



SPECIAL COMMENTARY

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Recent Bond Market Developments: Adjustment or Trend?

Mark Vitner, Senior Economist
mark.vitner@wachovia.com
(704) 383-5635

John E. Silvia, Chief Economist
john.silvia@wachovia.com
(704) 374-7034

This past week's sell off in the bond market sent the interest rate on the 10-year Treasury bond up to 5.31 percent, which is more than a 40 basis points higher than it was three weeks ago. The trigger for the run-up in yields has been the sudden turnaround in the economy's near-term growth prospects, which has thrown cold water on any notion that the Fed would cut interest rates this year or that the economy was headed for recession. The yield curve is now upward sloping, indicating that the investors expect economic growth to accelerate.

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Is the rise in rates a one time adjustment or a signal of a sustained trend? Our explanation is that the 5.31 percent threshold will hold for now and that yields may even slide back toward 5.00 percent over the next few weeks. One thing is certain, however. Interest rates were clearly too low three weeks ago. Back then the market was still focusing on the fallout from the unwinding of the housing boom. The collapse of the subprime lending market, the impending reset of adjustable rate mortgages and the rising tide of foreclosures were widely touted as threats to consumer spending and overall economy growth during the second half of the year.

Today the economic outlook has improved substantially. Real GDP growth is now widely expected to rise at a 3.0 percent or better pace during the second quarter. Our own forecast calls for a 3.8 percent increase. Growth during the second half of the year is likely be around three percent, which we believe is close to the economy's long-term sustainable growth rate.

Tuesday's sell-off was largely driven by the poor auction results for the Treasury's 10-year note. By the end of the session, the yield had risen to a 5-year high of 5.26 percent and the yield drifted up to 5.31 percent in after-hours trading.

By Wednesday, it appeared the worst of the bond market rout was over. Retail sales rose much faster than expected in May, surging 1.4 percent overall and 1.0 percent after excluding motor vehicles and gasoline. Those stronger numbers along with a small upward revision to the April data mean that real personal consumption

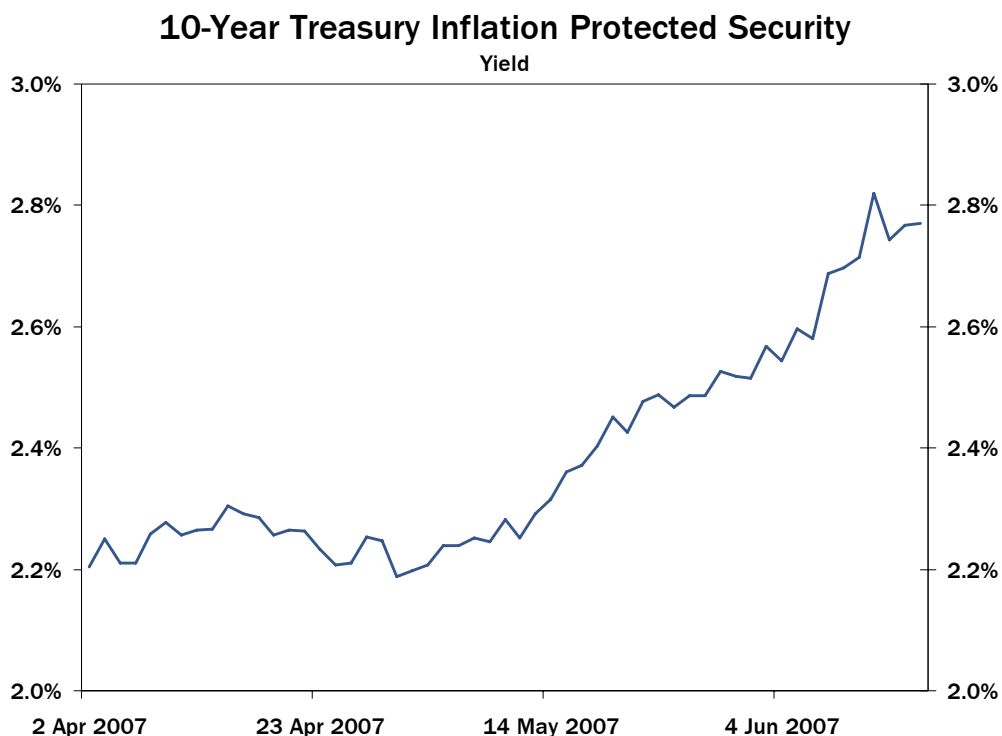
expenditures probably climbed at around a three percent pace during the second quarter. But rather than selling off on this news, the bond market rallied and yields drifted down toward 5.20 percent.

