Bond Market Cold Turkey

It is a problem the nation's police forces and social services have to face every day, what do you do with the hopeless wreck of an addict now in your custody? Both continued indulgence of the habit and immediate withdrawal - cold turkey - are rife with problems. A gradual withdrawal program and maybe a few visits to the methadone clinic are required.

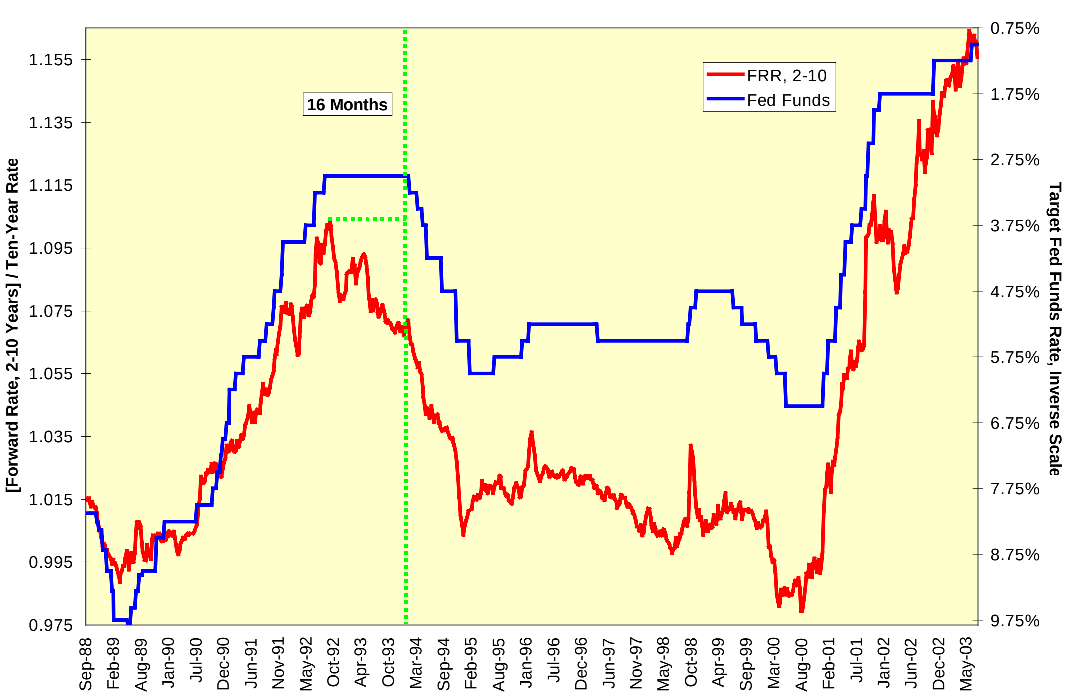
The Federal Reserve now predictably finds itself in the same position with respect to the fixed income markets. Bond traders, homeowners, derivative shops, and the biggest debtor of them all, Uncle Sam, became addicted to near-zero short-term interest rates and to a wide carry between the short and long ends of the yield curve. The Fed's largesse produced losers along the way, as lenders as diverse as retirees, corporate cash and pension fund managers and foreign central banks all had to endure substantial losses in portfolio income.

Let's not mince words: The FOMC statement in May hinting at the need for extraordinary actions to forestall deflation encouraged a final bout of reckless speculation that cannot be unwound painlessly, and their June cut in the federal funds rate to 1.00% was both unnecessary and counterproductive. They now have one more rate cut to rescind on the road back to sanity. When will this trip begin, and what adventures will be encountered along the way?

