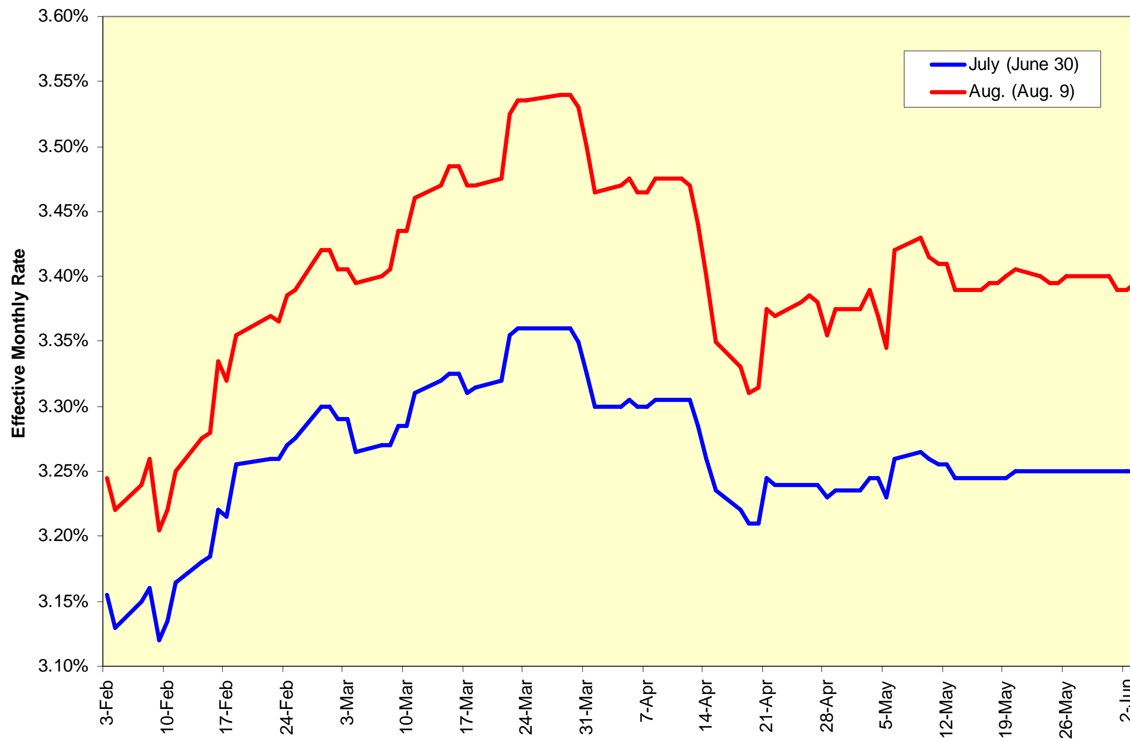
Does Zinc Link Still Work?

Even after last Friday's stunning intraday reversal following the employment report, the bond market remains, as some high-ranking officials might say, conundrificated. We may be in the seventh inning, in a soft patch or in a tight spot, but where we really are is in a place where the compasses have ceased working.

Quite simply, the old magnetic needle would say we are not supposed to be in an environment with 3.7% year-over-year growth in GDP and 2.5% year-over-growth in the GDP deflator, a budget deficit of 3.5% of GDP, a current account deficit at 6.16% of GDP, eight consecutive increases in the federal funds rate and still have a ten-year note yield buzzing about the 4% line. I noted back in July 2003 that stocks are not GDP futures, and we clearly have to describe bonds similarly.

The implications of this line of thinking are sweeping: The vast resources, time and attention paid to forecasting the next economic data point are misplaced. Unless we can attribute meaningful policy responses to the next report and can attribute a direct market response to those policy changes, it is all just noise. Over the past year, the Federal Reserve has been on a mission, one that has remained largely unchanged, to raise rates at a measured pace. The federal funds futures market has remained steady in the face of all economic data since the FOMC meeting on February 2; only the mid-April stock market disruptions linked to the General Motors profit warning budged the July contract away from pricing in a 25 basis point hike on June 30 and the August contract from pricing in another 25 basis points on August 9. Last Friday's employment report failed to make the needle twitch.

