Market Insight: Uncertain future for bonds
By Philip Coggan, Investment Editor
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Just how long is "a considerable period?" Last week, the US Federal Reserve committed to keep interest rates low for that indeterminate stretch of time.

If one is to judge by the markets, the answer is less than a year. Eurodollar futures prices indicate that the Fed funds rate is expected to rise by June 2004 and should have doubled, to 2 per cent, by the end of next year. Two-year Treasury bonds, yielding 1.6 per cent, point to a similar picture.

One reason why bond yields, and interest rate expectations, have moved higher in recent weeks is the evidence of stronger US economic growth. The annualised growth rate is widely expected to reach 5 per cent in the third quarter, well above the trend rate.

Many economists say that the size of the US budget deficit - expected to be $500bn this year - along with the Fed's easy money policy are having the long-awaited effect of stimulating the economy. Eventually, they reason, inflationary pressures will start to emerge and the Fed will be forced to push rates higher.

This economic optimism is widespread. Merrill Lynch's global survey of fund managers, published last week, showed that 87 per cent of those polled expected the global economy to grow over the next 12 months, with most in favour of "much" stronger growth.

But not everyone agrees with this scenario. Peter McTeague, interest

rate strategist at RBS Greenwich Capital, compares the current boost of economic euphoria to the "sugar high" that you get after eating a chocolate bar. The high makes you feel good for a few moments but quickly subsides.

McTeague points out that, while the growth numbers look good, strong productivity gains mean this has not resulted in a fall in unemployment. Jobs growth is a key component of consumer confidence. And consumers will also be affected by the recent back-up in mortgage rates, which will cut their income gains from refinancing. The result is that the strong second-half growth will not be sustained.

The Fed seems unlikely to raise interest rates while unemployment is still rising. Indeed, McTeague thinks the next move in rates will be down.

If he is even partly right, the summer surge in bond yields will prove to have been overdone. Indeed, the speed with which bond yields rose suggested that the adjustment had more to do with hedging in the mortgage-backed securities market than with economic optimism. As yields start to rise, few people repay their mortgages. That lengthens the duration of mortgage-backed portfolios, causing the holders to sell Treasury bonds (and close equivalents) to offset the risk. Given the scale of the mortgage-backed market, this hedging has a big impact on government bond yields.

Much of this selling has already taken place. That may allow the bond market to settle down, or rebound, especially as investor opinion is currently negative; most fund managers polled by Merrill Lynch felt that bonds were overvalued.

One factor that may help bond yields drift lower is that there are few signs of inflationary pressure. The US core (excluding energy and food) rate fell to 1.3 per cent in August, the lowest rate since 1966. The Economist's consensus poll of forecasts shows that the average prediction for US inflation in 2004 is 1.3 per cent, the same as in the euro area. That does not suggest any pressing need for the Fed to raise rates.

Bond yields are unlikely to fall as far as they did in the early summer, when deflation fears were rampant and the market was hoping that the Fed might step in to support the market. But if the Fed funds rate is staying at 1 per cent into 2005, as Goldman Sachs believes, then 10-year bond yields of 4.2 per cent look too high.