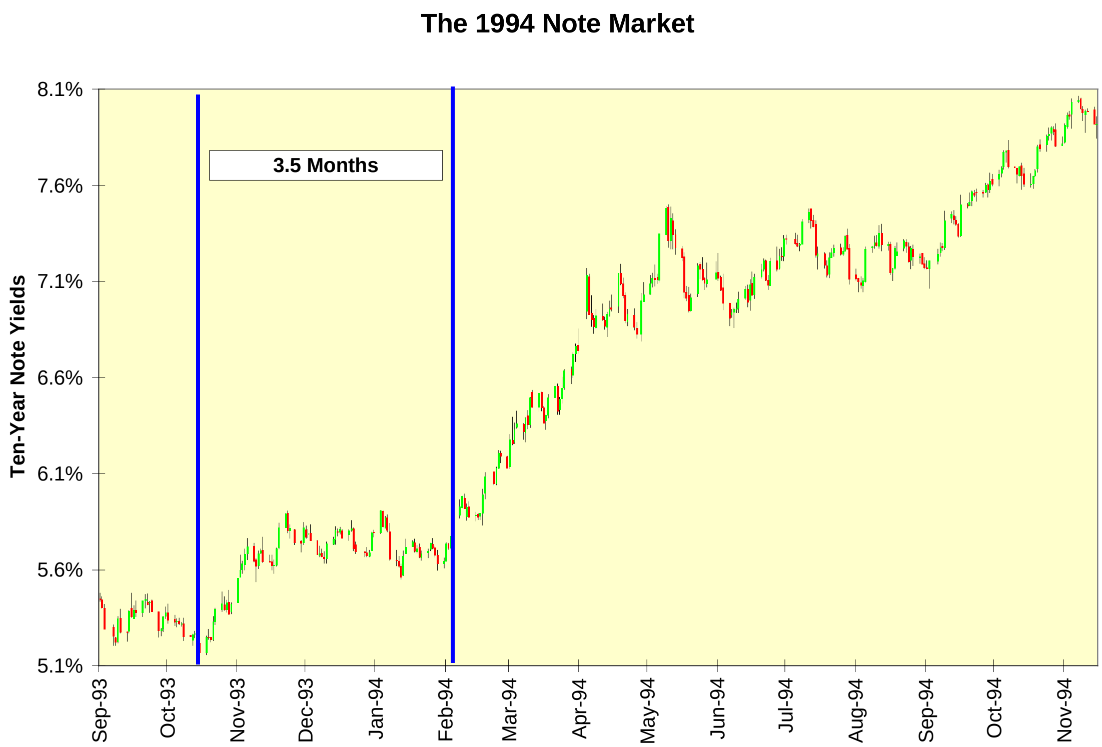
1994 And Today

The last and only time the Greenspan Fed began a rate-raising campaign in the aftermath of a mild recession was in February 1994. They had lowered the fed funds rate to 3.00% in September 1992. The yield curve began pricing in a recision of that decision by mid-October 1992, a full sixteen months prior to the first rate hike. The yield curve measure used here is the forward rate between two- and ten-year Treasuries, the rate at which you could lock in borrowing for eight years starting two years from now, divided by the ten-year note rate itself. This forward rate ratio is and has been at a record high for more than a year and one-half.

When Will The Journey Begin?



The Fed's reticence in raising rates then may hold some lessons for us today. Alan Greenspan began warning in the fall of 1993 that the fed funds rate would not be held at 3.00% indefinitely. Bond yields themselves began to rise at the same time. But, even with the shape of the yield curve warning of higher yields, and even with Greenspan's repeated warnings, the Treasury market reacted very badly to the first rate hike.



Some of this bad reaction can be attributed to the FOMC statement of that time, which in an eerily inverse premonition of their recent warnings about deflation cited the threat of impending inflation. Well, if inflation was going to be a problem, reasoned the bond market, a 25 basis point rate hike would be insufficient to fend off the scourge. Words matter.

