# Bonds Don't Stop Thinking About Tomorrow

Is it at all surprising how the present confluence of book tours, presidential nostalgia and the impending change of direction of U.S. monetary policy should lead us back to that magic moment in 1992 when the Clinton/Gore ticket accepted the Democratic nomination to the strains of *Fleetwood Mac*, a band whose off-stage activities could have been used to illustrate the principles of permutations and combinations to high school math students? Happy days were here again indeed; perhaps Bach's *Ode To Joy* might have been more appropriate given what we know now.

The admonition "don't stop thinking about tomorrow" is superfluous for financial markets, the regular histrionics over soon-to-be-revised and backward-looking government reports notwithstanding. Given the new era of higher federal funds rate virtually certain to begin on June 30, let's take a look backward and see which segments of the interest rate market were best at surfing the expectation waves since the federal funds rate was cut to 1.00% in June 2003.

The world is a big place and has room for more yield curves than just the Treasury market, more short-term rates than just federal funds and a wealth of spreads measuring various risk preferences. More important, these indicators contain important information for market analysts, savers and even stock investors.

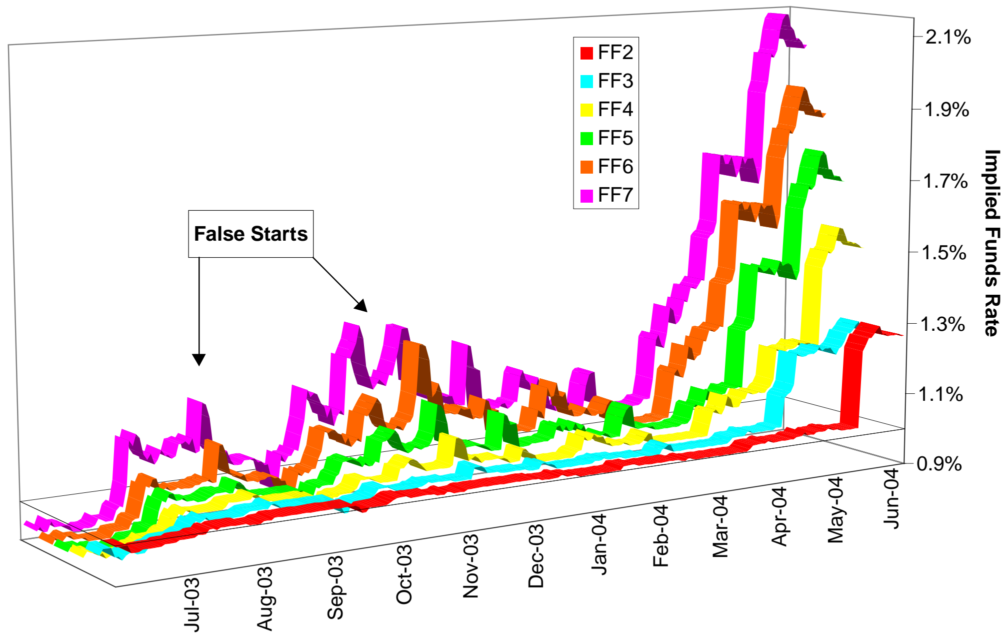
**Federal Funds Futures Forecast Follies**

The federal funds futures market is both an extraordinarily useful tool for measuring existing sentiment and a distraction forcing a certain conformity of opinion as everyone is looking in the same mirror and seeing each other in real time. And, as I have said a number of times to collective disbelief, markets do not forecast, they measure; we cannot pool our ignorance and somehow distill greater wisdom therefrom. As recently as March 11th of this year, Wall Street's top economists and strategists were falling over each other to push back the date at which the Federal Reserve would, if ever, raise rates.

Much of the work done in behavioral finance returns to the conclusion that investors extrapolate current trends and conditions. While it would be extreme to say we all should ignore the collective assessment offered by the futures market, we should remember just how fallible and susceptible to instant and extreme changes of emotion it is. If individuals extrapolate the present, and all traders who see the futures market are led perhaps subconsciously into a version of group thought, then why should the futures market be able to avoid acting like the individual investors from which it is comprised?

