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## Guideposts for Confusing Times in the Bond Market

\*Based on an article in the  
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Forecasting bond yields over the next few months is complicated by the unusually large number of issues likely to affect market behavior. Examples include: (1) whether the domestic economy is heating up or cooling down, (2) the state of the global economy, (3) the market implications of the political tensions that have erupted around the world, and (4) who is or is not buying what bonds—the Federal Reserve, the Chinese, domestic pension funds—and whether it matters.

*Our bottom line is a reassertion of the basic parameters that have bounded Treasury bond market behavior. Our 3% soft cap on the 10-year yield remains in place, and so does the extremely strong probability that the U.S. and global financial excesses will eventually cause a severe, deflationary recession that will drive the 10-year yield to under 1%. Breaking 1% during the next two years is still a good bet. Moreover, while the signs of strength in the economy have so far primarily affected the front of the yield curve and not the back, we maintain our view that a significant sell-off in bonds on further signs of a “growth scare” this summer is still more likely than not.*

Investors are not likely to gain insights into the outlook for the yield curve by dwelling on the shifting roles of big bond players—large pension funds, the Chinese government, and the Federal Reserve. We doubt that Chinese government Treasury purchases are on a larger scale than the Fed’s bond buying program, which is now being tapered out of existence. Furthermore, the Fed’s tapering has maintained QE’s dubious record of having yields move in the opposite direction to what the policies are supposed to do. Since the Fed has been reducing bond buying, Treasury prices have gone up, not down.

### **The Second Quarter May Be Stronger Than Economists Think**

Active bond investors probably know that the transition to the new health care act and, especially, severe weather were responsible for the -2.9% first-quarter GDP growth rate, but there is still broad sentiment that, even without these disruptions, underlying economic conditions were soft during the winter. This sentiment is likely being reinforced as forecasters have lately revised down their second-quarter GDP estimates in the face of weaker monthly data than they had anticipated.

Before the recent downward revisions, the consensus forecast had been for a considerable bounce-back in the second quarter, somewhere approaching 4%. Now the view is that real output merely returned to about where it was in the fourth quarter of 2013, a growth rate of around 3%.

Yet security analysts’ views of the second quarter have brightened even as economists’ views have dimmed. Analysts have raised their estimates for second-quarter S&P 500 earnings as the companies reporting early have beat consensus expectations by more than usual. And, for a change, many companies have also beat revenue estimates.

The seemingly inconsistent GDP forecasts and company earnings revisions may be disconcerting, but eventually we expect more harmony as GDP comes in higher than the consensus presently expects, although possibly not until after the second revision, which will arrive on September 26.

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The fact is that even at the time the BEA releases its preliminary GDP figure, a lot of information on the second quarter has yet to be released, and the information that is already available is subject to large revisions. For the preliminary GDP report, only two months of data are available for key source series for a number of critical, volatile, and often substantially revised GDP components—change in inventories, exports, imports, residential investment, and nonresidential investment in structures. Meanwhile, until GDP and the rest of the NIPA data are initially released, there is precious little information about state and local government spending and revenues besides withholding taxes, which are themselves subject to revision.

These issues are fairly routine, but the second quarter has, in addition, a huge, unusual problem: unknown changes in consumption of health care services as a consequence of the implementation of the largest part of the Affordable Care Act. Americans consumed less health care in the first quarter than in the previous quarter (chart 1), a striking event for this fast growing category. Perhaps uncertainty about the new program caused consumers to make an effort to see doctors and receive other care before year-end, pulling it forward from the first quarter of 2014. Maybe start-up problems delayed enrollment or slowed pre-approvals or otherwise delayed first-quarter health care consumption.

The only reason these questions are relevant to second-quarter GDP is that no one has much information on what happened to health care consumption this spring, including the BEA. Although the BEA publishes monthly figures on personal consumption, and those data do show a moderate and steady recovery in health care spending since March (chart 2), *there is a problem with the April and May health care consumption numbers: they are not really based on measurements but on projections*

*from crude models and from guesswork.* (For services provided by hospitals, nursing homes, and paramedical services, the BEA makes estimates based on employment and hours data from the Bureau of Labor Statistics' payroll series. For physician, dental, and government hospital services, the BEA estimates with a methodology called "judgmental trend," which says it all.)

The quarterly data will initially be based on the dubious monthly guesstimates until the quarterly services survey becomes available in September. Do not rule out huge revisions; note that the BEA's original estimate for the first quarter not only showed a rise rather than a fall, but a huge rise, bigger even than the fourth-quarter surge (see chart 1). When the preliminary second-quarter real GDP estimate is released, it may show growth near the consensus estimate of about 3% or it could be markedly different. But whatever the initial figure, when the second revision is released two months later, the growth is likely to be substantially higher than 3%—at least 4% and likely more. We think it highly unlikely that real GDP failed to grow from the fourth quarter of 2013 to the quarter just ended.