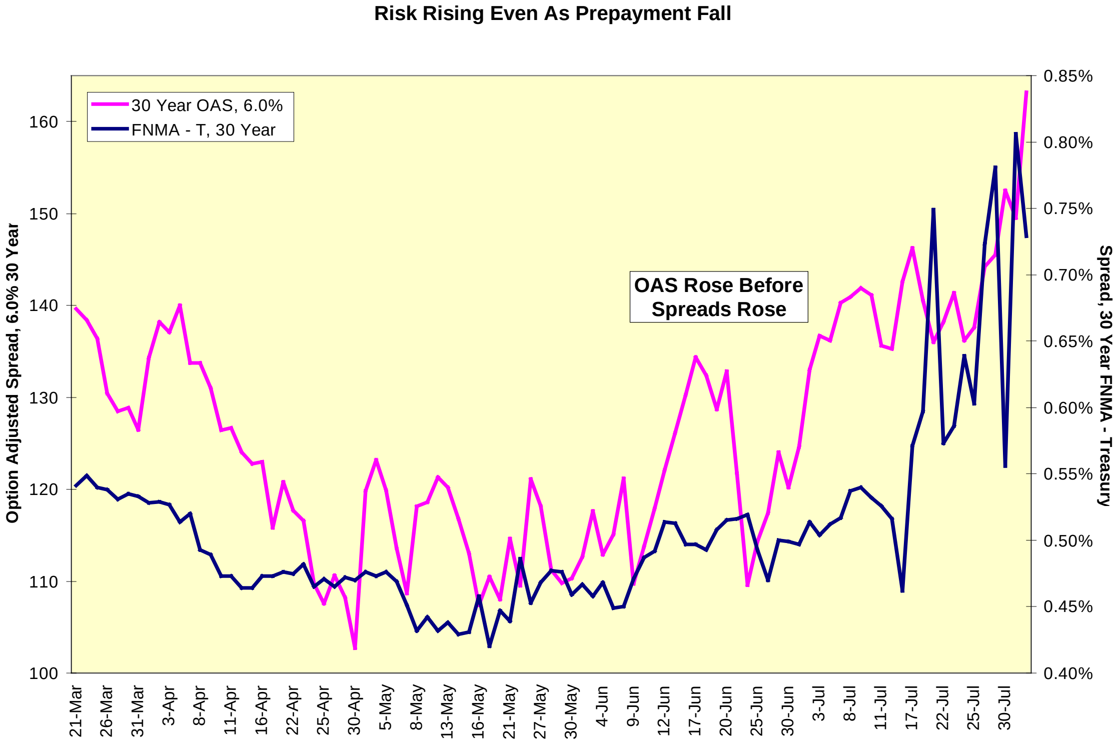
The 1994 precedent is not at all encouraging. The Fed could and did cite yield curve actions as justification for its move, and Greenspan himself had been warning of an impending rate hike so often that it became part of the background noise. And yet the bond market fell apart in 1994, a year that became infamous for a series of derivative disasters including Procter & Gamble, Gibson Greeting Cards, Orange County, Daiwa Bank, Kidder Peabody and mortgage bond hedge fund manager David Askin. Given the more fragile state of the economy at this point and the more stretched state of the fixed income markets, it would not be unreasonable to see a few bodies carried out on stretchers in 2003.

The Disappearing Commodity

The supply of liquidity disappears when its price rises; think of how violent the moves in stocks become at high VIX levels and their often-associated spike bottoms on the charts. This is particularly true in the fixed income markets, which are more dealer-to-dealer and often involve complex instruments that are difficult to price under the best of circumstances. Bond traders typically are forced into selling what they can - Treasuries - rather than what they should, which are the illiquid securities.

That is happening at present in the mortgage market, the largest segment of the fixed income market. We can measure this either through the spread between Agency and Treasury securities or by the option-adjusted spread (OAS) on to-be-announced FNMA pools. OAS reflects the additional compensation in terms of basis points the mortgage lender requires to compensate for the risk of prepayment.

In a normal market, the greater the OAS, the greater is the perceived risk of mortgages being prepaid. OAS began declining last spring in anticipation of lower prepayment risk, which in turn was destined to remove mortgage-related buying from the bond market. But OAS, like volatility, can jump for reasons other than prepayment risk, including anticipation of higher yields in general or greater credit risk for a class of security. Both of these factors started to emerge in June for 30-year 6.0% TBA mortgage pools even as 30-year FNMA vs. Treasury spreads remained static. Last week's chaos in the bond and mortgage markets increased both measures.



