Can Japanese Rates Happen Here?

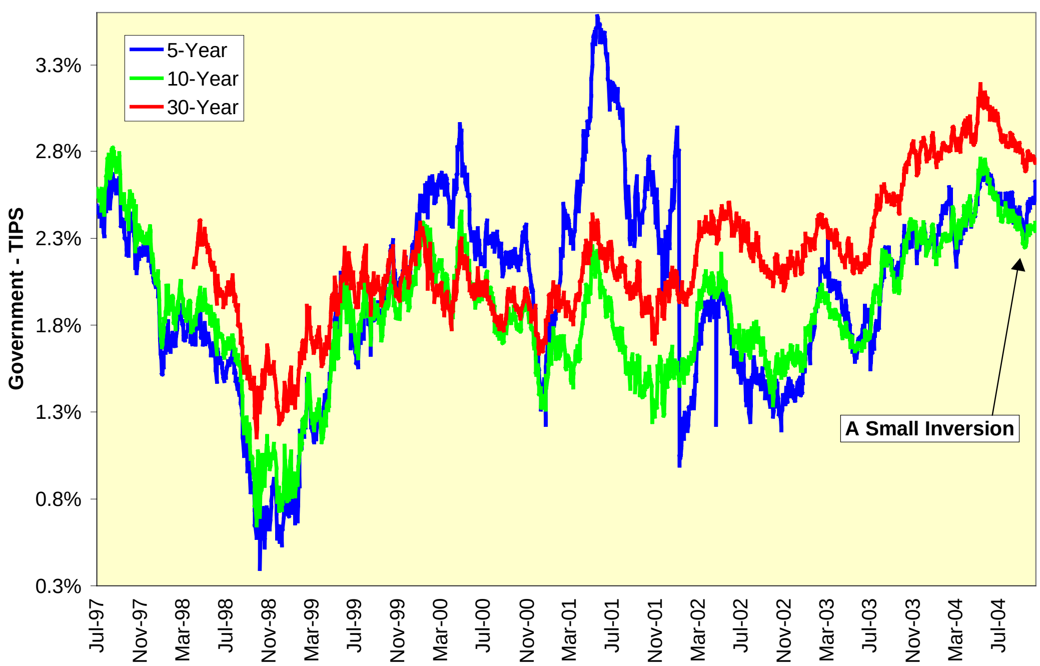
The last time we visited the Oracle of Delphi was in July, which curiously enough was the last time I felt it necessary to proclaim crude oil prices were headed higher. The purpose then and in today's restatement is not to glamorize the substance-induced hallucinations of our pagan predecessors around the time of Halloween - that would be wrong, wouldn't it? - but to emphasize that free will does not always operate in the manner intended. After all, we Baby Boomers were raised to believe both religious wars and infectious diseases were things of the past, and how well have those triumphs of the rational endured?

Whither Rates?

That energy prices are rising certainly qualifies as the dominant market story of 2004, but the persistent bull market in bonds has to run a close second. The links between these two developments have been the Federal Reserve's refusal to offset the implied tax increase from higher energy by continued monetary ease and the decline in inflationary expectations engendered by the combination of a flattening yield curve and this implied tax increase.

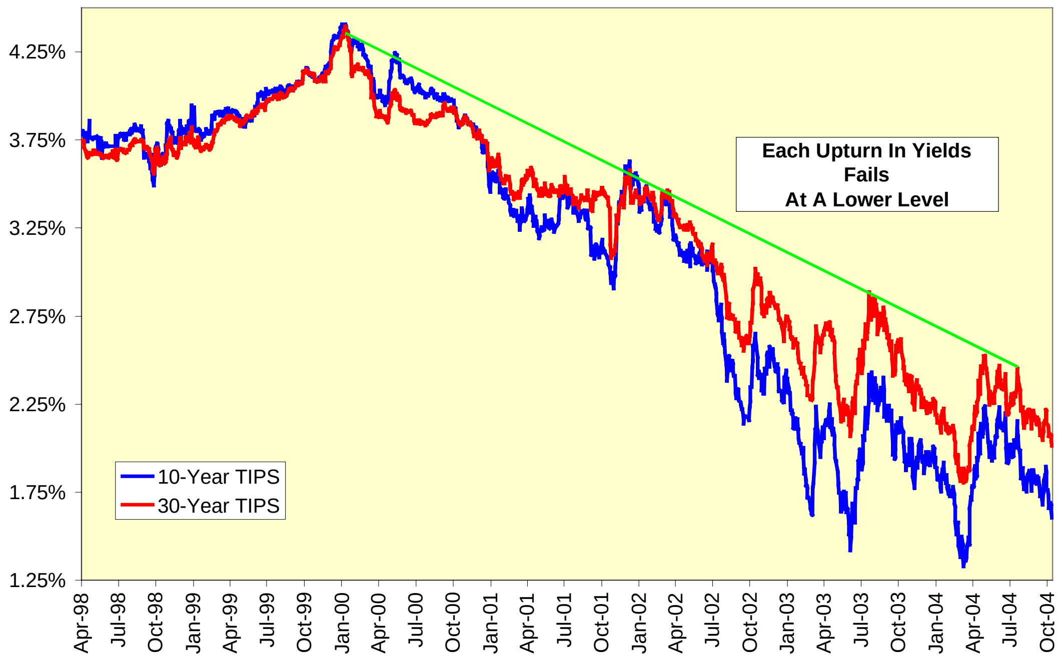
To top off the confusion, not only have the inflationary expectations as measured by the spread between TIPS and regular government bonds decreased since May, they have inverted as well. The CPI is expected to increase at an average rate of 2.625% over five years, but only 2.371% over ten years. The TIPS market is making something of a path-dependent forecast, and those have a lower success rate than regular forecasts, which scarcely have a success rate at all.