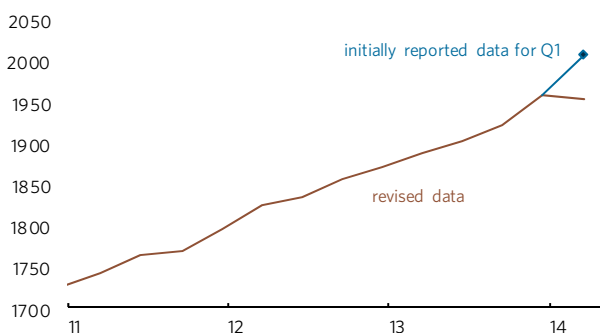
### So What Lies Ahead for the Bond Market?

Over the next month or two, investors are likely to see evidence of a stronger domestic economy than they expected. With job growth probably continuing at a faster pace than during recent years, the knee-jerk market reaction would be to depreciate bonds, all else equal. However, the erosion of the EM sector or the languishing of the euro area economy could keep a strong bid in the market. Alternatively, more economic and financial fallout from the world's political trouble spots might do the same. On the other hand, if tensions seem to

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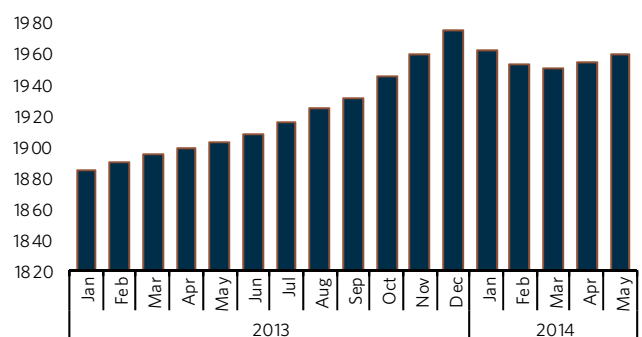
**Health Care Showed Big Rise Before Revision** CHART 1

BEA: Personal Health Care Services Consumption Expenditures  
\$ billions, seasonally adjusted, annual rate, last data point Q1 2014



**Monthly Health Care Data Show Rise** CHART 2

BEA: Personal Health Care Services Consumption Expenditures (Monthly)  
\$ billions, seasonally adjusted, annual rate, last data point May 2014



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ease in Ukraine and in Gaza and if the Iraqi and Syrian situations seem more contained, bonds could be vulnerable. Even if the global news remains neutral to bonds, it is not exactly clear when the signs of the strong second quarter will start being accompanied by news of the much slower third quarter.

In recent months, the front of the yield curve has steepened while the back has flattened. During the past two months, the yield on the five-year Treasury note has risen, the 10-year yield has changed little, and the 30-year yield has fallen. One interpretation is that the market is rationally pricing in its belief in upcoming Fed rate hikes but that there remain major fears about the long-term stability of the global economy. Another interpretation is that foreign central bank and major institutional buying has affected bonds more than shorter paper. Whatever the reasons, is it possible that more bullish economic news will continue to support bonds while hammering Treasuries with 1-to-7-year terms? Certainly, but this curve behavior, like other idiosyncratic market behaviors, is likely to have its limits. From a fundamental view, if the next month or so generates enough excitement about U.S. economic growth prospects, it will also encourage optimism about the global economy (if the global news is not already bad enough to offset it), and a dramatic reversal of the bond rally could occur. Then again, a bond sell-off would in all likelihood rattle EM financial markets before too long. Our conclusion: Some correction in bonds is probable, but its extent and endurance are uncertain.

Therefore, we are managing our bond portfolio with great respect for the uncertainties of this period and not banking on any particular scenario this summer. If we had 100% cash and were starting to build a new bond portfolio today, we would immediately spend at least half of it, maybe three-fifths. We would not want to be largely out of the market and risk missing a sizable part of the major rally that we firmly expect will take yields to record lows. That rally could begin any time, although it might not begin for months and, in fact, will more likely than not be preceded by a sell-off. However, we would be inclined to be patient and would wait for a bond sell-off before taking more positions, and we would expect to buy in increasing increments as yields moved higher. Although we will continue to reevaluate the outlook, we would be inclined to be mostly invested by the time yields climbed halfway back to the year's highs, assuming they go that far. This buying schedule is merely suggestive because we may well adjust our plans in the face of new events.

Our patience for buying more bonds will start to dwindle as the window of opportunity for the U.S. growth scare begins to close. One can do much worse than buying long Treasuries today and ignoring them for the next couple of years, and investors with sufficient time frames and tolerance for paper losses should not ignore the opportunity that is probably the highest probability investment one can make today.



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