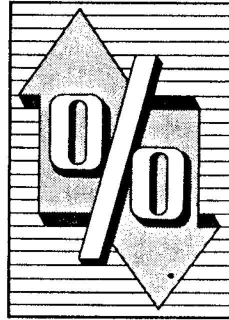
CURRENT YIELD / By RANDALL W. FORSYTH

Bad News Bulls Buoy Bonds

BAD news was the bond market's best friend last week. The stock market's plunge Monday and fresh news of sluggish economic growth Friday gave the debt securities a boost, but only a modest one as concerns about higher oil prices, rising interest rates abroad and a looming Treasury financing weighed on the market.

After opening the week sharply lower, long-term government bonds soared more than a point, or $10 per $1,000 bond, in a classic "flight to quality" as the Dow Jones Industrial Average plummeted more than 100 points Monday morning. The credit market gave back part of its gains after equities managed to recoup nearly half of their losses by the day's close, finally ending the roller-coaster session little changed.

After meandering the next three days within a narrow range, the debt market moved higher again Friday in reaction to news that not only was the second quarter's gross national product growth below expectations but earlier periods also were weaker than previously reported. For the week, the Treasury's benchmark 30-year bond gained 20/32 in price, all of which came Friday. The long



A shift in the yield curve's slope points to faster economic growth, one economist contends.

bond's yield slipped to 8.47% from 8.53% a week earlier.

Real, inflation-adjusted GNP grew at a 1.2% annual rate in the June quarter, less than the preceding quarter's revised 1.7% pace, which previously was estimated at 1.9%. While the latest quarter's showing was under the 1.5%-2% pace projected by economists, last quarter's growth came mainly from inventory accumulation. Real final sales (GNP less inventory swings) fell at an annual rate of 1.5% in the second quarter, in contrast to the first quarter's healthy 3.8% yearly gain.

Real GNP for 1989 was revised down as well, to a 2.5% growth rate from 3.0%. Gains in personal consumption expenditures were revised down by nearly a third, to 1.9% from 2.7%, the biggest factor accounting for last year's GNP reduction. Last year's decline in residential fixed investment (housing) also was worse than previously thought, 4.1% instead of 2.9%.

The picture emerging from the GNP report was that not only was the economy struggling in the second quarter but it wasn't doing as well as had been thought in earlier periods either. Nor do leading indicators augur stronger future activity. Durable goods orders fell 3.2% in June, a sharper-than-expected decline following the previous month's 4.2% gains. Defense goods were responsible for much of both month-to-month swings; excluding military hardware, orders dropped 1.7% last month after a 3.1% gain in May.

The weak economic data, especially the GNP numbers, convinced the debt markets that the Federal Reserve was indeed correct to ease policy two weeks ago. And, moreover, that the central bank will have to lower rates again to get things moving again.

Fed Chairman Alan Greenspan's explanation of the recent shift to greater accommodation didn't go over well in the financial markets. His contention that a quarter-point cut in the federal funds rate (to 8%) was merely to offset the effect of tighter bank lending policies was viewed by cynics as a capitulation to pressures from the White House and Capitol Hill and an abandonment of the Fed's inflation fight.

In the second round of his semiannual Humphrey-Hawkins testimony on monetary policy last week, Greenspan insisted to the House Banking Committee that "we have not done anything to alter our policy path." Inflation, while higher than the central bank would like, should be brought down by its policies, he contended.

Friday's GNP data provided some confidence on that score. The implicit price deflator rose at 4.4% annual rate in the second quarter, down from 4.8% in the first quarter. The fixed-weight deflator, favored by some economists because of being less prone to quarterly aberrations, showed greater improvement: 4.0% in the latest reading from 6.6% in the first period.

But the employment cost index published by the Labor Department showed no easing in inflationary pressures. This gauge showed a 5.4% increase for the 12 months ended in June, vs. 5.5% for the 12 months ended in March. A year earlier, the 12-month increase was 4.8%. Wages and salaries increased 4.7% in the latest 12 months, vs. 4.3% in the year ended March and 4.3% in the year ended June 1989. But benefits—perhaps even more valued by workers as taxes and medical costs climb—increased 7.2% for the 12 months ended last month, little changed from 7.4% in the year ended March but substantially higher than 6.0% in the year ended June 1989.

Greenspan's vow to fight such inflationary pressures gave negligible comfort to the markets, which had heard him say just a week earlier that recession posed the slightly greater threat. Other Fed officials took up the central bank's anti-inflation standard later in the week, and somewhat more convincingly.

Board Governor Wayne Angell said Wednesday he opposed easy money to stimulate the economy, preferring policies

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that would bring down long-term interest rates. "If the Federal Reserve eases at this time," he told the American Legislative Exchange Council in Boston, "the money markets and world capital holders would be confused as to Federal Reserve policy and long-term interest rates would rise."

Angell's credibility on stable prices is perhaps greater than any other Fed official. He dissented against the central bank's previous easing move last December because of the financial and commodity markets' signals that they would view it as inflationary. Bond yields subsequently rose sharply while the dollar fell in the wake of that move. It would not be wildly speculative to think Angell did not approve of the Fed's latest easing, which has had the same effect.

Most dramatically, the slope of the yield curve has steepened. Short- and intermediate-term rates fell while long-term bond yields went the other way. That classically has been a sign that the financial markets anticipate higher inflation and interest rates in the future, along with stronger growth.

