Is the 'Growth Scare' a Bond-Buying Opportunity?

By RANDALL W. FORSYTH

Sharp rise in yields will be unsustainable, say a pair of economists who depart from Wall Street's consensus.

Bill Clinton showed his star power is as bright as ever last Friday when he took the podium with President Obama to sell the latter's tax plan to reluctant Democrats. Indeed, the former president outshone the current one, staying behind to answer reporters' questions long after Obama left for the White House holiday party.

This isn't the first time Clinton has had to defend a policy to which the Treasury market has reacted negatively. Early in his first term, he railed that his administration's policies depended on a bunch of "[modifying gerund] bond traders."

The Treasury market hasn't reacted much better to Obama's deal with the GOP to extend current tax rates enacted during the Bush years. Yields, already in a pronounced uptrend, spiked up sharply to six-month highs last week on prospects for higher economic growth (good for us, bad for bonds) and a record fiscal 2011 deficit (bad for everybody.)

But have the bond vigilantes overreacted? Yes, say a couple of economists who are paid by their clients for their insights, not by financial services firms with products and services to sell.

The bond market's battering reflects a "growth scare" that will prove unjustified, Srinivas Thiruvadanthai, direction of research at the Jerome Levy Forecasting Center, wrote to clients.

The Obama-GOP tax deal cuts the probability of a downturn in 2011 to 40% from 60%, he reckons. "But the recession danger will not diminish, just shift out into 2012."

Similarly, Charles Dumas of Lombard Street Research in London agrees the Obama tax proposals should boost economic growth in 2011. He looks for a half-percentage-point fillip, to 2% from 1.5% in his previous forecast. Other economists are dialing up their numbers for next year's gross domestic growth to the 3%-plus range.

But that short-term boost to growth comes at the cost of a massive budget deficit. The longer-term result, according to Dumas, will be "much more austerity later."

For now, says Thiruvadanthai, the bond market is being battered by one of its periodic "growth scares," which he says "will prove unjustified." The reasons: "the economy has virtually no prospect of picking up enough steam to reverse disinflation, markedly cut unemployment, or budge the Fed from its zero-interest-rate policy."

The scare could drive bond yields higher, he continues, but in real terms, they already are at their highest levels of the decade relative to core inflation. The yield curve also has steepened to a slope that in the past has presaged either a Fed tightening or a sharp decline in bond yields. "And you can be confident that Fed rate hikes are not in the cards for a long, long time," Thiruvadanthai adds.

But the Fed's efforts to hold down intermediate-to-long-term interest rates through QE2 -- the planned purchase of an additional $600 billion in Treasury securities -- have backfired totally. The key

10-year Treasury note yield is up nearly a full percentage point from its October lows, to 3.32% Friday, before easing off to 3.29% Monday.

"The primary reason why QE2 is counterproductive is that it spooked commodity markets, which, unlike people bargaining for higher wages, have actionable inflation expectations," according to Dumas. "The result is that real consumer incomes have been lowered by 1/2 to 3/4%."

That was the pattern in 2008, when the economy already was buckling under the burden of $4-per-gallon gasoline on consumers -- well before Lehman Brothers failed in September, sending the financial system into a free-fall.

The betting in the options market is heavily toward lower bond prices and higher yields, with a preponderance of buying of put options relative to calls, writes Paul Macrae Montgomery, author of the Universal Economics newsletter.

The last time options sentiment was so lopsided was in late August, right around the peak of prices and the lows in yields. "Bonds are not quite overdone to the downside today as they were overdone to the upside in August -- but they are getting close," he writes.

Indeed, the growth scare could carry yields still higher, but they wouldn't be sustainable, Thiruvadanthai adds.

"Current market expectations for economic growth and inflation beyond early 2011 are unrealistic. Bonds are becoming increasingly attractive. Even if the bond market's growth fears are not assuaged by economic data for another four-to-six months, bond yields may turn down because of further evidence of deflationary pressures, more financial scares abroad, or domestic financial stresses emanating from the mortgage market, state and local finances, or regional bank problems.

"The market is providing a buying opportunity," he concludes.