THE Fixed Income View

RIVERFRONT INVESTMENT GROUP

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Bernanke – His Bark is Likely Worse than His Bite

Bond market sentiment has shifted dramatically over the past week -- from worrying about the increased likelihood of a recession, after the large increase in May's unemployment rate (from 5.0% to 5.5% on 6/6/08), to worrying about near-term rate hikes. The fear of impending rate hikes contributed to the nearly 70-basis-point ("bp" = 1/100th of 1%) increase in the 2-year Treasury yield last week to 3.04%, one of the largest weekly increases in history. The turnaround in market sentiment has been largely driven by tough talk from Fed Chairman Ben Bernanke on both inflation (6/9) and the U.S. dollar (6/2). Bernanke's tougher stance on inflation puts him more in synch with the European Central Bank (ECB), whose President, Jean-Claude Trichet, has said that a rate increase may be needed as early as July to combat inflation.

The change in market sentiment is evident in the Federal Funds Futures market, where the odds of a 25 bp hike at the Fed's June 25th meeting increased to 20% last week, from 0% a week ago. The odds of a 25 bp rate hike at the Fed's August 5th meeting increased to 49% from 9% a week ago, and the odds of a 50 bp hike by the 9/16 meeting have risen to 48% from 2% a week ago.

On Friday, the bond market largely shrugged off a slightly worse than expected reading on May's Consumer Price Index (CPI) which rose 0.6% versus expectations for a 0.5% increase. However, Core CPI (excluding food & energy) rose 0.2%, matching expectations. The year-over-year headline inflation rate rose to 4.2% last month (up from 3.9% during April) while Core CPI remained at 2.3%.

We do not believe that Bernanke is in a position to initiate a series of rate increases, given the frailty of the U.S. economy and the weakened state of the banking system. A significant increase in interest rates would likely lead to an acceleration in home price deflation, a further increase in mortgage delinquencies and foreclosures, increased loan loss provisioning at banks (further tightening credit), and could further depress U.S. economic growth. As our Investment Strategy team wrote on 6/2/08, we believe that a large rise in bond yields would likely be "self-extinguishing," due to their impact on mortgage rates and the economy.

However, we do believe that Bernanke would like to "jawbone" his way to the following two objectives, without actually having to raise rates:

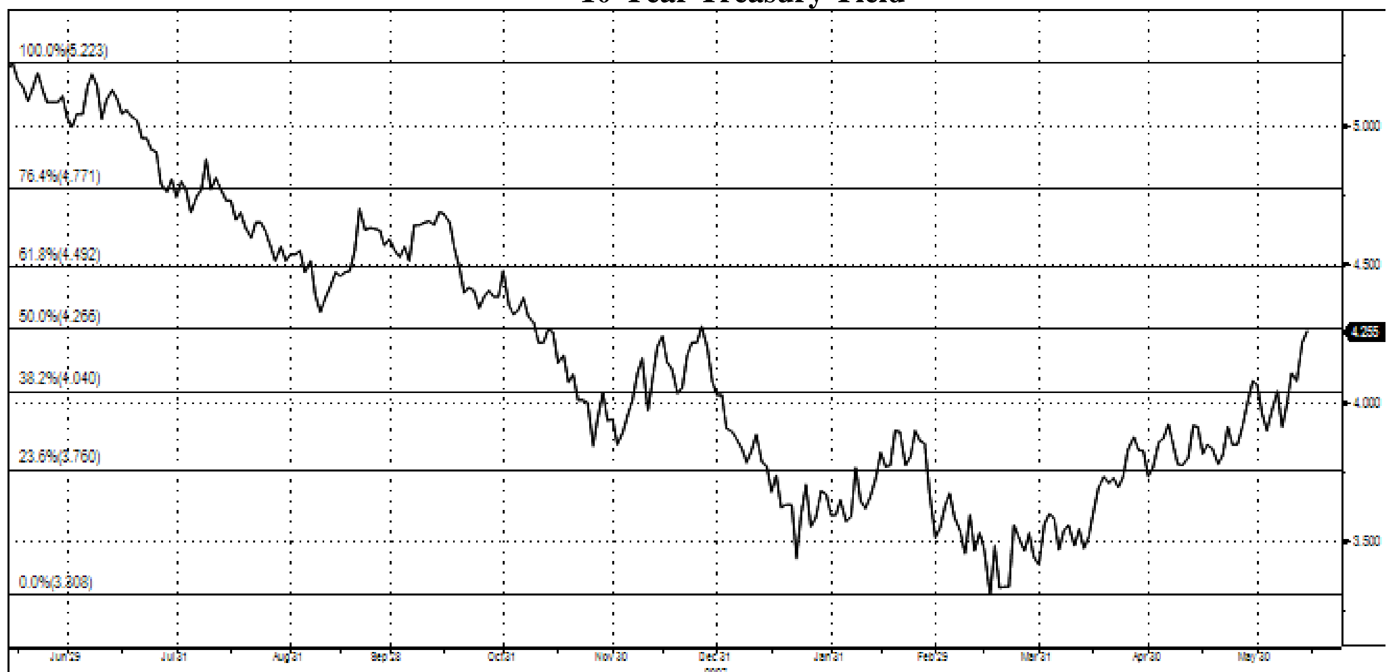
1. **Contain inflation expectations.** The Fed monitors inflation expectations very closely in order to prevent them from becoming engrained in investor and employee mindsets. If the current, elevated inflation rate is viewed as more than temporary, employees may push harder for wage increases, which could lead to a wage price spiral (ala the 1970s). While this is less likely in the U.S. given the structural changes in our labor market, it is more likely in a high percentage of the world, in our view. In addition, if cost increases are viewed as temporary, producers are more likely to try to absorb them rather than pass them along to consumers.