Implied Yield, Federal Funds Futures



That the markets might ignore the Federal Reserve is a radical notion, but really it should not be. The simple truth of the matter is the Federal Reserve began losing its ability to slow the economy with its favorite tool, a two-by-four across the face, all the way back in 1980 when interest rate ceilings on time deposits were loosened. This prevented them from crushing housing, a market remarkably un-crushed at present. The explosion of mortgage derivatives and asset-back securities in credit cards and auto loans, amongst other instruments, allowed funds to flow between whoever wanted to lend them and whoever wanted to borrow them in a sort of grand coalition of the risk-seeking.

If you still think the Federal Reserve or any other central bank of note, say the Bank of Japan or the European Central Bank, is calling the shots, just ask yourself how well the Federal Reserve managed the equity bubble of the late 1990s or how well either the Bank of Japan or the Federal Reserve re-stimulated their respective economies

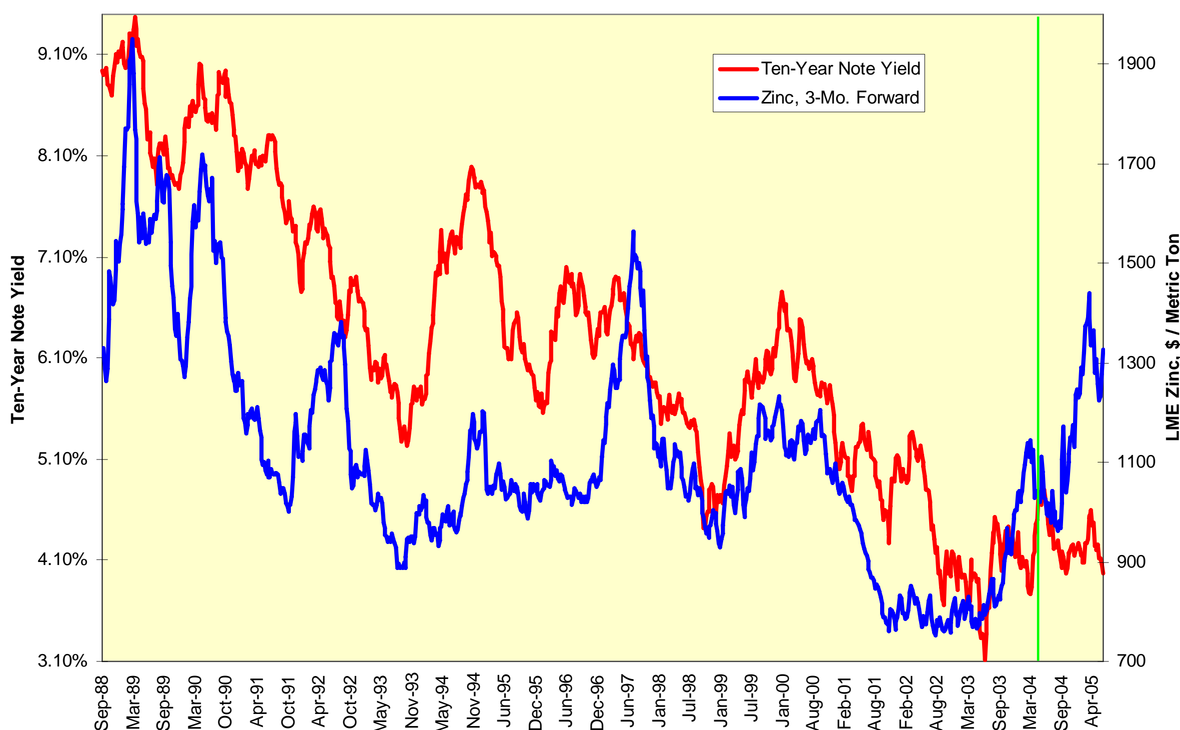
after their equity bubbles burst. Japan is still floundering after all these years, and economic historians will debate the relative roles of the Federal Reserve against the 2003 tax cuts for years to come.

