First Trust
Monday Morning OUTLOOK
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The Bond Bear is Waking Up

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We've been bond bears for quite some time, and we still are. The good news is that the violent part of the bear market has passed. We expect a slower, but still painful and consistent, move higher in interest rates during the quarters ahead. The 30-year bull market in bonds is over.

The low in yields, after a 30+ year bull market, was seen in the past few years. In past cycles (mid-1970s, 1992, 2004), when the Fed had reached its most accommodative stance, when the federal funds rate was at its lowest point, the spread between the 10-year Treasury and the funds rate was 3.5% or a little higher. This is because long-term investors thought short-term rates would rise in the future.

In the most recent cycle, with the Fed promising to hold rates down for a long time and telling the market it would end QE before lifting rates, the yield spread collapsed and the 10-year went as low as 1.5%. Now, with the Fed preparing to taper QE, the specter of higher short-term rates is pushing the yield curve toward historical norms.

This does not mean bond yields are about to catapult into the stratosphere. The US is not Argentina, or Weimar Germany, or Yugoslavia, and QE can be unwound without creating hyper-inflation. In the past sixty years, including the double-digit inflation of the 1970s, the yield on the 10-year Treasury Note has never been more than 385 basis points higher than the funds rate.

Think of it like a boat with an anchor. The 10-year bond is the boat, on the surface, moving back and forth with the waves. But the anchor, the federal funds rate, remains locked in position by the Fed. The chain between the anchor and the boat is the yield spread. As long as the chain doesn't break, there's only so far the boat (and the 10-year) can go.

In Argentina the chain broke (with hyper-inflation, 10-year bonds denominated in pesos weren't possible). In the US, the chain has never broken. And if it held in the 1970s, with double-digit inflation and an expanding government share of GDP, it's hard to make the case that it won't hold today.

Inflation remains relatively subdued, with the consumer price index (*including* food and energy) up only 2% versus a year ago. We expect inflation to move higher, but we don't expect hyperinflation. Yes, QE has expanded the Fed's balance sheet enormously, but, it has been contained in excess reserves and has not led to a sharp expansion in the M2 money supply.

The reason talk of tapering lifted bond yields this past spring was because the Fed will end QE before it lifts rates. In other words, tapering is a sign short-rates are eventually headed higher and when the market expects this it automatically prices in higher long-term interest rates. In other words, the bond market is normalizing and the bear is coming out of a 30-year hibernation.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-3 / 9:00 am	ISM Index – Aug	54.0	**54.7**	55.7	55.4
9:00 am	Construction Spending – Jul	+0.4%	**+0.3%**	+0.6%	-0.6%
9-4 / 7:30 am	Int'l Trade Balance – Jul	-$38.8 Bil	**-$38.8 Bil**		-$34.2 Bil
Afternoon	Total Car/Truck Sales – Aug	15.8 Mil	**15.8 Mil**		15.7 Mil
Afternoon	Domestic Car/Truck Sales – Aug	12.3 Mil	**12.3 Mil**		12.2 Mil
9-5 / 7:30 am	Initial Claims – Aug 31	330K	**330K**		331K
7:30 am	Q2 Non-Farm Productivity	+1.5%	**+2.7%**		+0.9%
7:30 am	Q2 Unit Labor Costs	+0.9%	**-0.1%**		+1.4%
9:00 am	ISM Non Mfg Index – Aug	55.0	**55.3**		56.0
9:00 am	Factory Orders – Aug	-3.4%	**-2.9%**		+1.6%
9-6 / 7:30 am	Non-Farm Payrolls – Aug	180K	**157K**		162K
7:30 am	Private Payrolls – Aug	180K	**160K**		161K
7:30 am	Manufacturing Payrolls – Aug	5K	**3K**		6K
7:30 am	Unemployment Rate – Aug	7.4%	**7.4%**		7.4%
7:30 am	Average Hourly Earnings – Aug	+0.2%	**+0.2%**		-0.1%
7:30 am	Average Weekly Hours – Aug	34.5	**34.4**		34.4

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.