The drop in yields that followed the stronger retail sales figures is encouraging. For now, 5.31 percent likely marks the upper end of the trading range for the 10-year note, while 5.00 percent likely marks the lower end. Back in early May, the yield on the 10-year was around 4.60 percent.

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The rise in long-term interest rates and return of a positively sloped yield curve likely signals increased expectations for economic growth and not increased concerns about inflation. Another way of looking at this is to look at the yield on the 10-year Treasury Inflation Protected Securities (TIPS), which have risen 60 basis points over the past six weeks. Since the spread between the 10-year Treasury note and the 10-year TIPS has not changed materially, all of the increase in the TIPS yield is due to higher real interest rates, or what economists refer to as the opportunity costs of money. In other words, investors expect economic growth to improve.

Figure 1



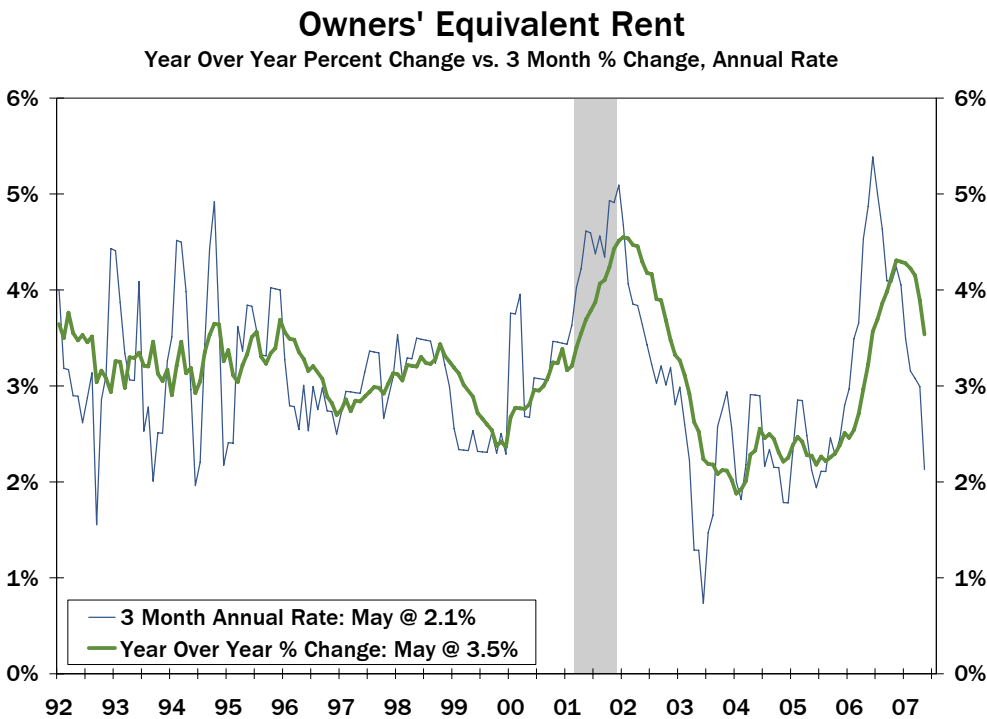
Source: Bloomberg LP

The Fed's Beige Book also had some bond friendly news in it. The economy is reported to be growing modestly and higher energy prices do not seem to be spilling over into the prices of other goods and services or to be impacting inflation expectations. The tone of the Beige Book also appears to be much more subtle than the gains we have seen in most of the major indicators this past month, including the ISM report, the employment data, and the May retail sales report.

With so much action earlier in the week, the bond market barely budged after the long awaited Consumer Price Index (CPI) number. The headline CPI came in about as expected, with higher energy costs driving the overall CPI up 0.7 percent. The gain puts the CPI up at a 7.0 percent annual rate over the past three months, almost entirely due to a spectacular surge in gasoline prices. Gasoline prices rose 10.5 percent in May and are up at a 168.2 percent annual rate over the past three months.

From the bond market and Fed's perspectives, the key question on the inflation is how much of the surge in gasoline prices has passed through into the prices of other goods & services and how has that influenced inflation expectations. So far the answer to this question has been surprisingly little. The core CPI rose just 0.1 percent, with modest gains in housing costs, declines in prices for apparel and new motor vehicles, and unusual restraint in prices of prescription and nonprescription drugs. The ongoing correction in the housing market should continue to cut into rent and owners' equivalent rent, which make up close to 40 percent of the core CPI. As a result, we should continue to see only modest gains in core inflation.

