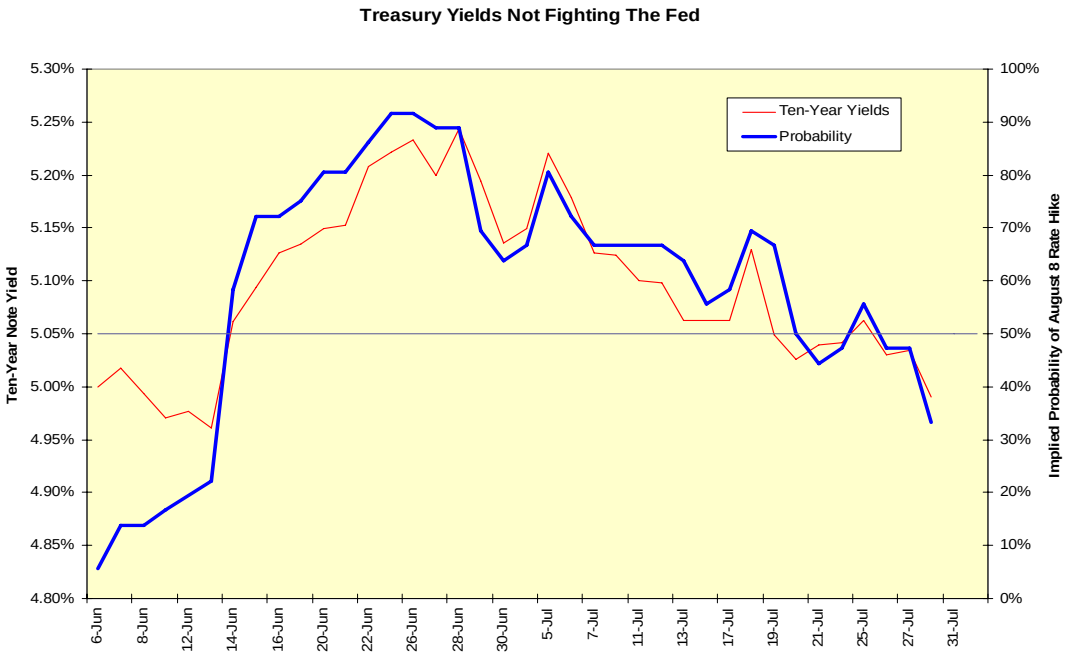
No Late Inning Monetary Heroics

Here's a bet for all you gamblers out there: The seventeen consecutive FOMC meetings producing an increase in the target federal funds rate will remain on the books for forever as a streak. That's right, one day you will be able to drive to Cooperstown and see Alan Greenspan and Ben Bernanke enshrined next to Lou Gehrig and Cal Ripken, Jr.

Gehrig, of course, was struck down tragically by ALS, and Ripken decided to end his streak on his own terms. The Federal Reserve's streak will end by virtue of its own successes in reining in inflationary expectations and in ending the housing bubble. Cynical observers, some of whom have been known to inhabit these precincts, might note both of these successes would be triumphs over problems caused by the Federal Reserve's own lax monetary policies between 2001 and 2005. Create the problem, and then solve it: That's how they sell mouthwash.

How can we be so sure the streak is over before it is over, in direct contravention to Yogi Berra's dictum it is never over 'till it's over? The implied probability of a rate hike on August 8 has fallen toward the 30% level, and no one from the Federal Reserve has attempted to jawbone the market higher.

