

Dichotomy of Economic Heavyweights

They've staked out their territory, it's a battle of heavyweights. The bond market vs. the homebuilders. Who's right, who's wrong? Trillions of dollars may be at stake. The economy of the United States could be in the balance, and the world is waiting.

Here's the deal. The Federal Reserve controls the fed funds rate. This is the rate that banks are allowed to charge each other for short-term loans. By raising this rate, it is the Fed's intention to slow down the economy, and thus reduce inflation. By lowering this rate, just the opposite happens, the economy is sped up, and inflation eventually will rise. This rate is important because it affects all lending, most notably home mortgages. Thus, over the past few years, with interest rates low, the residential real estate market has exploded (but I'm getting ahead of myself.) The fed funds rate is also important in its relationship with the bond market. More specifically, the Ten-year US Treasury Bond. The normal difference between the fed funds rate and the ten-year treasury yield could be three quarters of a percent (0.75%). Thus, with the current federal funds rate at 5.25%, the ten-year treasury could be comfortably at 6%. This would not be abnormal. *However, the current ten-year treasury yield is 4.83%.* This is well below the fed funds rate of 5.25%. We call this an inverted yield curve.

If the bond market's current ten-year yield is correct in relation to current economic conditions, then you would expect that sooner or later, the fed funds rate would come down to be less than the current ten-year treasury yield. Historically speaking, when the short rates are higher than the long rates, a recession is on the horizon.

The housing stocks are singing a different tune. After having fallen almost 50% in value, the housing stocks are starting to rebound. (Some call it a dead cat bounce, meaning there is more downside to come!) However, economists for the National Realtors Association suggest that after a few quarters of unsettledness, the housing market will resume its upward trend in sales and pricing. They point out that this downtrend is just a normal correction in an over-heated market. They also state that no recession is on the horizon.

If the bond market is right, then a major crash in residential real estate could be just around the corner. The Fed would be forced to lower interest rates, and the economy and the stock markets would be in for a major shake-up.

If the homebuilding stocks are right, there will be no recession. The economy slows, but continues at a decent growth rate, and the Fed would have no reason to lower rates. However, the ten-year treasury yield must rise above the fed funds rate, and, as we all know, rising bond rates mean falling bond prices. In my opinion, that would be bad for the bond market.

Which way to place your bet? I learned a long time ago not to fight the bond market. Therefore, it's the bond market camp for me. A lot of cash, a negative opinion on homebuilders, some guarantees, and alternative investments non-correlated to the stock market.

Till next time,

Bill

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