July 2010

ING Market Intelligence Series

F.I.R.S.T

Fixed Income Research and Strategy Trends

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"Stubbornly high unemployment, prolonged weakness in housing and deleveraging conspire to hold interest rates lower for longer."

"It Won't Feel Terrific"

Those were Federal Reserve Chairman Bernanke's words summing up the prospective U.S. economic expansion. We agree.

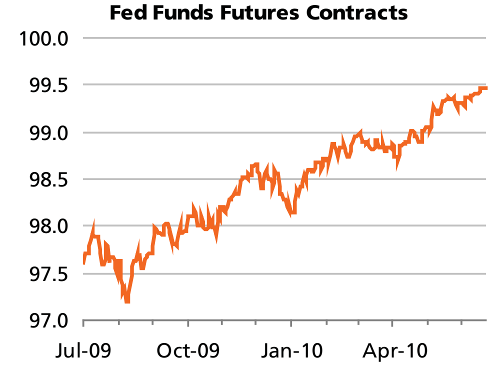
Our economy is growing, but not sufficiently to surmount a few problems. First, we will have difficulty reducing the high rate of unemployment as quickly as policy makers and the public might desire. It is going to be a crimp on confidence and consumer spending to have 9% (or something in that neighborhood) unemployment for a prolonged period. Second, we have a nasty overhang of excess housing supply. A *Barron's* columnist called this a "wet blanket" for the recovery.

What policy bullets do we have to address these problems? Monetary policy is "all in" and has been since late 2008: full accommodation. But the Fed is not out of ammo. They could restart asset purchases; they have other tricks in their bag. These may be needed, as fiscal policy looks to be increasingly leaning toward enforcing austerity.

The implications of this are worth a look. The fiscal outlook is increasingly dominated by the view that we cannot continue to borrow and spend our way out of our debt situation. The problem is growth, but it's in the context of too much debt. This view holds that the stimulus from Keynesian deficit spending is exhausted when we have passed a point of too much debt. Confidence is undermined when debt dynamics are not on a sustainable path, and returning to a more controllable situation — it takes a round of belt tightening to restore it — would result in better longer

The market now expects lower rates for longer

Fed Funds Futures Contracts



Source: Bloomberg

term growth prospects. The budget submitted by the new government in the U.K. takes this view. The implications of it are that by cutting spending, rather than raising taxes, private demand will accelerate, public borrowing costs will decline and the economy will be more competitive as fewer government workers lighten labor costs.

The U.S. is less likely to take the U.K.'s fiscal view, given a more activist executive branch. Taxes are more likely to rise, which markets see as anti-stimulative. Reflecting this, markets generally view it as difficult at best to achieve prosperity through austerity. Thus, the bond market forecast of continued low rates for a longer period of time. The graph above shows the futures market for the fed funds contract in June 2011, a year from now. Expectations have dropped from a forecasted fed funds rate of over 2%, as "lower for longer" settles in to the markets' mentality.

In this regard, it's important to remember that interest rates give lip service to supply pressures, typically a function of budget deficits, but really trade based on expectations of inflation and expectations of Fed policy. This brings us to the important underlying theme that it is not inflation in the immediate future but the ascendance of disinflationary forces.

Since inflation peaked at nearly 15% in 1980, technology gains, globalization, decline in labor power, outsourcing, more open global trade and other factors all drove inflation lower. These forces remain in place and are now aided by the collapse of credit expansion. The unsustainable debt dynamics discussed above create further pressures. At all levels, individuals, finance companies and governments in much of the world, there is far too much debt. We moved from an environment of debt creation to one of debt destruction. The payments to service this debt are daunting in comparison with growth and income generating power. Pairing down this debt, which will take years, is deflationary. Further, presented with this situation, central banks will remain accommodative. On the fiscal side, there are unfortunately few solutions for it. It prolongs the ability to make progress on the federal debt and deficit and is sufficient to take bond yields lower. ■