Capital Markets

A compendium of timely news, analysis and opinion.

CURRENT YIELD / By RANDALL W. FORSYTH

Hope of Fed Easing Sparks Rally

WHAT a difference a season makes.

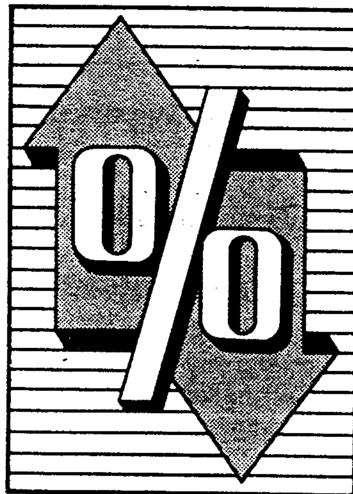
Following the vernal equinox, the strong dollar sparked vigorous rallies in the U.S. bond and stock markets. But since last week's summer solstice, the capital markets seem to have decoupled from the dollar. Bond and stock prices soared despite a marked weakening of the greenback.

Rumors of a pact among the U.S., Japanese and West German authorities to ratchet down the dollar back to its levels of several weeks ago accelerated the currency's skid that began the week before last. The story, combined with further signs of a U.S. economic slowdown, fanned market speculation that the Federal Reserve was planning to take further steps to loosen monetary policy, including a possible cut in the discount rate. Such a move could help ease the upward pressure on the greenback and forestall any further softening in the domestic economy.

The prospect of easy money sent prices soaring across markets Friday, with bonds, stocks, precious metals and foreign currencies mounting spirited rallies. The bellwether Treasury long bond, the 8⅞s of 2019, jumped 1½ points, or $15 per $1,000 bond, while money-market rates plunged as much as one-quarter of a percentage point. Those moves helped send stocks roaring to new post-Crash recovery highs, with the Dow Jones Industrial Average vaulting 49.69, to 2531.86. Gold prices also advanced, with the August Comex futures contract gaining $7.60 to settle at $381.80 an ounce.

Speculation that the Fed would ease again soon was fanned by Friday's report that durable goods orders plunged 4.2% in May, the steepest decline since last July, when they fell 7.4%. In April, durable goods orders posted a revised gain of 3.2%, which was previously estimated at 3.0%. This latest report indicating that the manufacturing sector is decelerating largely reflected a 9.4% drop in transportation orders, which was concentrated in the aircraft sector. But even excluding this volatile category, orders were off 2.1% in May after rising 4.5% in April.

The durable goods report also pointed to a slowing in capital spending, one of the economy's bright spots this year. Orders for nondefense capital goods, a leading indicator of plant and equipment expenditures, plunged 8.3% in May following a 5.8% rise in the preceding month. While the report pointed to a further loss of momentum, it did not indicate a massive fall-off in the manufacturing sector. The backlog of unfilled orders continued to increase, albeit only 0.1% vs. 1.3% the month before.



Still the overall report was substantially weaker than economists' projections, which had called for a fractional increase in durables orders. It also suggested a slowing in U.S. export growth, another strong feature of the U.S. economy.

Other data released Friday indicated that the consumer sector continues to muddle along. Personal income rose 0.3% in May, less than April's revised 0.5% gain (originally reported as a 0.4% increase) but in line with expectations. Personal consumption spending also increased 0.3% last month, down from the 1.1% jump in April, which was induced by automobile sales jump-started by financing incentives. Since then, car sales have languished around the seven-million-unit annual pace, or 10% less than a year ago, in the absence of cut-rate loans.

The Fed's "Tan Book" released last week also found widespread weakness in auto sales. This summary of economic conditions, prepared in late May and early June for the July 5-6 meeting of the policy-setting Federal Open Market Committee, found mixed conditions across the nation, however. Except for autos, consumer spending was strong. Manufacturing activity was mixed in different areas. But the report also noted some continued price pressures.

The Tan Book provides only a minimal guide to the FOMC's future actions, however. The panel will consider other forthcoming indicators before acting. This week will see the release of May's index of leading indicators and factory orders. Both are apt to show weakness, in part traceable to the plunge in durable goods orders, which is a component in both series.

The panel also is likely to await the first indicators for June, especially the key employment data, which is due for release July 7, two days following the coming FOMC meeting. The June National Association of Purchasing Managers report is slated for release next Monday but will be widely available in the market this Friday if recent patterns continue.

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NOTWITHSTANDING market speculation of a cut in the discount rate from its current 7%, any easing decided by the FOMC is apt to be less dramatic. The discount rate technically is the purview of the Fed's Board of Governors, not the FOMC. But the Board comprises the majority of the 12-member FOMC, which also includes the New York Fed President and four other District Presidents who vote on a rotating basis. (There will be only six Governors voting at the next meeting, with the resignation of H. Robert Heller announced last week.) The discount rate and open-market policy are the determinants of the Federal funds rate, the central bank's main policy lever, and are always coordinated, so the distinction is moot.

