

Atypical US market trends warn of deep investor concerns

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- The recent combination in the United States of a stock market rally, bond market sell-off, and a shift to a somewhat weaker US dollar is unusual and a potential irritant to US economic and monetary policy makers.
- The common thread is that US and global investors apparently believe that the financial crisis is winding down but are becoming increasingly concerned that the measures that have been taken to support the banking system are bound to revive inflation pressures at some point over the next couple years.
- If these trends continue, the implication is that the Federal Reserve will face the dilemma of when to start normalizing monetary policy much sooner than most officials now anticipate. Put simply, the Fed may have to choose between maintaining market confidence in its policy independence or good relations with the White House and the Congress.

Market movements reflect expectations but also influence the outcome

Stock prices are one of the ten components of the index of leading economic indicators and perhaps one of the most important. They are not perfect predictors, because it is often hard to differentiate between normal volatility and strong trend reversals. So they don't always provide an early warning that the end of a business expansion or of a recession is at hand. But they are worth paying attention to, not least because the behavior of the stock market affects consumer confidence as well as household wealth. And consumer spending behavior is linked, albeit loosely, to both factors.

US STOCK MARKET AVERAGES IN MAJOR RECESSIONS

<i>S&P 500 index</i>	cyclical peak	recession low	trough
Nov 1973-Mar 1975	102.0	67.1	83.8
Jul 1981-Nov 1982	129.1	109.4	138.1
Jul 1990-Mar 1991	360.0	307.1	372.3
Mar 2001-Nov 2001	1185.9	1044.6	1129.7
Dec 2007-present	1479.2	757.1	na

Source: Standard & Poor's, UniCredit Research

The recent rally in the stock market, which has taken the major indexes up by almost 40%, is consistent with a gradual tapering off of the severity of the recession and with a trough forming by the end of the third quarter or the beginning of the fourth quarter. It may have come as a surprise to a lot of market observers and investors that the turnaround in the stock market took place so quickly and has gone as far it has. But no one can deny that the degree of pessimism that pervaded the investment community three months ago was unusually intense. Moreover, short positions were reportedly quite large. Therefore, when something touched off a flurry of buying (in this year's case, a comment from Citigroup's chairman that the troubled bank would have positive operating earnings in Q1 2009) the stock market proved able to move ahead with considerable speed. So no one should be surprised by the fact that market participants have now concluded that the recession will bottom out relatively soon, despite the considerable obstacles that still exist. The combination of rising stock prices and improving consumer sentiment makes investors more confident that the recession won't drag on indefinitely.

No consensus yet on what the sharp jump in bond yields means

Bond market movements are ordinarily thought of as a contemporaneous indicator of the business cycle. Yields on US government securities by themselves are not considered a leading indicator, although the slope of the yield curve is (with steep yield curves normally predicting expansion and inverted curves predicting a business slowdown). In the recessions of the 1970s, 1980s and 1990s, yields on longer-term US Treasury securities tended to be rising both well before and during the early months of an economic downturn. That partly reflected the market's response to Federal Reserve policies. Normally inflation would tend to accelerate as a business cycle matured. Pressures on capital and labor resources would intensify, and monetary policy would be progressively tightened. Whether the Fed intended to produce a recession or not, the period of monetary restraint would normally last until an economic downturn took hold. There was no regular pattern of when and to what degree the subsequent easing of monetary policy would be reflected in longer-term interest rates. Sometimes declining bond yields would signal an ensuing recovery, but not always.

US TREASURY BOND YIELDS IN MAJOR RECESSIONS

<i>10-year yield</i>	cyclical peak	recession low	trough
Nov 1973-Mar 1975	6.73	6.67	7.73
Jul 1981-Nov 1982	14.28	10.55	10.55
Jul 1990-Mar 1991	8.47	7.85	8.11
Mar 2001-Nov 2001	4.89	4.57	4.65
Dec 2007-present	4.10	2.08	na

Source: US Treasury, UniCredit Research

By contrast, longer-term US Treasury yields were declining as the 2001 recession began. They continued to move irregularly lower during the recession and continued to go down for some time as the economy started to rebound. By comparison, Treasury yields were essentially trendless in the months prior to December 2007, when the current downturn began. They tumbled from about 4% at the business cycle peak to just under 2.10% in mid-December 2008. They have subsequently fluctuated sharply higher, almost erasing the entire cyclical decline in long-term interest rates.