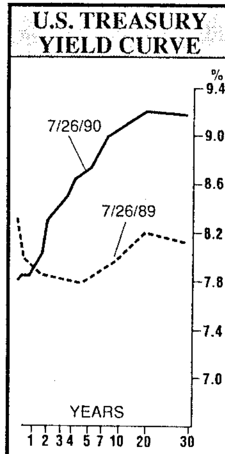
Campbell R. Harvey, associate professor of finance at Duke University's Fuqua School of Business, says that this shift in the yield curve's slope points to faster economic growth down the road, not a recession, as worrywarts fear and bond bulls hope. His model, based on the yield curve, predicts real GNP growth of 2.4% from the third quarter of 1990 to the third quarter of 1991, which is "not bad compared to what we've been experiencing." His model had predicted the current slow-down, to a growth rate of 1.7% from the third quarter of 1989 to the third quarter of 1990. He expects the actual number to come in a hair lower, at 1.5%-1.6%.

More than precise forecasts, Campbell says his model points to turning points in economic activity. And the current steepening strongly implies a pick-up in 1991. For fixed-income investors, meanwhile, he advises them to look for more of the same: easing in shorter-term rates and higher longer-term yields.

The credit markets already appear to have placed their bets according to the professor's forecast. December Eurodollar futures prices discount a further easing in monetary policy. The contract settled Friday at 92.14, which implies a three-month London interbank offered rate of 7.86% by year-end. That would be consistent with a 7¾% fed funds rate, which would take another easing.

But, observes one money-market professional, those betting on a further easing and steepening of the yield curve may ironically work to thwart that from coming to pass. Fed officials, such as Angell, who pay careful attention to the shape of the yield curve, are apt to be reluctant to loosen policy because of the upward slope's implied expectation of higher inflation.

Also possibly acting to deter near-term Fed easing could be the dollar's softness. The greenback continued to give ground last week as it was spooked by the same things that cheered bonds—the stock-market slide and weak economic numbers. Only against the yen did the dollar manage to hold its ground. But that said as much about the woes of the Japanese currency and financial markets last week as anything.



Barron's / Knight-Ridder Tradecenter.

Yields on 10-year Japanese government bonds climbed to a six-year high of nearly 7.60% last Friday. With comparable 10-year U.S. Treasury notes yielding 8.41%, the gap between the two markets was the narrowest in nearly a decade. And despite frantic efforts by the Bank of Japan to convince the Tokyo money markets that it is not preparing a hike in its official discount rate, Japanese short-term rates continued to move sharply higher.

With dollar money rates coming down in the wake of the Fed's move, Eurodollar and Euroyen deposit rates are coming close to convergence for the first time in five years. The last time that happened was after the September 1985 Plaza Accord, in which the major industrialized nations decided to devalue the dollar, notes Salomon Brothers' Comments on Credit. The plan was to flood the globe with liquidity but Japanese officials used the occasion to tighten monetary policy and engineer a higher yen. The stronger exchange rate for its currency has permitted Japanese investors to accumulate global assets at bargain prices.

Whether Japanese investors will be willing buyers now that their currency and financial markets are again under pressure is a major question for the U.S. bond market to ponder. During the first quarter, when Japan suffered the "triple demerit" of the crash in the Nikkei, plunge in the bond market and weakening of the yen, Japanese investors liquidated nearly $4 billion of U.S. Treasury securities, according to Treasury data. Japanese institutions sold dollar securities to offset losses in domestic markets. (Cynics might wonder if the sales were to fund payments to reimburse brokerage customers for their losses. Two major brokerage houses reportedly did just that following Black Monday in 1987, it came to light last week. See The International Trader, page 50.)

The position of Japanese investors raises the specter of six months ago, when U.S. yields moved sharply higher ahead of the February Treasury refunding. Since then, the yield advantage of U.S. securities has dwindled. U.S. rates have moved lower while yields around the globe have increased. The dollar, meanwhile, has steadily lost ground, especially against currencies offering significantly higher yields, such as the U.K. pound and the Canadian dollar.

From the domestic standpoint, the supply-demand situation for U.S. bonds also has worsened. The Treasury is likely to unveil a record $31.5 billion quarterly refunding this Wednesday and outline record borrowing plans for the fourth quarter of the year. The budget summit continues to crawl along and no deficit-cutting pact is likely before September, if not Election Day.

This week, the markets will get the first round of July economic data, which will show whether the second quarter's sluggishness is extending into the current period. The National Association of Purchasing Managers' monthly index, due Wednesday, is expected to show some slippage from the June 51.1% reading but remain above the 50% mark, denoting manufacturing growth. The estimates for July's employment data call for no change in nonfarm payrolls but a gain of 125,000 workers if census layoffs are excluded. ■

BOX SCORE

Sentiment

Bullish Consensus

	Last Week	Two Weeks Ago	Three Weeks Ago
T-Bonds	55%	58%	59%
Euro$	67%	59%	58%

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

Performance

Last Week	Two Weeks Ago	Three Weeks Ago
30-Year T-Bonds		
8.47%	8.53%	8.45%
Prices*		
1295.67	1287.44	1294.87
Total Return†		
320.47	319.15	318.81

*Shearson Lehman Index of long Treasury bond prices; Dec. 31, 1980=1000.
†Ryan Labs Treasury Index.