

Yesterday the Fed released the minutes from its April Federal Open Market Committee (FOMC) meeting. Committee members were able to keep the idea of a rate hike on the table, while leaving themselves an out – if the data does not support a rate hike, they simply will not do it. According to the minutes, the meeting participants “expressed a range of views”, which is a very polite way of saying there was no agreement about what to do next. The minutes also noted the participants will leave their “policy options open”, suggesting anything can happen in future meetings.

Market Reaction

The bond market appears to have swallowed the bait about a Fed tightening in June hook, line, and sinker.

Yesterday’s sell-off in Treasuries may have created an excellent buying opportunity at the front end of the curve for those who believe the Fed will not tighten. The forward Treasury curve is now implying an increase in rates of about 40-50 basis points in shorter maturity bonds – which is not likely to happen if the Fed wants inflation up to 2%.

To compound matters, the hint of tightening has sent the dollar soaring – in exactly the wrong direction for the Fed. The strong dollar can be destabilizing to world markets, as well as disinflationary.

The US Treasury Inflation Protection Securities (TIPS) market may be giving the Fed a clear warning on that point – break-evens on 5-year TIPS (which reflect the market’s expectation for future inflation over the intermediate term) are actually falling – that is the wrong direction given Fed policy objectives. Interestingly, they have been falling since the meeting.

Exhibit 1: 5-Year TIPS Break-evens

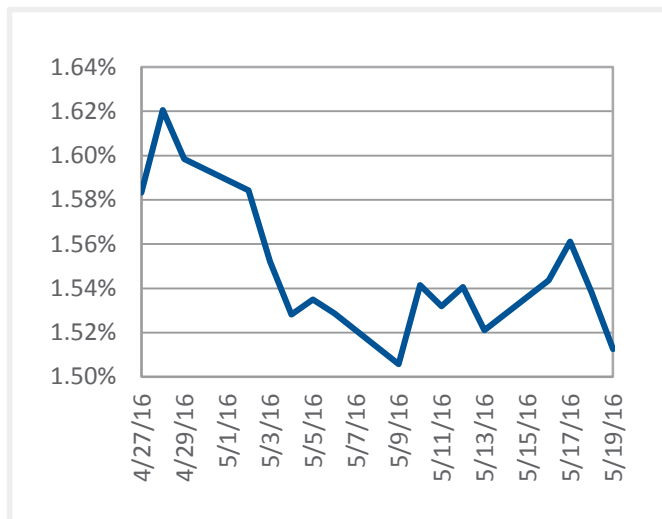
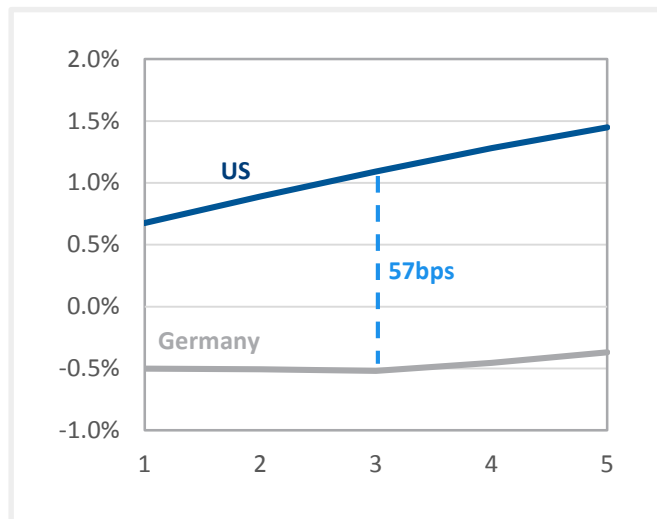


Exhibit 2: US and German Yields



Source: Bloomberg, Merrill Lynch.

Another reason why Treasury bonds look attractive right now is how good they look compared to overseas rates. Since rates overseas have moved increasingly negative in recent months, we don’t see how higher US rates at the shorter end will fail to draw the attention of yield-thirsty overseas buyers. A buying opportunity in those maturities may be developing – cash on the sidelines, domestically and globally, should move into 3-year Treasuries.

Here is why: a German 3-year government Bund now yields -0.51%. A 3-year US Treasury now yields 1.08%. The spread between the two is nearing the widest levels of the past 15 years and is unlikely to move much higher given global conditions.

Looking Forward

For those who believe the spread between Bunds and Treasuries will not widen further, the only support for higher Treasury yields is a rise in German rates. We believe this is unlikely.

As for the 10-Year Treasury? Crystal balls are always foggier in longer maturities, but the spread between 10-year Treasuries and Bunds is also at multi-year wide levels. While it would be foolhardy to call a top in 10-year yields, they could go up a little further if stocks gain their footing. Nonetheless, given the spread between Bunds and Treasuries in 10 year maturities, we are likely closer to the top of trading range in 10-year Treasury yields rather than the bottom.

From a yield curve perspective, we believe the curve is likely to steepen – but with short rates falling more than longer rates.

If the analysis above is wrong, and the Fed does tighten in June, it will be a sign to the world that the FOMC has not learned from its errors. The market's reaction to the last tightening showed that the psyche of investors is just too fragile. Quantitative Easing is more likely to work if there is a wealth effect that bolsters consumer confidence. If the wealth effect disappears, there is no confidence, and no recovery.

We believe that tightening would be an error as it would support a dollar rally. This would destabilize markets, put pressure on Emerging Markets nations that have dollar-denominated debt, and pressure China to devalue again. The Fed should know by now how destabilizing all these events could be. However, the Fed's hands are tied – the jawboning about tightening is to create the illusion they actually have a choice.

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