Such a snap back in yields is virtually unprecedented, and market observers have offered varying interpretations. Some feel that it is simply an echo of the stock market rally, reflecting relief that the recession is not likely to last much longer. But the US stock market has often rallied before the end of a recession, and in the past bond yields rarely moved up at all, let alone moved up sharply. Others have pointed to the resumption of risk-taking in other market segments both in the US and internationally. They view the unusual ferocity of interest rate increase as merely a rebound from a period of excessive risk-aversion. Still other analysts feel that the jump in Treasury bond yields reflects a growing concern over the extraordinary measures that the US authorities have taken to protect the banking system. These have led to massive increases in the Federal Reserve's balance sheet and have accommodated a sharp increase in the monetary aggregates. Essentially, a number of bond market participants are deeply concerned about how the Fed will be able to unwind operations already undertaken or those yet to be conducted over the coming months, notably additional purchases of mortgage-backed securities and full implementation of the Term Asset-back Securities Lending Facility, the TALF program. Fed officials downplay the difficulties, arguing that much of the unwinding will be automatic as normal functioning of the fed funds and commercial paper markets is gradually restored. But nagging doubts remain, especially about the Fed's decision to buy a sizable amount of US Treasury securities. This has triggered fears that the Fed is prepared to monetize huge upcoming US Treasury deficits. In that context, the severity of the bond market sell-off has made many bond market participants even more nervous about the future course of long-term interest rates.

Do exchange rate fluctuations clarify the issue?

Unfortunately, there is little guidance from the cyclical experience of movements for the major foreign currencies against the dollar. The trade-weighted average value of the dollar against the major currencies has strengthened in some business recessions (1981-82, 2001), depreciated in others (1990-91), and fluctuated widely with little net change in others (1973-75). Even in the 18 months since the current recession began in December 2007, the dollar has moved over a wide range, basically appreciating during much of 2008 before slipping back in recent weeks. On balance, the dollar is considerably stronger against a basket of key currencies than when the recession started. That is because the weaknesses in the US economic and financial situation were well known by the middle of 2007, but the fact that the rest of the world would turn out to be just as vulnerable to a global financial meltdown was largely unforeseen. Yet, even that generalization has to be qualified by the fact that the dollar has weakened considerably on balance against the Japanese yen, even as the euro is down 5% on balance since December 2007 and the pound sterling has plunged 23%.

Implication: the Fed may soon face conflicting pressures

The financial markets generally applauded what the US Treasury and the Fed have managed to achieve in stabilizing the US banks and helping to unfreeze segments of the capital markets that seized up after the Lehman Brothers bankruptcy last fall. They appeared comfortable with the Obama administration's fiscal stimulus program, conceding that large budget deficits were an inevitable (but presumably temporary) ingredient in reviving economic growth. Two developments seem to have shaken this market support: the Fed's foray into buying US Treasury securities, which over time made investors worried that the Fed may try to monetize growing US government budget deficits; and a reassessment of the long-term budget consequences of the Obama economic policy, especially after a rating agency raised the possibility of a downgrade in the credit rating of UK government debt because of its own long-term budget problems. As market participants paid more and more attention on how monetary policy might be influenced by political considerations, sentiment began to sour, especially in the bond market, but also to a limited extent in the exchange market. So far the stock market has been relatively shielded, but a generalized loss of market confidence would be bound to spread to equities, sooner or later. If the market comes to the point at which it genuinely fears that Federal Reserve monetary independence is in jeopardy, recent trends would clearly be magnified. And the outlook for economic recovery could be set back. It would be ironic if the only way the Fed could assure that the US recovery was put on a solid footing is by raising the federal funds rate well before it and market participants expect. But it might come to that unless the ferocious sell-off in the bond market is not quelled soon.

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