Inflation Expectations At Various Horizons



The path of real, or inflation-protected interest rates, has been declining since the beginning of 2000. The rate of decline has been anything but steady, however: Its volatility has increased markedly since the beginning of 2002. More important for the direction of rates over the long-term, each upturn in yields fails at a lower level.

TIPS Yields Retreat With Rising Volatility



For those wishing to blame bond rallies on either a failing economy or on the effects of mortgage-related prepayment hedging by the likes of Fannie Mae and Freddie Mac, the burden of proof is on you. First, chain-weighted or real year-over-year growth in GDP since the start of 2002 has never been negative; it ranged from a low of 1.2% in the first quarter of 2002 to a high of 5.0% in the first quarter of 2004. The most recent reading was 4.8% year-over-year real growth. Second, mortgage refinancing has been decreasing as a percentage of the stock of existing mortgages over this time; each wave of refinancing removes those mortgages from the potential refinancing pool until the next major downturn in yields arrives.

The increasing volatility of inflation-protected yields is not consistent with the theory that the bond rally of 2004 has been fueled by the risk-averse. Each basis point on a bond is worth more at a lower yield, and it requires exponentially more "energy" to drive yields lower from these levels than to drive them higher. Bonds are now a riskier investment than they were at the start of the year.

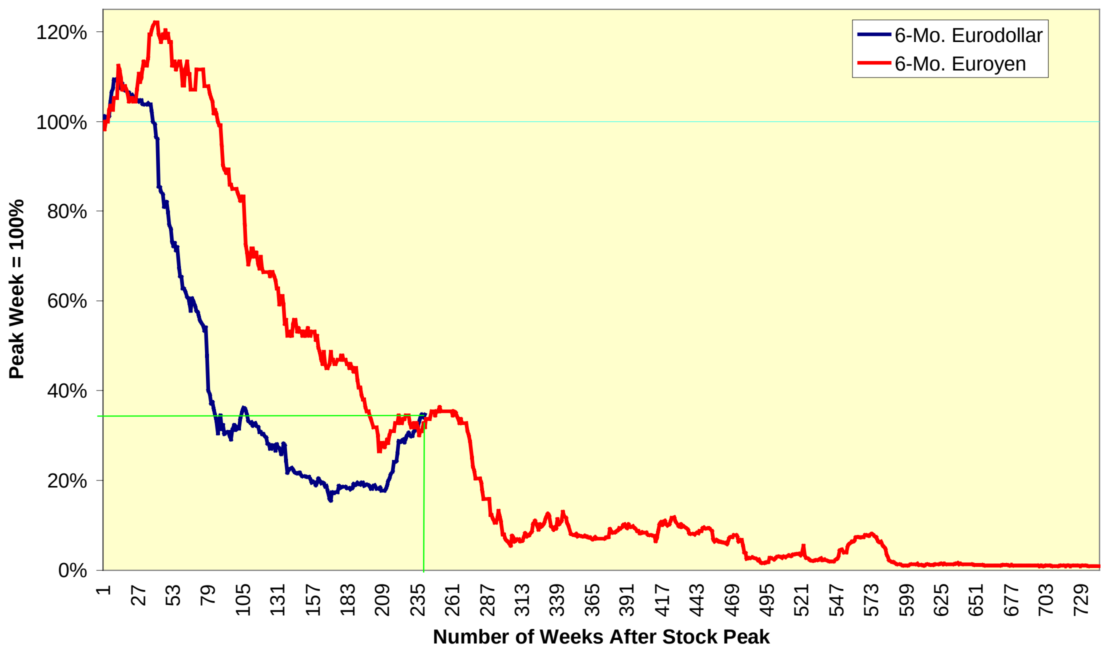
The Japanese Parallel

Twice before in this space I have drawn parallels between Japanese and U.S. interest rates after the two countries' respective stock market peaks in December 1989 and March 2000. The parallels for both six-month Eurodollars and euroyen and for ten-year notes continue on the parallel paths first noted here in October 2002 and again in March 2004.