Figure 2



Source: The Bureau of Labor Statistics

Friday's CPI report was the last piece of data that presented a significant risk to the bond market, and the modest 0.1% growth on the core was reassuring to the bond market. Most of the reports we will receive over the next three weeks should be relatively market friendly. The housing data are widely expected to weaken and we should see a reversal of last month's peculiar rise in new home sales. We also suspect we will see at least a partial reversal in some of the recent strength in the regional Fed surveys. The next big unknown for the markets may be the advance

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report on durable goods, due out on June 27, which is just before the Fed's June 27/28 FOMC meeting.

We now see the financial markets turning full circle, with optimism about the economy just a bit over the top.

A few weeks back we wrote in our weekly commentary that 'there are no monsters under the bed or in the closet.'¹ The piece referred to what we felt were irrational fears about the correction in housing market, the impending reset of adjustable rate mortgages, and the apparent lack of capital spending. The financial markets have finally gotten the message. Yields were too low three weeks ago because concerns about the economy were considerably overblown. We now see the market turning full circle, with optimism about the economy just a bit over the top.

Let's start with the economic outlook. We boosted our forecast for second quarter GDP the very same day first quarter growth was revised down by 0.7 percentage points to 0.6 percent. A good part of that downward revision was due to a larger drawdown in inventories and a wider trade deficit during the first quarter. The current quarter will see a reversal of these trends, with inventories and trade adding to growth. We boosted our forecast 0.3 percentage points to 3.8 percent.

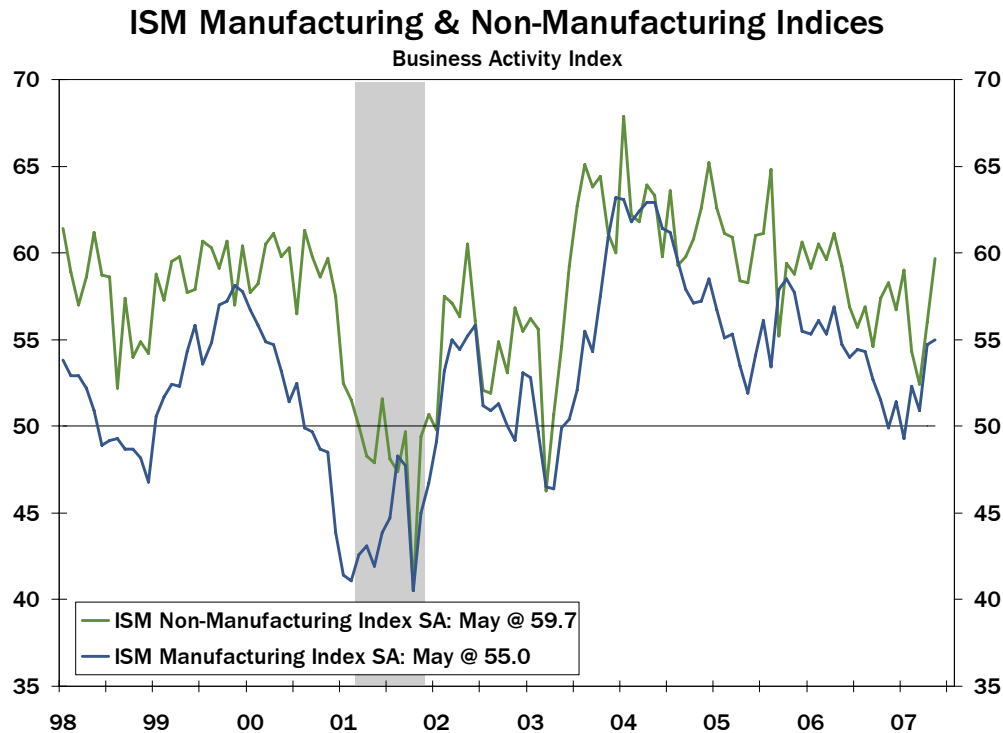
Does 3.8 percent real GDP growth in the second quarter represent a major change in the economic outlook? The answer is, somewhat surprisingly, no. If you average first quarter growth with our estimate of second quarter growth it comes to around 2.2 percent, which is roughly equivalent to where the economy has been the last four quarters. The biggest change, however, is what comes later in the forecast. After decelerating for the better part of a year, the economy is now reaccelerating. The bulk of the drag from the housing slowdown is now behind us and we are finally beginning to see some encouraging signs in business fixed investment.