The Zinc Compass

Just to see how far the mighty have fallen, let's take a look at an old favorite for coincident economic activity last headlined here in December 2002, zinc. As noted then in reference to the strong relationship between ten-year note yields and zinc:

> Since 1988, zinc has gotten it wrong only once, and that was during early 1997, just prior to the Asian crisis that defined so much of our recent financial history.

We can add the post-April 2004 era to the list of when zinc diverged from note yields. As was true in 1997, much of the demand growth for zinc in world markets can be attributed to Asia; then the emerging markets of South Asia, today China.

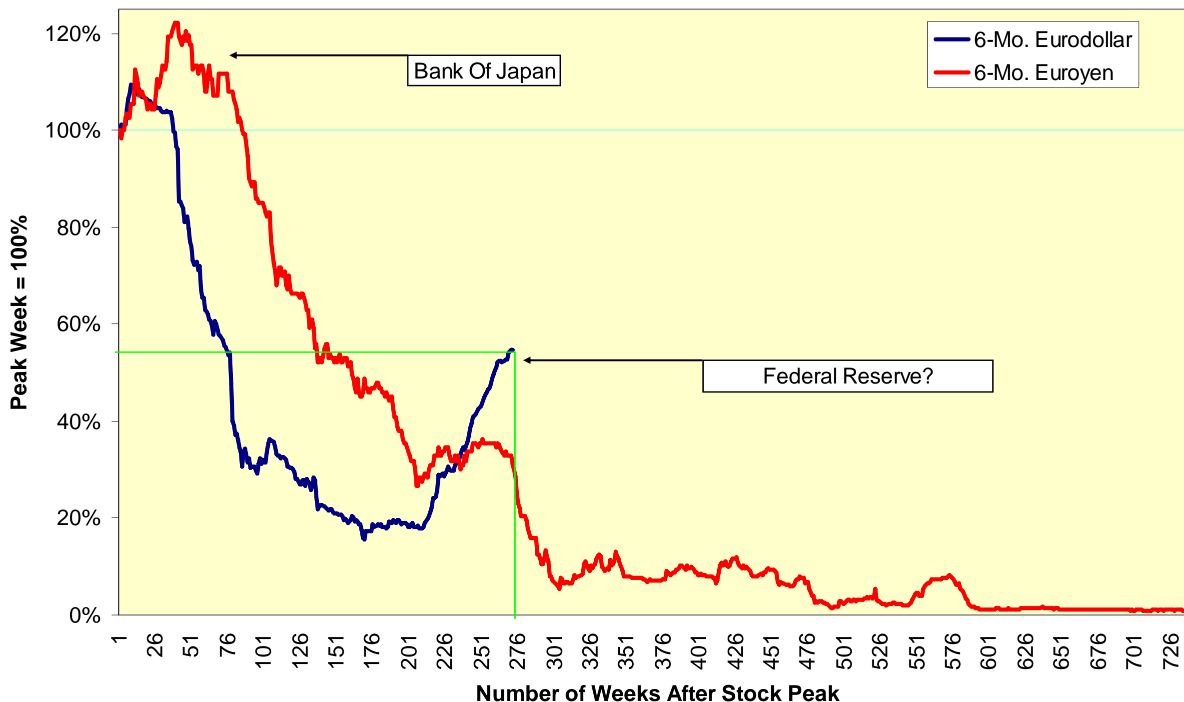


How will the present divergence end, with note yields rising or with zinc prices falling? The answer is conditional, of course, on China's ability to keep growing by whatever means necessary. If they succeed in doing so, more and more of the world's manufacturing will shift to China. This will perpetuate the cycle of global commodity prices rising while consumer prices for those goods China exports remain tame. More important for the above relationship, it will keep the cycle of foreign buying of U.S. Treasuries and other financial instruments going; the U.S. capital surplus is a mirror of the U.S. current account deficit.

