August's 87.6 to test all-time lows near 84.0 during 4Q10. **For January 2011, at 83.6, the broad real-trade weighted dollar has achieved a brand new record low** (since 1973). Prior bottoms around 84.0 were those of April 2008, July 1995, and October 1978. Among important cross rates, note the timing of lows in the Euro FX: 1.1877 on 6/7/10 and 1.2588 on 8/24/10. Thus in recent months, the weak US dollar- aided by low interest rates (especially nominal short term ones), money printing, and deficit spending- has encouraged rallies in equities and commodities.

****

What are critical yield levels in this current bear marketplace for the US 10 year government note? The present yield is around 365. First, keep in mind that the Fed does not have a specific rate target for longer dated securities (see the video conference meeting of 10/15/10, part of the Minutes for 11/2-3/10).

History is not destiny, either for price levels, the distance and duration of price moves, or the calendar period of marketplace trend changes. As for 10 year Treasuries, around 400 to 425 is a key level. Recall various four percent range tops in recent years. Glance at 6/13/08's at 427, the 10/15/08 one at 410, 6/11/09 at 400, 12/31/09 at 391, and 401 at 4/5/10. In the more distant past, the 416 bottom of 10/5/98 and that around 410 on 11/1/01 are noteworthy. Twice the 2.04pc low of 12/18/08 is 408.

Suppose the Fed reaps enough self-confidence to permit the Fed Funds level to rise to one percent. Though potential yield curve levels and shapes are conjectural, suppose the two year note edges up to around 1.75 to 2.00 percent. Adding 200 to 250 basis points (less than the current spread around 290bp) to the two year yield to would push the 10 year to around 400.

Around 500/550 is a significant level for the 10 year government note. Remember the major double top of the June 2006 and June 2007 (532 on 6/13/07 and 525 on 6/28/06). Don't ignore highs around 551 on 8/29/66 and 547 on 3/15/02, as well as the key low of 538 on 3/23/71 (an inflation era began in the 1970s). Keep in mind the 517 bottom of 10/15/93, and that of 552pc on 1/18/96.

In this context, keep eyes on credit spreads involving Treasuries (corporates, municipal debt; other sovereigns). Watch interest rate trends for other key nations and relevant spread relationships for them.

****

What are key calendar time periods for the US Treasury note? Calendar March has had a couple of trend changes of note. The bottom of 3/23/71 around 538 is one. However, calendar June appears to be far more popular, particularly in recent years.

The Fed meets 3/15/11. Interest rate trends are not separate from those of stocks and commodities, and March is an important time for equity levels and trends. The S+P 500 made a major low on 3/6/09 near 667; the final low of the bear move beginning in 1Q00 was in 2003 on 3/12. The S+P 500's major pinnacle in 2000 was 3/24 around 1553 (though the Dow Jones Industrial Average plateau was in January). Not only is calendar March a memorable time, but the equity move since the March 2009 low of 667 has been substantial (twice 667 is 1334; around current levels and not far from the 1440 final top of 5/19/08). From the 7/1/10 low of 1011 (some may choose the 1040 of 8/27/10 as the starting point), a 33 percent jump is about 1345. Commodities have tended to trade in the same direction as equities. The broad GSCI made a major low in February 2009 (2/19/09 at 306), not long before that of the S+P 500. Everyone knows the GSCI has made an enormous ascent over the past couple of years, and a significant stride since 8/25/10's 490. The DJ-UBS index low was 2/20/09 at 101.5. Moreover, the broad real trade-weighted dollar made a minor high (around the time of lows in equities and commodities) at 96.7 in March 2009.

Thus stocks, commodities, and the dollar are vulnerable to at least a minor trend change fairly soon. Given that this arguably is around calendar March, and as the Fed meets in mid-March, that's an initial time to look for 10 year note yields to challenge the 400/425 level before retracing somewhat.

****

Suppose that equities and commodities fall, even fairly sharply, sometime around March 2011. Suppose the dollar strengthens some from its new all-time trade-weighted low. What next for these gardens and the field of interest rates? Stocks probably will resume their rally. First, the Fed schedules quantitative easing to end at the end of second quarter 2011, not in March. It meets on 6/21-22 (and 4/26-27). As of now, the Fed does not think there's enough inflation, and it sees too much unemployment. Consumer balance sheets still need fixing. The Fed was slow to act in the early stages of the financial crisis, so why will it act quickly to declare the problems it faces are over? The World Bank and IMF Spring Meetings are 4/16-17/11. The Fed and its US and overseas allies do not want an equity meltdown near the time of these campfires. Moreover, corporate earnings have been rather strong. Many peaks in American equity benchmarks have occurred during summer, and the all-time high 2007 was in October (and final high in May 2008).

What do commodities add to the calendar timing picture? If commodities fall, policies and recent history are roughly consistent with a renewed rally. In 2008, the broad GSCI peaked in summer (7/3/08) after the final top in the S+P 500 in May (5/19/08). The final peak in the Goldman Sachs Agricultural Index in 2008 was in June (6/26/08, around 496). The 2008 peak in the FAO (United Nations) food price index was in calendar June at 224.1 (recently broken by January 2011's 231). OPEC's next meeting is in June (6/2/11), not soon. Moreover, the OPEC Secretary General recently stated (1/17/11) that producers will not raise production quotas, for the petroleum marketplace is well supplied. "But OPEC will not act because of speculators." Middle East unrest (Egypt; hypothetical potential for nations such as Saudi Arabia) is a bullish factor. So is current tightness in many agricultural commodities.

In addition, as calendar June has been an important time for trend changes in the 10 year US note, particularly in recent years. Noteworthy recent tops include 532 on 6/13/07 and 525 on 6/28/06 (and interim tops at 6/13/08 at 427 and 6/11/09 at 400). Other June pinnacles include the 706 one at 6/12/96. On 6/16/03, a key low was reached at 307. Before yields raced up to over 1580 in September 1981, the note made a trough around 947 on 6/16/80.

Thus the 10 year note probably will resume its price decline, with yields challenging the 400/425 level again in June.

****

And after that, what conjectural webs remain to be spun? A sustained break in the 10 year Treasury above 400/425 probably will occur. Though one should never confuse a forecast with a trade, a move toward 500/550 eventually will take place. A sharp move above 425 to around 500 or so would be quite bearish for stocks and commodities "in general". It might take some time for stocks and commodities to slump after such a yield rise (and remember the 2003-07 bull move in stocks lasted four years, twice as long as the current one), but maybe not very long. The upward flight in equities since March 2009, like that of 2003-07, already has traveled a long distance. US dollar weakness does not generate equity and commodity rallies according to some natural law. Is the US asking for a strong dollar these days? It seems to wish for a feebler one. The broad real trade-weighted dollar will fall even lower than it is now to make new all-time lows. How long will rallies in stocks and commodities continue if interest rates go up and up alongside a steadily weakening dollar? No marketplace (even the US equity one) is a Garden of Eden, and "no market grows to the sky."