

U.S. Bond Market Outlook

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[Excerpt from a 19 page article]

Our analysis of the current return prospects for the U.S. bond market starts with the question of inflation. With nominal interest rates at very low levels across the Treasury curve (in other words, for all maturities), any increase in inflation and/or inflation expectations would drive up interest rates and drive down bond prices generating losses for bond investors.

Add to this concern about the low level of interest rates, the record deficit spending by the Federal Government, extensive money creation (quantitative easing) by the Federal Reserve¹, and global concerns about the value of the dollar—all of which seem to augur for higher inflation and/or higher interest rates—and the picture does not look promising for U.S. bond market investors. In fact, some anecdotal evidence appears to indicate that these concerns are motivating investors to reduce their exposure to future rate increases by keeping maturities short, since prices on short term bonds are less sensitive to increases in interest rates, all other things being the same.

We do not think inflation poses a serious threat to bond investors for the foreseeable future. Although the current concerns about inflation would be warranted under normal economic conditions, today's conditions are not normal, and the dynamics affecting inflation and interest rates are different from those prevailing in ordinary times. The Federal government's deficit spending and the Fed's quantitative easing were and are necessary to counter deflationary pressures in the

economy—pressures which could have pushed the U.S. into a depression. Now that the U.S. has avoided a more severe contraction than it would have otherwise experienced, the challenge for policymakers is not how to unwind fiscal and monetary stimuli before inflation becomes a problem, but how to reduce the stimuli without pushing the economy back into recession. Those who see inflation as the greater risk do not appreciate the challenges faced by the U.S. economy.

The extraordinary measures taken by the Fed have been motivated by a concern for price stability with the threat to that stability coming primarily from deflationary pressures, not inflationary pressures. The impetus from both the supply and the demand side is towards lower prices not higher. Even a casual observer today sees evidence of the pressure in salary and wage freezes, reductions in hours worked, mandatory unpaid furloughs, labor concessions in collective bargaining, and widespread price reductions on goods and services. Richard Fisher, president of the Federal Reserve Bank of Dallas, in an address in Tokyo on April 8th spoke most candidly. "Presently the risk is deflationary job destruction."

Like the Bank of Japan in the 1990s, the Federal Reserve has reduced its key interest rate to virtually zero giving it no more power to spur credit and money creation through its traditional lever. With this lever now ineffective, the Fed had to resort to alternative means to expand money and credit such as the creation of money through securities purchases.

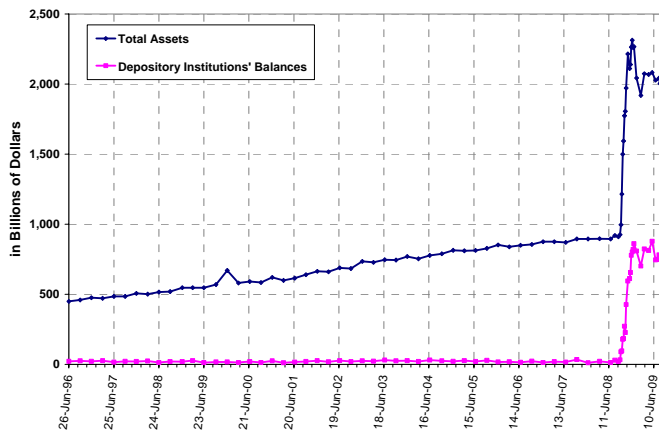
Under normal circumstances, the large increase in the Fed's balance sheet with its attendant money creation (see Figure 1) would and should be a source of grave concern. The excess bank reserves created by the Fed's purchase of \$2 trillion of securities in the open market could fuel an explosion in credit and the money supply and

¹ Commentators often talk about the government printing money to finance deficits. In fact, the federal government doesn't have the authority to create money. It must finance deficits with borrowed money. Only the Federal Reserve can "print money" or create money—something it has rarely done on the scale it announced in March when it said it would buy an additional \$1.2 trillion of securities. Where will the Fed get the money to pay for these purchases? It will create it – out of thin air. It will write a check to buy the securities, and presto! the sellers will have \$1.2 trillion in money that did not previously exist. The balance sheet of the Fed will grow by \$1.2 trillion: with the securities on the asset side. The growth in assets will be funded on the liability side by a growth in bank reserves. And that's the rub, because the bank reserves represent an enormous potential increase in the money supply.

lead to sharp increases in prices (see Figure 2). The key here, however, is that this can only happen through a growth in credit. But credit is not expanding. Quite the reverse, with the exception of government debt, credit is contracting. Mortgage debt and consumer installment debt are declining, and total business debt has leveled off (see Figure 3).

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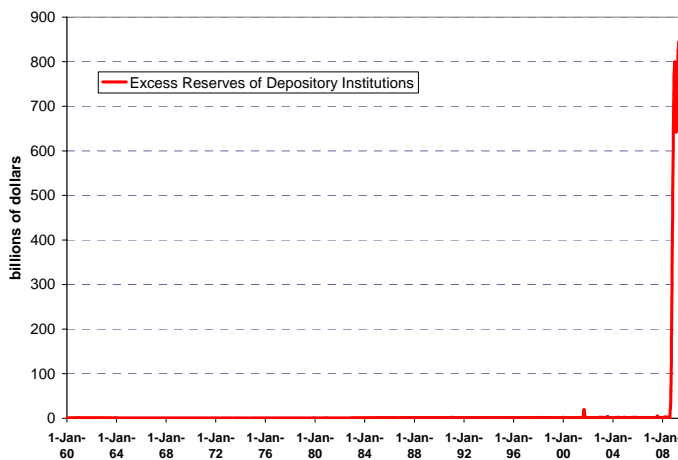
Figure 1
Federal Reserve Bank Total Assets and Depository Institutions' Deposits
Selected quarterly data through June 2008 followed by weekly data through 29 July 2009



Source: Federal Reserve, Statistical Release H.4.1

With the Federal Funds rate at nearly zero, the Fed has had to resort to quantitative easing, through the purchase of securities and the expansion of its balance sheet, to provide liquidity and to ease conditions in the credit markets. The expansion of the Fed's balance sheet to over \$2 trillion has resulted in an unprecedented increase in excess bank reserves (Figure 2).

Figure2
Excess Reserves of Depository Institutions, January 1960 through June 2009



Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis