

## Fixed Income Insight November 25, 2003

### *Economic Recovery Chugging Along: Bonds Hold Course*

As the end of November nears, bond yields were lower than they were on Labor Day in spite of evidence that a recovery has been underway for the past three months. The Fed has helped the case for lower rates by sending a repeated message that it does not expect to raise rates for a considerable period due to fears that disinflation remains a potential threat. Nevertheless, the last few months have seen a consistent string of positive economic announcements that seem to forebode the probability that higher rates are likely to emerge in the not too distant future—barring a sudden, unexpected surprise in the global picture.

On the positive economic front, job creation has been in the plus column for the past three months, jobless claims have been on the decline, housing starts and building permits have continued to soar, federal and consumer spending has been up and the October “leading indicators” number swept past expectations. Adding to potential inflation concerns, the trade deficit and commodity prices have been moving higher. While there are a few restrainers on the other side of the equation—such as climbing personal debt, high corporate debt, the state fiscal crises and the continuing global geopolitical risks—the preponderance of factors seems to suggest that interest rates are more likely to turn up than down.

Going into an election year, the Fed is likely to be very careful to avoid suspicions that it is trying to interfere with the economy for political reasons. Initially, this would suggest that it would not want to tighten too early. On the other hand, procrastination to tighten could unleash the danger of a rapid spike in inflation. All said, the market consensus expects rates to rise gradually.

Currently, the futures market has priced in a 25 basis points increase in the Fed Rate beginning in the second quarter of 2004. Fed actions usually take about six months to work their way through the market. If that’s the case, a May tightening would not rein in growth or inflation prospects any earlier than November and the impact of such a small increase would likely be modest. A slow tightening in the face of consistent growth news, if that were to occur, risks the danger that the Fed could act too little and too late, which would stir up a sharply higher interest rate rise in 2005. It is too early to make that prediction since there still remain several factors that have been helping to hold down price as well as interest rate increases, such as strong productivity, slow job growth and personal income growth. Recently higher commodity prices and the decline in the dollar run counter to what has been a period of benign price inflation. These numbers should be watched closely. Meanwhile, we will continue to look for moderate growth to continue into 2004.

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### Final Words

While the month of December will be fairly critical to determining whether Treasury bond total returns will end in the positive column, results for the year are likely to turn out better than expected given the economic recovery present in the second half of the year. Municipal returns are faring somewhat better than T-Bonds, in part due to the fact that municipal yield changes often lag the Treasury market. Corporate bonds have done even better given the credit spread tightening taking place as corporate profitability and balance sheets have generally improved with the economy. We anticipate that growth will remain moderately paced next year, which would allow for a more gradual rise in interest rates and the yield curve. However, we are concerned that if the Fed remains fairly lenient in its monetary restraint and fiscal policy does not reduce the budget gap, we would not be surprised to see interest rate surprises to the upside.

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