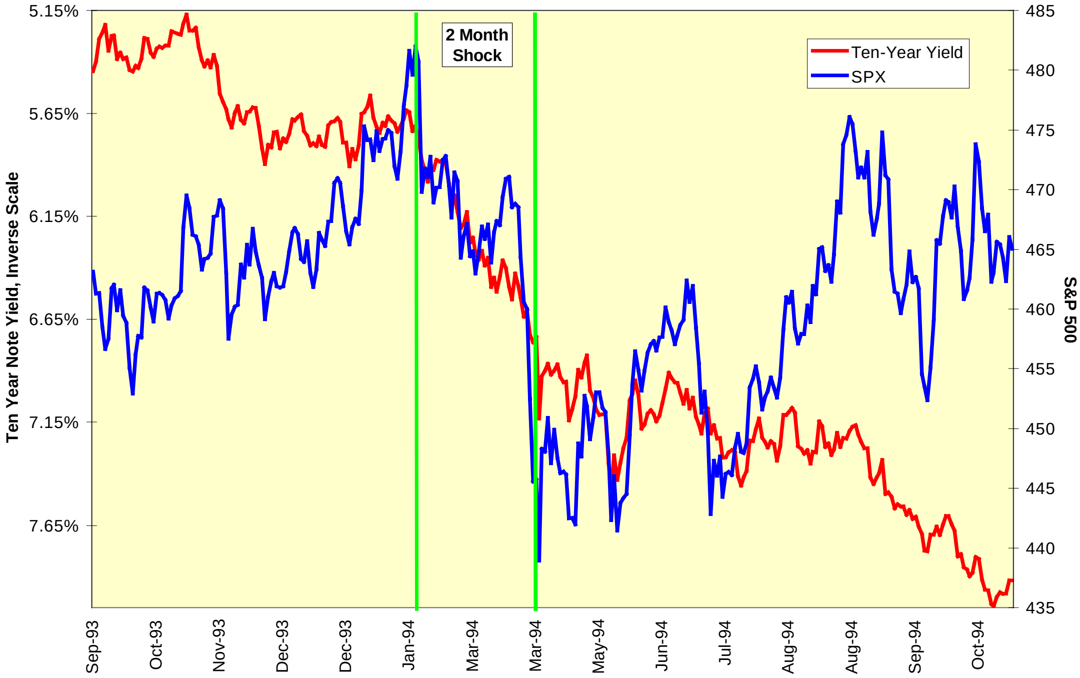
It would be quite difficult to envision stability in the mortgage market returning quickly even if Treasury yields stabilize. The mortgage refinancing boom was going to end once all those willing and able to refinance had done so, and that leaves mortgage lenders with huge pools of low-yielding securities and low-yielding Treasuries bought as prepayment protection. Both situations are going to overhang the market for a while; after all, Rome was not un-built in a day, either.

News Flash: World Won't End

It would be foolish to suggest that chaos in bonds and the sudden end of a strong sector of the economy will not have effects on the economy. But the 1994 experience is oddly encouraging for equity investors. The chaos in fixed income markets came after a massive transfer of wealth from lenders to borrowers; the recent transfer has been larger and more prolonged. When someone asks, "Where did the money go?" you can point to the balance sheets of debtors, including homeowners, corporations and governments.

The initial jump in rates in 1994 shocked stocks, but the victims in the bond market were not forced into liquidation of equities to meet their losses. They were forced into further liquidation of bonds. The equity market sold off quickly between February and April 1994, and then stabilized even as bond yields continued higher. Once the bond rout of 1994 was over, the 1995-2000-bull market in stocks emerged.

1994 Stock Shock Stabilized Quickly



So, for all of the messiness of 1994's bond slaughter, the S&P fell all of 9.3% from February to April, a move of less than 50 S&P 500 index points. We have just lived through one of the worst bond selloffs ever, and the current 10-year note yield of 4.4% is less than the low yield then of 5.15%. Stocks have witnessed this selloff, and yet have been able to remain in a range.

One of these markets is right. My previous work on this question, done at a time of falling yields, indicated that stocks were the "smarter" of the two markets. The subsequent bond market reaction to stronger economic news and the stock market's ability to shrug off the bond market's mess does nothing to change that original conclusion.