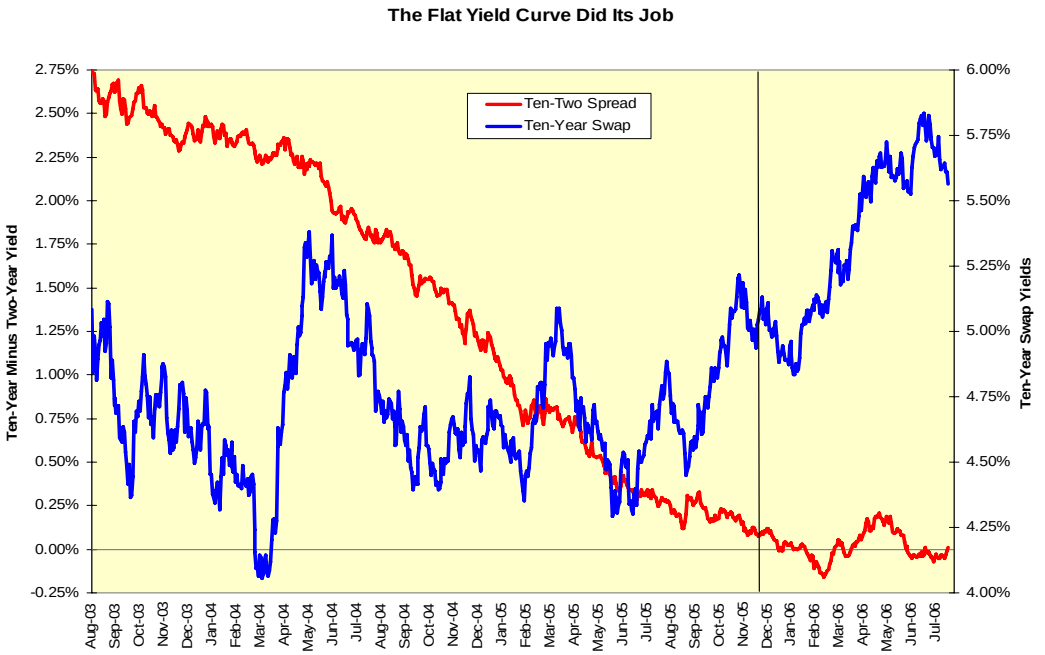
More interesting, however, is how the yield on ten-year notes has moved up and down with the implied probability. Long-term rates are supposedly set in the market, not by the Federal Reserve. The message from this unusual confluence is the bond market has turned bullish for the very same reasons the Federal Reserve is going to cease and desist.



Let's Go Do The Swap

We should update a set of indicators done last December and again in April on the behavior of long-term rates, ten-year swap rates in particular. As noted in December, marked on the charts below with a vertical line, much of the financing of American business is done at the swap rate, which is simply the present value of the yield curve, as opposed to a single rate such as the ten-year Treasury plus a spread. At the time, we noted how the constant stream of rate hikes, then twelve, had failed to derail business borrowing. Furthermore, even though the yield curve had flattened and was headed toward inversion, this would not matter so long as swap rates remained in their range.

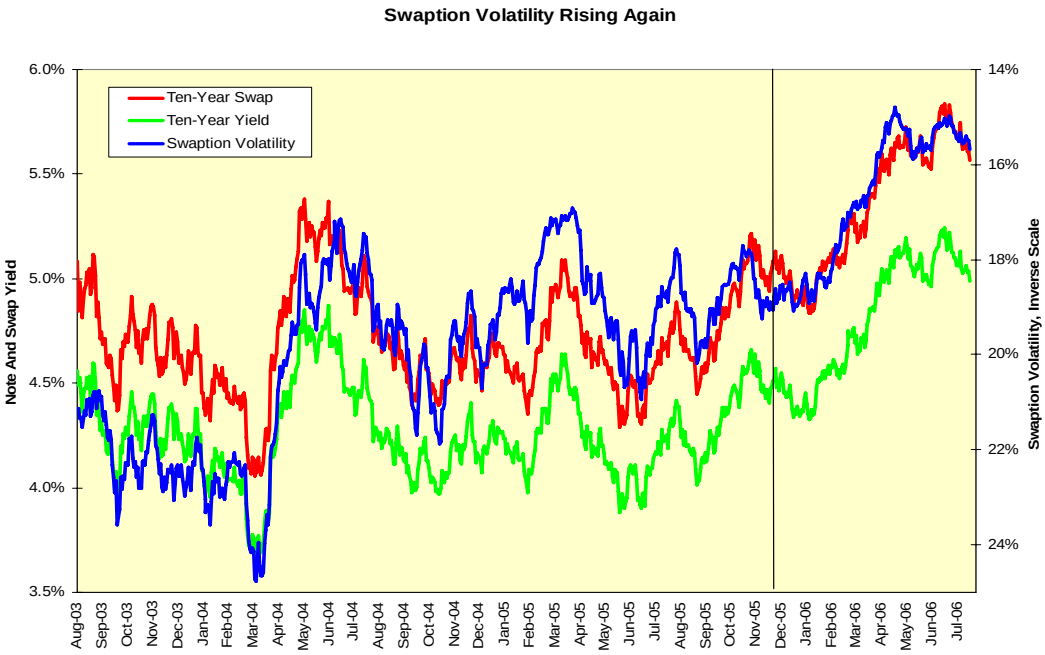
The yield curve as measured by the spread between the ten-year note rate and the two-year note rate did in fact move into an inversion both between January and March and then again in June. Swap rates broke out of their range to the upside in late February and continued higher into the end of June. They since have turned sharply lower; tellingly, this turn lower is coinciding with a re-steepening of the yield curve. This indicates the bond market no longer regards looser monetary policy as inflationary or over-stimulative. For stock investors, this is unalloyed good news: A fall in the swap rate should, all else held equal, be supportive of interest-rate sensitive industries.