Accordingly, we can see in a chart of the second through seventh consecutive months of the federal funds futures contracts how the market at least twice priced in rate hikes in 2003 and twice removed them before the current consensus emerged in April 2004. Those experiences made this market quite shy: Even after the March employment report's release on April 2, an event which shocked the long end of the Treasury market and many higher-risk bonds, only the seventh month future priced in a 25-basis point increase.

**A Few False Starts Along The Way**

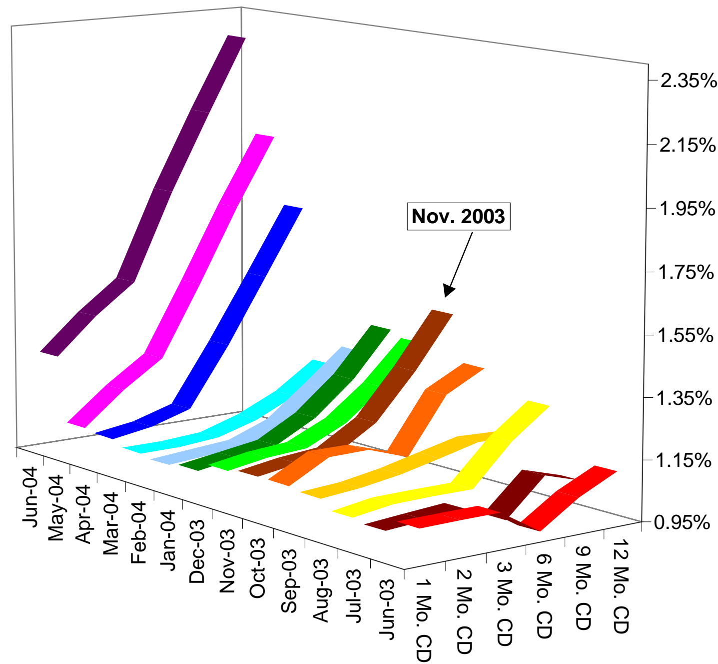



**Stay Short And Float**

While federal funds receive an inordinate amount of attention, it is important to remember only Federal Reserve member banks can trade these, and then for only very short periods. The overnight rate is the one targeted by the Federal Reserve; the futures contract is for thirty days. Let's take a look at how some other money market instruments behaved over the past year.

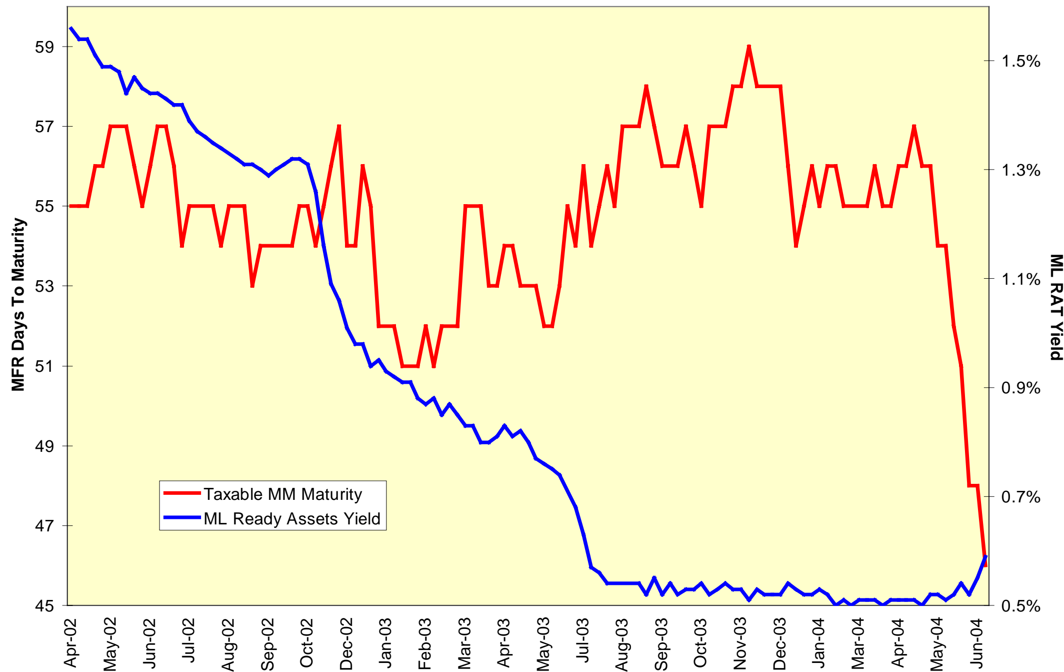
Risk-averse savers, including many retirees and those otherwise on a fixed income, considered themselves victims of the last three years' monetary policy. The bank CD market, much like the federal funds market, had a few false starts, most notably in November 2003, in pricing in higher rate expectations. These were gone by the end of March 2004, at which point rates jumped and the yield curve began to steepen.