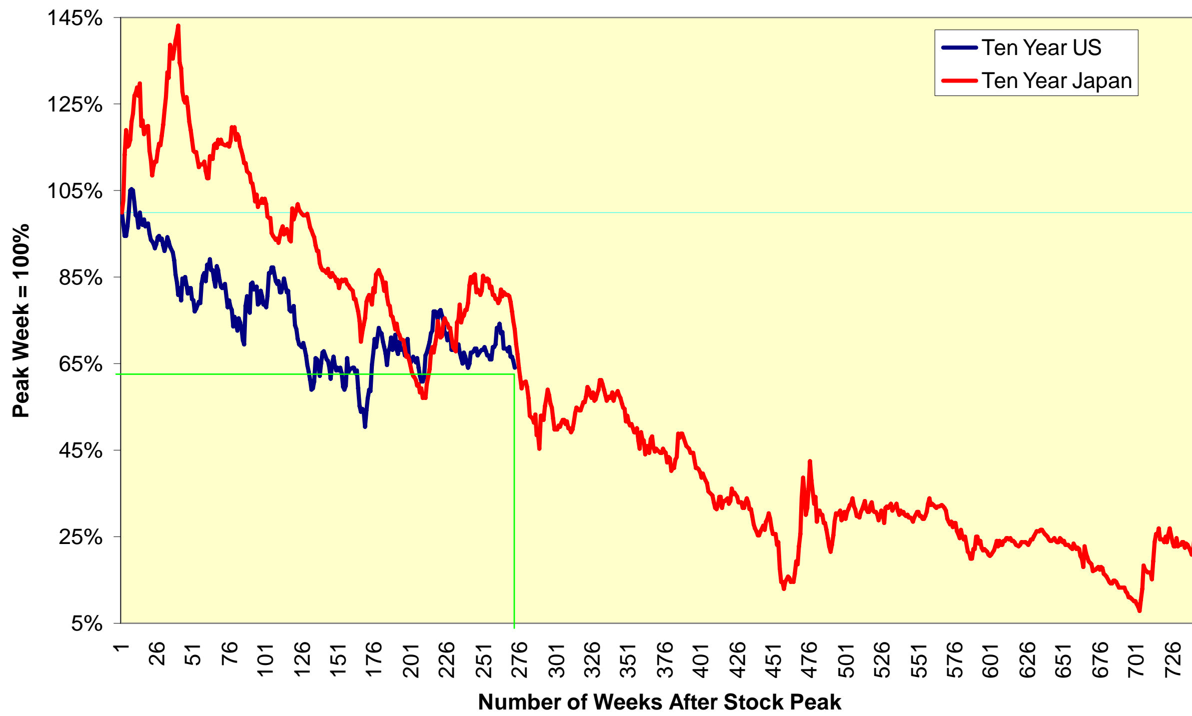
The biggest risk to this scenario is a bungled revaluation of the Chinese yuan. I am still of the opinion, expressed here last month, that a more freely traded yuan will mean a quick attempt by hot money accounts to flee China while they still can.

What will propel note yields higher? If you ask this question of a standard-issue Wall Street economist, you will get the same litany of forces and events that have failed to produce the right answer since the stock and credit markets bottomed in October 2002. You know the drill, so let's skip it and return to an analogy I have offered several times, most recently last October: The one between the U.S. and Japan after their respective stock market tops in December 1989 and March 2000.

If we compare the respective paths of six-month LIBOR rates in the yen and the dollar, respectively, we can spot the Bank of Japan's obvious-in-hindsight policy error of raising rates too soon after their stock bubble burst. The Federal Reserve was determined to avoid this error; it was one of their motivations behind driving rates aggressively lower. They now have driven six-month rates well over the Japanese analogue path.



But what about the long end of the curve? If we look at the parallel paths of ten-year note yields, we find that U.S. note yields have fallen further and faster than did their Japanese counterparts, and if the Japanese parallel persists, we have a ways to go on the downside.



Viewed in this respect, we almost can say we are condemned to see lower yields, regardless of Federal Reserve policy or economic data. The compass, whether made of magnetic iron or zinc, is as broken today as it was in the early 1970s, another time when the economics profession was flummoxed. We will visit that topic next week.