In any case, the Greenspan Fed has preferred to move in small, measured steps. Most of its tightening moves were accomplished via quarter-point monthly boosts in the Fed funds rate. The exception was early this year, when the central bank moved in one-half and three-quarter point increments in reaction to full-point jumps in the producer price index for January and February and a weak dollar.

Thus, if the FOMC votes for another easing, it will most likely result in a step down in the Fed funds rate to a new range centered around 9¼%, from the current 9½%. That would parallel the easing from the 9¾% level effected earlier this month.

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THE easing in the dollar may actually have its plusses for the bond market. If the currency markets take the hints from the major central banks that they want the dollar to return to around the 1.90-Deutschemark and 137-yen levels, their massive dollar sales would ease. (The greenback ended the week at 1.9425 marks and 138.80 yen, down sharply from 1.98 marks and 144.60 yen the previous Friday.) And with reduced intervention, foreign central banks' huge liquidations of their holdings of U.S. Treasuries would subside. Over the past five weeks, the Fed's custody holdings of U.S. Government securities have been slashed by more than $10 billion. That represented liquidations by foreign central banks to provide them with dollars to dump on the currency markets.

An absence of foreign-central bank selling of short U.S. Treasuries would be especially welcome to the market this Monday's weekly auction of $12.8 billion of three- and six-month Treasury bills will be followed Tuesday by the monthly sale of $8.75 billion of two-year notes, $7.5 billion of four-year notes Wednesday and $9 billion of one-year bills Thursday. In the agency sector, the Federal National Mortgage Association will price $2.1 billion of intermediate-term debentures on Tuesday and the Federal Farm Credit Banks Funding Corp. will price $2.6 billion of short-term bonds on Wednesday.

A stable dollar would also make U.S. bonds and stocks more attractive to foreign buyers. While overseas investors have reaped currency gains from the greenback's appreciation, those that bought at its peak levels over 2.00 marks and 150 yen two weeks ago would be sitting on losses resulting from the dollar's correction.

Holding the greenback at bay also would lessen the pressure on foreign central banks to tighten their domestic policies to support their currencies and stave off imported inflation. That also would pay benefits in maintaining U.S. export growth. Perhaps even more than the dollar's higher exchange rate, the U.S. trade adjustment would be threatened by a slowdown overseas induced by higher interest rates.

For the U.S. economy, however, a weaker greenback is not an unambiguous plus. As Fed Board Governor Wayne Angell commented several weeks ago, an effort to drive down the exchange rates is "fraught with risk." A weaker exchange rate would remove an important restraint on U.S. inflation. So would a shift to excessively easy monetary policy to cheapen the greenback.

The year-over-year gain in producer price inflation is running at a 6% rate while consumer prices are up 5½% from a year ago. Industrial commodity prices, as measured by the Journal of Commerce Index, are off less than 1.5% from their spring peak. And, as noted, gold prices are acting perkier.

Nor is it certain that the economy is about to roll over. While this week's LEI will show a drop on the order of 1%, a better leading indicator points to continued expansion. That indicator is the Treasury yield curve.

According to research by Campbell R. Harvey, an assistant professor of finance at Duke University's Fuqua School of Business, the slope of the yield curve provides superior clues about the future of the economy. While the yield curve has flattened markedly this year, which traditionally points to slower growth, it hasn't been so acute as to forecast a recession, he says.

His yield curve model predicts that the real gross national product should expand by 1.7% from the third quarter of 1989 to the third quarter of 1990. For a recession to be indicated, Treasury bills would have to yield a full percentage point more than 10-year notes. On a bond-equivalent basis, the three-month bill yielded 8.33%, only one-tenth of a percentage point more than the 10-year note—not enough to signal a downturn.

Interest-sensitive sectors, especially housing, are apt to get a boost from the spring break in interest rates. The influx of foreign capital that sent the dollar higher also has provided ample liquidity to the U.S. economy (even if it doesn't show up in the money-supply numbers). The Fed, meanwhile, is apt to step up its pumping. Friday's simultaneous surges in the debt, equity, currency and precious metals markets indicate anything but tightness. ■

BOX SCORE

Sentiment

Bullish Consensus

	Last Week	Two Weeks Ago	Three Weeks Ago
T-Bonds	62 %	72 %	70%
Euro$	47%	60%	57%

Source: Market Vane's polling of trader sentiment. High readings usually are signs of market tops, low ones, market bottoms.

Performance

Last Week	Two Weeks Ago	Three Weeks Ago
3-Month T-Bills		
8.07%	8.14%	8.19%
Prices*		
1333.67	1321.07	1343.39
Total Return†		
296.56	294.39	292.95

*Shearson Lehman Index of long Treasury bond prices; Dec. 31, 1980=1000.
†Ryan Index of total return from Treasury notes and bonds.