## CD Curve Steepens At Higher Yields



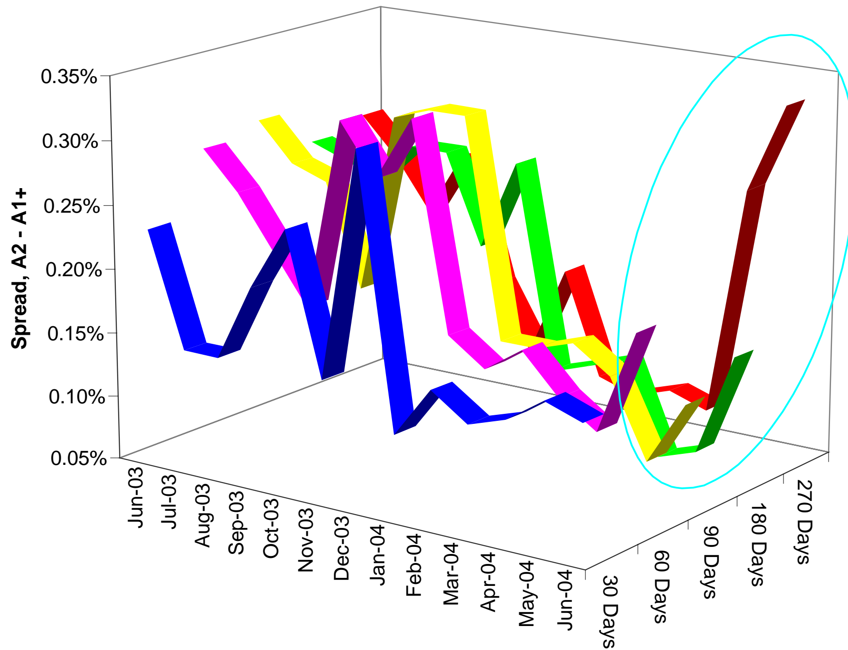

Just as many stock traders pounce on an issue falling from a recent high only to regret their dalliance with said Fallen Angel, many CD investors may be tempted to jump at today's rising yields. Who ever thought 2.25% would look good? It is not if rates are in fact headed higher. Savers are advised to mimic the actions of money market mutual fund managers: Shorten your maturities and wait for yields to rise. The maturity of taxable money funds is now down to 46 days from 55 at the end of March 2004; the yield on the Merrill Lynch Ready Assets Trust has risen from .51% to .59% over that same period. A 15.7% increase in yield with more to come prompted a 16.3% decrease in maturity.

**Keep Maturities Short**




## Corporate Borrowing

Just as individuals are in the money market, so are corporate borrowers. And, just as credit spreads are a key to bond markets, they influence commercial paper markets as well. If we examine the spread between secondary-tier commercial paper, that rated A2, and the very top tier, rated A1+, we see how credit spreads were tightening throughout 2004 until June. At this point, the spreads began widening out, especially for the 270-day issues marking the end of the commercial paper horizon.




Any widening of credit spreads in the money market as rates widen must be taken as a warning for all financial markets. After all, when high yield bond spreads stopped narrowing at the end of January 2004, the stock market stalled and has yet to take out those highs. These spreads, more than any return of the federal funds rate to a neutral level near 4.00%, will affect the market for risky assets such as stocks, corporate bonds and real estate, otherwise known as the things you own.