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There is now considerably less downside risk to the economy and this has greatly diminished the chance that the Fed will cut short-term interest rates this year. We believe the chances of a rate hike, however, are pretty slim. Much of the renewed optimism about the economy stems from the better than expected ISM manufacturing and non-manufacturing surveys, as well as regional surveys such as the Chicago Purchasing Managers' Index.

¹ Please see our *Weekly Economic and Financial Commentary*, June 1, 2007. Available on our website www.wachovia.com/economics or from the author upon request.

Figure 3



Source: Institute for Supply Management

The ISM and regional purchasing managers' surveys are diffusion indices. They measure the breadth of improvement or deterioration in the economy not the magnitude. A reading above 50 means that more purchasing managers see business conditions improving than see conditions weakening. Since so many purchasing managers were unduly pessimistic about the economy a few months ago, particularly on the manufacturing side, it was relatively easy for these series to bounce back in May. Conversely, today's optimism about the economy will make it harder for the ISM and regional indices to post additional gains in June and July. We look for these reports to give back some of their recent gains in coming months, which may provide some relief for the bond market.

Most other economic indicators, including employment and retail sales, will also likely soften a bit during the summer. Our current forecast for third quarter real GDP calls for a gain of around 2.8 percent and we still feel comfortable with that forecast.

We are in the process of updating our interest rate forecast to incorporate the latest moves in the bond market. Our June forecast was largely put together in late May and early June, when the yield on the 10-year Treasury note was nearly 40 basis points lower than it is today and the yield curve was essentially flat. Forecasting interest rates is always hazardous duty, particularly in the midst of a market rout.

Alan Greenspan noted in a speech to the Commercial Mortgage Securities Association Tuesday that bond yields were likely in the midst of a cyclical upturn

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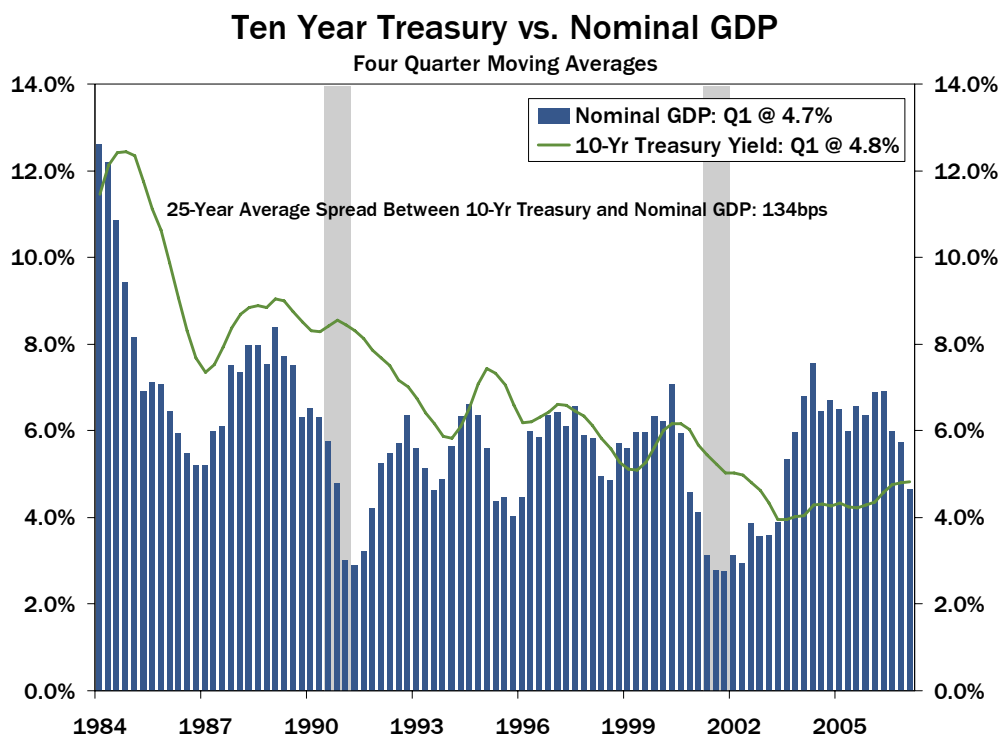
that could take interest rates higher than many people currently expect. We agree with this view but caution investors to remember that there are some seasonal and technical pressures that likely magnified the most recent jump in rates. Oftentimes we see some upward pressure on bond yields after taxes are paid on April 15. This year, with large numbers of households being hit by the Alternative Minimum Tax was no exception, leaving a little liquidity in the marketplace.

