High View Economics

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May 23, 2011

BONDS, THE DOLLAR AND THE END OF QE2

Expectations are growing that the end of QE2 next month will lead to higher bond yields and a stronger dollar. The thinking is that without the Fed's continued bond buying, yields will have nowhere to go but up and that with the central bank no longer supplying massive liquidity injections, the chronically weak dollar will get a boost. We think those expectations are likely to be proven wrong on both counts.

Treasury yields are determined by inflation, growth expectations, the prospects for currency strength or weakness, and the returns available on competing assets. Initiation of the Fed's $600 billion Treasury purchase program did not keep the 10-year yield from rising from about 2.5% last November to 3.7% this past February. Nearly half that rise in yields was accounted for by the higher inflation expectations seen in a widening TIPS spread. In the past several weeks, yields have fallen back again as signs of slower growth and the decline of commodity prices have eased some short-run inflation concerns and pushed out the date of the Fed's expected initial rate-hiking move.

As for the dollar, the end of QE2 does not mean that the Fed will in any sense be moving to normalize policy. In the minutes of the April 27 FOMC meeting released last week, the Fed made it quite clear that it envisions a very gradual return to a neutral policy stance. The process would start by not reinvesting the proceeds of maturing assets on its balance sheet, which would "constitute a modest step toward policy tightening." And the Fed minutes emphasized that the discussion of an "appropriate strategy for normalizing the stance of policy …. did not mean that the move toward such normalization would necessarily begin soon." Indeed, the futures markets currrently are pricing for a first rate hike a year out. The dollar is not going to be getting any help from a Fed expected to remain on hold in its hyper-accommodative posture for another year.

While we do not see any immediate risk in Treasuries due to the termination of the quantitative easing program, the outlook is in no way favorable. The most important factor affecting bond yields is inflation and at this point the year-on-year CPI is running at 3.2%. With the 10-year yield currently at around 3.1%, bondholders are earning a negative real return, a situation that cannot be sustained. In fact, the data indicate that the pace of inflation is accelerating, as the three-month annualized rate for headline CPI

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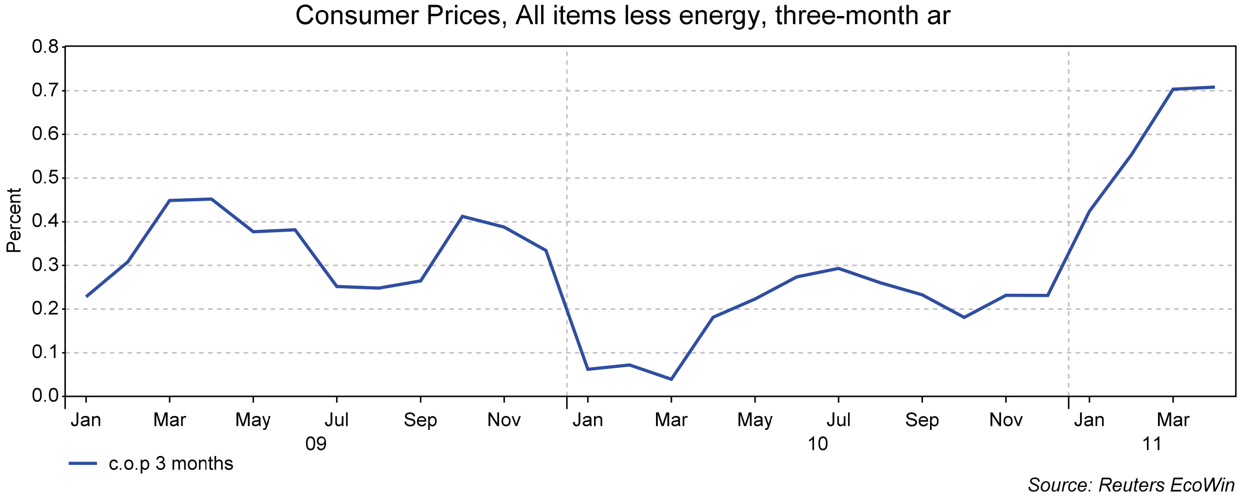
now stands at 6.2%, up from 3.3% last December. For now, the market is content to accept the Fed's view that recent inflation is explained by higher energy prices and with oil prices having fallen and the economy showing little sign of an impending acceleration, the rise in inflation is likely to prove "transitory."



The attached chart, however, makes that a difficult case to sustain. It shows the CPI ex-energy, which is up at an annualized rate of 2.9% the past three months. Last December, the three-month annualized rate was 0.9%. Inflation is moving higher and it's broad-based. At some point both the bond market and the Fed will have no choice but to confront that reality.

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