Swaption Signals

A swaption is the right but not the obligation to enter into a swap at some point in the future. A call swaption gives the buyer the right to receive the swap's fixed rate of interest and pay the floating rate of interest. This is a bullish position in bonds as you profit if rates fall in the future. A put swaption buyer has the right to receive the floating rate and pay the fixed rate; this is a bearish position in bonds as you profit if rates rise in the future.

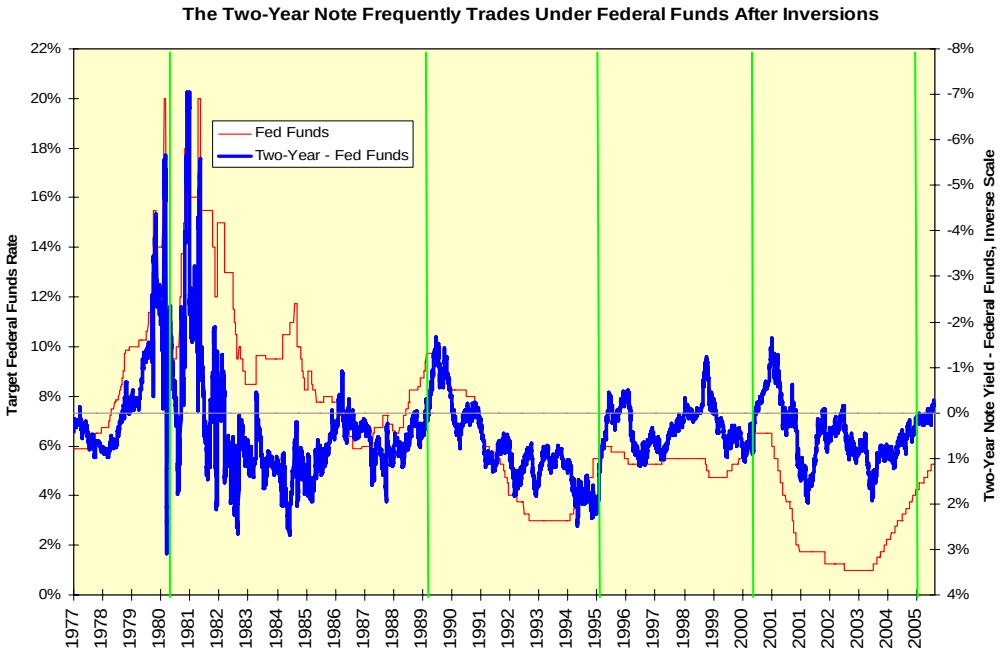
The volatility of these options, like the volatility on other instruments, contains information on the relative anxiety of traders in the market. Previous lows in swaption volatility have coincided with highs in interest rates. Swaption volatility has put in a double-bottom (plotted inversely) on its chart, first near 14.8% in May and again near 15.05% in early July. Its rise is consistent with an outlook for falling yields.



After The Federal Reserve Is Through

Now let's bring the closer in from the bullpen. Two-year note yields frequently trade under the federal funds rate at the time of the last rate hike. If we map the history of this spread against the target federal funds rate and overlay a set of vertical lines marking the time of maximum yield curve inversion in each cycle, we see how previous

maximum inversions occurred at the very time when the last Federal Reserve rate hike in the cycle was made. The current situation is different. The maximum inversion occurred on February 23, but we had three more rate hikes afterwards. Of course, most previous rate hike cycles ended with the Federal Reserve moving by more than 25 basis points at a time. It was different this time.



More important, however, is how each previous cycle's end preceded a bond market rally. While past performance does not predict future results (so why do we have such an elaborate system of measuring past performance?), it does indicate how we should bet. And that bet is for the bond market to rally.