First Trust
Monday Morning OUTLOOK

630-517-7756 • www.ftportfolios.com June 18, 2018

Bonds Misjudge The Future

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*

We've always been skeptical that bond yields carry deep meaning about the future. Low Treasury bond yields in recent years were said to be a signal of slower growth, or possibly a recession, ahead. And the bond world said stocks were over-valued.

Clearly, the forecasted recession never came. Not only is the economy accelerating, but the recovery is likely to become the longest on record. And stocks have handily outperformed bonds.

Now, low bond yields are supposed to signal the Fed is getting close to being too tight. Either too many rate hikes will cause a recession, or the Fed will hike rates only twice next year as the economy slows. And, of course, the bond world says this too is bad for stocks.

We see at least two mistaken beliefs that are influencing bond bulls these days. The first mistake is that the Fed will lift rates only once or twice in 2019. We believe four rate hikes are more likely, with more to follow in 2020. The reason is simple. Nominal GDP is accelerating, and likely to grow at a rate of 5%+ over the next few years.

But four rate hikes of 0.25% in 2019, after two more in 2018, will only push the federal funds rate near 3.5%. History (in 1969, 1973, early 1980s, late 1980s, 2000, and 2007) shows that, in order for the Fed to create a recession, it needs to push the federal funds rate above nominal GDP growth. Right now, the Fed is chasing growth, and bond markets are underestimating how much rates must rise before policy becomes "tight."

This, we believe, has pushed the long-term bond market into what appears to be a bubble. At a 2.92% yield, the implied Price-Earnings (PE) ratio for the 10-year Treasury Note is 34.2, with zero chance of an increase in earnings in the next 10 years.

That doesn't sound like a very good investment to us. Real GDP is likely to grow at a 3% rate this year, while consumer prices should rise 2.5%. In other words, nominal GDP – total spending in the US economy – will rise by 5.5% in 2018, which means revenue at the "average" company will grow at that pace, as well – double the yield on a 10-year Note.

Corporate profits are growing even faster than GDP – most likely 20%+ this year – and hundreds of companies have raised dividends in the past year. The PE ratio of the S&P 500 is 21 based on trailing twelve months' earnings, and less than 17 on forward earnings.

Yet, even with all that data in front of them, many bond investors are convinced the 10-year yield is likely to decline in the next year, making long-term bonds a slightly more palatable investment.

Instead, it looks like the bond market is acting like the stock market in 1999, when our capitalized profits model said stocks were 62% overvalued. But, like all bubbles, a vast majority of investors still believed stocks could go higher. Obviously, they were wrong.

The second mistake animating the bond market is the belief that the narrowing spread between the federal funds rate and the IOER (Interest Rate on Excess Reserves) signals a developing shortage of reserves – a sign of tight Fed policy.

Yet, there are still $1.9 trillion in excess reserves in the banking system – which contradicts any belief that Fed policy is remotely close to being tight. There are very few banks that actually trade federal funds, because they simply don't need them.

Meanwhile, the Fed has been doing reverse repos with institutions (like Fannie Mae and Freddie Mac) because it is not allowed to pay them interest on reserves. What has happened is that those reserves (the Fannie/Freddie kind) have now been mostly drained from the system, which means the difference between these short-term rates is narrowing. This is not a sign of a lack of bank reserves, just that excess liquidity <u>outside</u> of the banking system is getting tighter and more competitive.

As a result, the IOER is becoming the most important short-term rate in the monetary system. Today, at 1.95%, it is still too low. The key question is whether the Fed can pay banks enough not to lend out that money, even as accelerating growth creates more profitable opportunities to lend. If the Fed can do that – pay banks not to lend – then excess reserves are not a sign of easy money. But, lending rates are still much higher than IOER, and banks have excess capital as well.

In other words, the Fed is nowhere near "tight," and the market is mis-pricing both growth and inflation risks to bond yields. Rates look far more likely to rise than fall.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-19 / 7:30 am	Housing Starts – May	1.314 Mil	**1.289 Mil**		1.287 Mil
6-20 / 9:00 am	Existing Home Sales – May	5.530 Mil	**5.460 Mil**		5.460 Mil
6-21 / 7:30 am	Initial Claims – Jun 17	220K	**222K**		218K
7:30 am	Philly Fed Survey – Jun	29.0	**33.1**		34.4