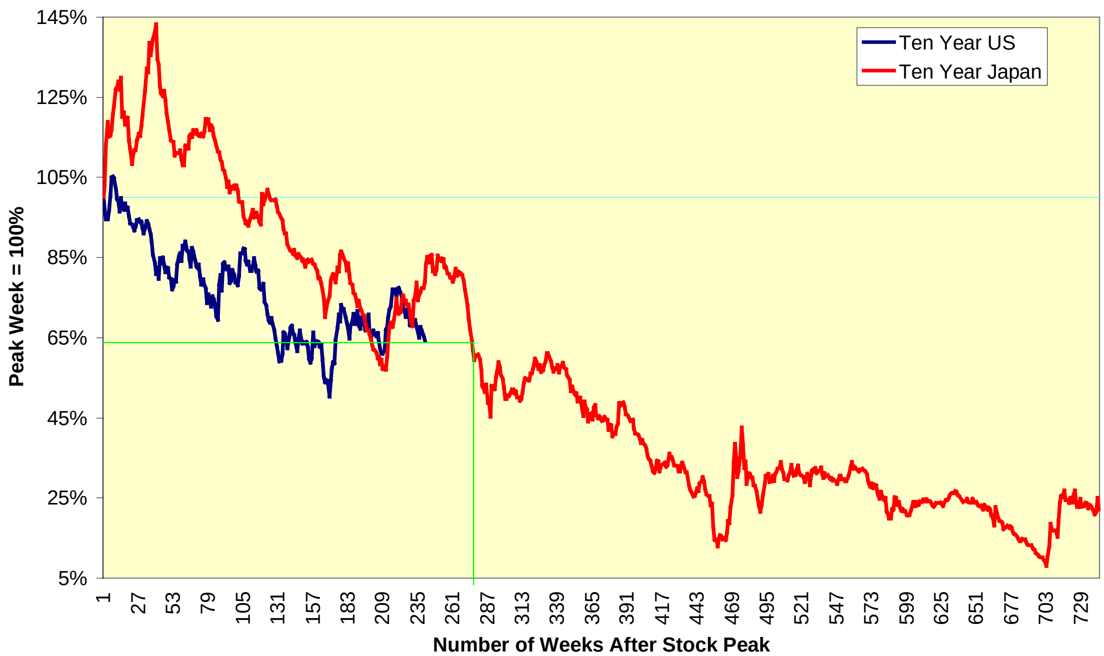
We can see some differences. In the six-month chart, the Federal Reserve's decision to cut rates rapidly and significantly after the stock bubble burst is readily visible, as is its recent decision to start raising rates. The U.S. six-month rate is now where the Japanese rates were on an indexed basis at a similar post-bubble point in time.

The ten-year chart is more interesting. U.S. rates fell more rapidly than did Japan's, but over the past year, our rates paralleled their experience, short-term reversals included. Our indexed rates are now below where Japan's rates were at a similar point in time.

A Tale of Two Rates



Ten Years After



Loss Of Free Will

Why these parallels should exist at all may be the scariest thing you see this Halloween. Let's recount some differences between the U.S. and Japan. First, the Japanese bubble of the 1980s was a mutually reinforcing affair between their stock and real estate markets, while our stock and real estate markets have had a shifted phase. Second, Japan has struggled through several periods of outright recession since 1990. Japan's export sectors faced increased competition from Taiwan, South Korea and especially China while several of its Asian customers faced devastating losses of purchasing power in 1997-1998. As noted above, our economy has grown since the bubble burst; the 2001 recession was one of the mildest and shortest on record.

Third, as noted in the six-month chart, the Bank of Japan continued to raise short-term rates after its stock market bubble burst; the Federal Reserve did the opposite. Fourth, Japan’s business culture precluded the forced consolidation of banks whose balance sheets indicated functional insolvency, while we have both allowed and induced some spectacular business failures.

Fifth, Japan’s national debt is approaching 139% of GDP, while the U.S. level is “only” 63.2%. Sixth, Japan raised its national sales tax in 1997. The U.S. has reduced taxes throughout the Bush administration. Finally, Japan has a culture of saving obsessively and let's just say the U.S. does not.

The persistent trend lower in yields despite economic growth and government deficits suggests there are forces, maybe just post-bubble forces, at work that are beyond our control. Consulting the Oracle will not help; we need to start thinking about the unthinkable and that is a continued trend of lower yields when all prior training suggests the opposite should be occurring.