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Agitation Inside A Holding Pattern

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Interest rates have been pushed and pulled by a range of forces recently. They have been pushed higher by concerns over the aggressive auction schedule from the Treasury and, in some minds, a fear of future inflation. Rates have also been dragged lower by rekindled worries of continuing economic slide and the reality of a Federal Reserve program for purchasing longer-term Treasury securities. Yet, even with this back and forth movement, yields remain inside a well-defined range between 2.5% and 3% for ten-year Treasuries since the second half of January. Credit spreads are similarly inside a range, half way between the wides of last November-December and the recent tights in February.

All of this reflects agitation inside a holding pattern. It is a time of anxiety about the direction forward, less and less of which is being determined by economic data. Instead, public policy announcements are moving the markets. The big break out, which will shift rates and credit spreads outside their recent ranges, will come when the ramifications of policy direction are more apparent.

Meanwhile, government intervention is ascendant and market players are having difficulty grappling with its consequences, many of which are likely unintended. Six months ago, the failure of Lehman Brothers was a game-changer and spending three or four months in survival mode was the best portfolio response. Now the AIG bonus battle has changed the environment just as much, but in a different way: contract rights are under assault. Some are being run over; others are not, depending on policy prescriptions.

Two distressed municipal bond issuers, Jefferson County, Alabama and City of Vallejo, California, are using bankruptcy to tear up employee contracts. Court-supervised reorganizations have long been a part of the administration of the economy. But the Treasury Department is also seeking to modify contracts of institutions it may take over, a course that eliminates the judicial oversight of bankruptcy proceedings.

There is also talk of granting Treasury takeover capabilities for non-banks. This made some sense when we were told that the disruption of Lehman and AIG were due to the lack of such provisions. (The FDIC has long had the power to take over banks, a good idea because their deposits are federally guaranteed.) But with the Treasury seeking the ability to take over any firm that poses a systemic risk, however arbitrarily that may be defined or invoked, it gives pause as to how asymmetrically it may be applied. Maybe after Lehman and AIG, the wisdom of Chapter 11 would be preferable: recognize legally that it's broken, and rebuild something more sustainable.

Then there is TARP, which some banks can't seem to get out from under. Granted it was needed in many situations, but was always not welcome at others. While several small banks have been able to pay back government funds, not wishing to have the accompanying restrictions on compensation, hiring policies and other intrusions, larger banks have not able to do so because of the public policy desire for increased lending.

At this point the outcomes are as varied as Henry VIII's wives: "divorced, beheaded, died, divorced, beheaded, survived." There is increasingly a whiff of zero sum economics at play. Previous fiscal policies tended to be a contest over how to share a growing pie. Now it looks like a gloomy sense of simple winners and losers.

The market response to all this is to examine if all previously conceived notions are built on sand. There have been deep implications for our thinking on portfolio structure. Long established fundamental and quantitative processes are at the mercy of the changing regulatory paradigm: hence, our view that the market is in a consolidation process as it sorts out its next strong move. For bond investors, credit threats remain front and center. Security selection in an environment of rising defaults and lower secondary market dealer liquidity is treacherous. Secondary to this more immediate threat is the long-held fear of inflation for investors, kindled by a sense that price pressures could rise along with the Fed's expanding balance sheet as it injects record reserves into the economy.

In a largely unnoticed recent release, the Fed and the Treasury announced that while the Fed works with other agencies on financial stability goals, it alone is in charge of price stability. This independence is critical, especially as, when and if political pressures come to bear that would delay the start of measures directed at suppressing inflation. It is likely that, when the Fed undertakes such measures, administration and legislative officials will balk at what they see as pre-emptive removal of accommodation. Yet, hesitation on the Fed's part would likely provoke inflation fears. Keenly aware of this risk, Bernanke proved his mettle in securing an excellent policy understanding with the administration.

Implementing a tightening policy still appears to be some ways off. The scale of the accommodative fiscal and monetary policy initiatives is just filling a hole emptied by private sector declines in demand, due in no small part to real estate and retirement asset losses. When it appears that the hole on the consumer and corporate side is filling up, then we can begin to worry about inflation; until then, we continue to see wage cuts and freezes and, as unemployment and wages are lagging indicators, this trend is not likely to change for some time. And price inflation is not likely without wage inflation. With all of this happening globally, there is economic slack everywhere that is reinforced by the ongoing processes of deleveraging and higher savings rates. Don't look for inflation soon. ■