Economic growth is likely to strengthen in coming quarters, as business investment ramps up and the drag from the housing slump diminishes. With little slack in the economy, inflation is unlikely to decelerate to any significant degree but we do not see it becoming a major problem in 2007 either. In this environment, the Fed will likely remain on hold through the rest of this year and will not tighten until they see some sign that housing has bottomed out. We think that will put the first tightening in the spring or early summer of next year. The yield curve should retain its positive slope, which it only recently regained.

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The yield on the 10-year Treasury note has largely been below nominal GDP growth for the past 5 years, which is not sustainable. Remember that an interest rate has three components: opportunity cost, which we believe is best represented by nominal GDP; the time value of money, which was consistently around 135 basis points before the Fed and other central banks began to flood the economy with liquidity in the wake of the Asian Economic crisis in the late 1990s; and a risk premium, which is irrelevant for Treasuries. The U.S. Treasury cannot go out of business.

Figure 4



As we noted back in our March 6 piece, *March Madness and Global Liquidity*,² long-term Treasury yields below nominal GDP clearly do not make sense. What this literally says is that if you could borrow enough money, you could buy the entire U.S. economy and make money on the spread, the mother of all arbitrage opportunities. Maybe this is why we have seen so much hedge fund and private equity activity.

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We now expect the yield on the 10-year Treasury note to either equal nominal GDP or slightly exceed it. With real GDP likely to expand at around a 3 percent pace and inflation likely to rise at a little over a 2 percent, a reasonable expectation for the 10-year note in the near-term would be somewhere between 5.00 percent and 5.50 percent through the end of this year.

Yields should generally rise over the forecast period, although we will almost certainly see some seasonal pullbacks along the way. A year from now we expect the yield on the 10-year note to be closer to 6 percent and expect the 10-year note to end 2008 at slightly above that level. This is a much different environment than we have become accustomed to in recent years but is generally consistent with an economy moving into the mature phase of the business cycle, when there is less slack available in the U.S. and global economies.

Wachovia U.S. Economic Forecast												
	Actual				Forecast				Actual		Forecast	
	2006				2007				2006	2007	2008	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q				
Real Gross Domestic Product ¹	5.6	2.6	2.0	2.5	0.6	3.8	2.8	3.1	3.3		2.3	3.3
Personal Consumption	4.8	2.6	2.8	4.2	4.4	3.0	2.8	3.0	3.2		3.5	2.9
Inflation Indicators ²												
"Core" PCE Deflator	2.0	2.2	2.4	2.2	2.2	2.0	1.9	2.0	2.2		2.0	2.1
Consumer Price Index	3.7	4.0	3.4	1.9	2.4	2.5	2.0	3.0	3.2		2.5	2.3
Industrial Production ¹	5.0	6.5	4.0	-1.5	0.8	2.3	2.7	3.4	4.0		1.8	3.5
Unemployment Rate	4.7	4.6	4.7	4.5	4.5	4.5	4.5	4.4	4.6		4.5	4.3
Housing Starts ³	2.13	1.86	1.70	1.55	1.46	1.50	1.45	1.44	1.81		1.46	1.49
Quarter-End Interest Rates												
Federal Funds Target Rate	4.75	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.25		5.25	5.75
10 Year Note	4.86	5.15	4.64	4.71	4.65	5.15	5.30	5.40	4.71		5.40	6.10

Data As of: June 15, 2007

¹ Compound Annual Growth Rate Quarter-over-Quarter

³ Millions of Units

² Year-over-Year Percentage Change

² Available from the author upon request.

Wachovia Economics

John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wachovia.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wachovia.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wachovia.com
Sam Bullard	Economist	(704) 383-7372	sam.bullard@wachovia.com
Huiwen Lai, Ph.D.	Quantitative Analyst	(704) 715-7415	huiwen.lai@wachovia.com
Jason Schenker	Economist	(704) 383-3695	jason.schenker@wachovia.com
Adam York	Economic Analyst	(704) 715-9660	adam.york@wachovia.com
Tim Quinlan	Economic Analyst	(704) 374-4407	tim.quinlan@wachovia.com

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