2. **Stabilize the U.S. dollar.** A weak dollar is generally viewed as inflationary since it raises the cost of imported goods for U.S. consumers, and it has been cited as an important factor in the record run-up in oil prices (as oil is priced in dollars). Bernanke has had early success on this front as the dollar rose more than 2.5% against the Euro last week to $1.54, its best level since mid-March. The dollar also rose more than 3% against the Yen to $108.18, its best level since mid-February. Partially in response to the stronger dollar, oil prices have backed off their highs. Oil was at $138.54/barrel on 6/6/08 and it closed at $134.72 on Friday (-2.76%).

What the Fed would like to avoid:

1. **A Sharp Increase In Longer-Term Rates.** The 10-year Treasury yield is a primary driver of the 30-year fixed-rate mortgage rate, and the Fed would like to avoid increasing mortgage rates, for obvious reasons. By talking tough and keeping inflation expectations contained, Bernanke hopes to prevent longer term rates from rising much. The chart below shows that the 10-year Treasury yield has risen more than 90 bps from its low of 3.31% on 3/17/08, at the height of the recent credit crunch. The yield hit an important technical level of 4.25% on Friday, which represents a 50% retracement of the decline from its high of 5.22% a year ago to its recent low. The market had also tested this level in late 2007, before resuming its downward march. Another important level of technical yield resistance is 4.50%, and a decisive move through this level could result in selling pressure from mortgage investors looking to hedge their durations. The 30-year, conventional, fixed mortgage rate increased to 6.32% on 6/12/08, according to Freddie Mac's weekly survey, up from a near-term low of 5.85% on 3/27/08. This translates into an increase in monthly mortgage payments of almost $120 on a $300,000 mortgage.

10-Year Treasury Yield



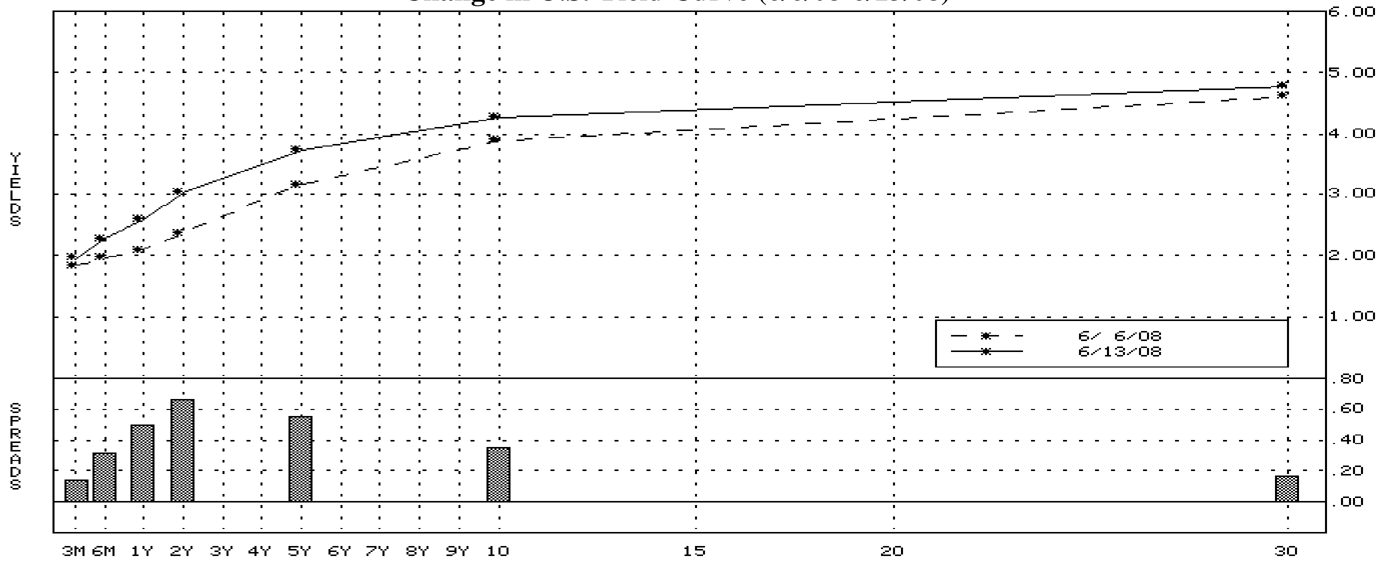
Source: Bloomberg

2. **An Increase In Short-Term Borrowing Rates (LIBOR).** LIBOR is a much more important lending benchmark than the 2-year Treasury, in our view. An increase in LIBOR would have a direct impact on the borrowing costs of global corporations (as most loans are priced at a spread above LIBOR) and consumers (adjustable rate mortgages). LIBOR has historically been closely correlated to the Fed Funds Rate, so any rate hike would likely flow through to companies and consumers almost immediately.

Strategy Implications

We have been heavily underweight U.S. Treasuries since the first quarter, as interest rates hit their near-term lows in mid-March, and we saw better relative value in corporate bonds, agencies, and mortgage backed securities (MBS). In addition, we have allowed the duration of our portfolios to drift shorter than that of our benchmark. However the recent back-up in Treasury yields has improved their valuation substantially (especially on the short end) and we may look to increase our weighting to the 2-year portion of the yield curve. We may also increase our duration to neutral (versus our benchmark) as the 10-year Treasury yield approaches 4.50%.

Change in U.S. Yield Curve (6/6/08-6/13/08)



Source: Bloomberg

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