

# US Macroeconomics

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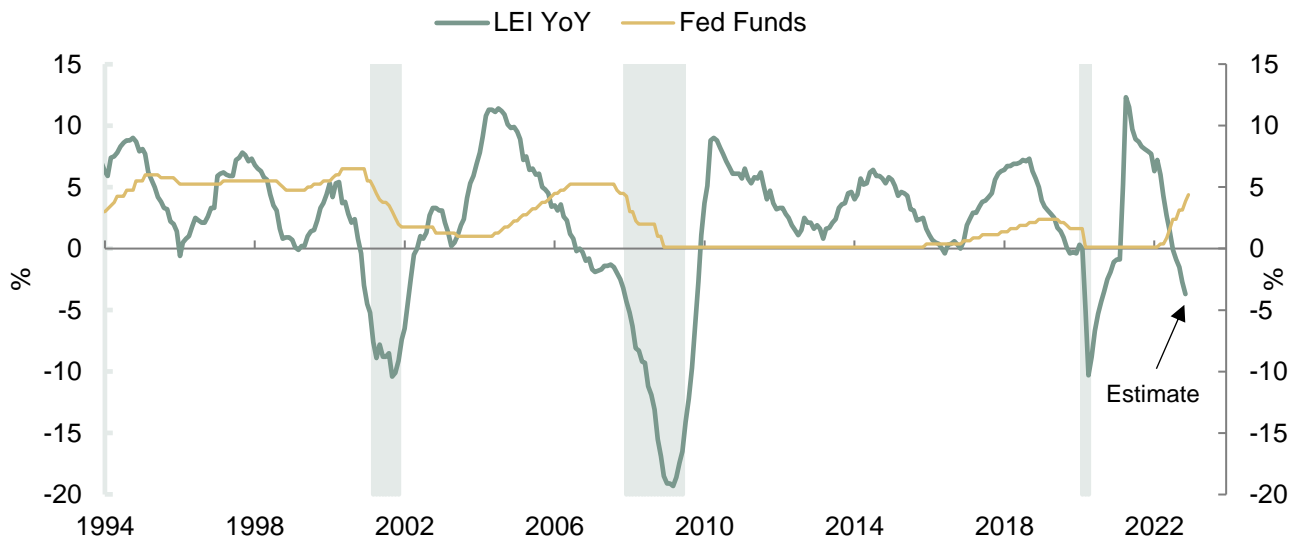
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## Why Isn't The Bond Market Listening?

Yesterday we wrote a piece about the massive divergence between Fed expectations for monetary policy and bond market's expectations for monetary policy. The key question is why this discrepancy? **The answer lies in where the bond market thinks the economy is trending.** If real GDP growth is trending downward, and by all indications it is, then the Fed will not lift rates as far as it expects. If it does, it will reverse course quickly and by a much larger amount than what the official central bank forecasts show. The Index of Leading Economic Indicators (LEI) perhaps best captures the bond market's view.

The chart below shows the growth in the LEI versus the fed funds rate. Over the past 12 months, the series is down 2.7% and is set to fall nearly 4% when November data are released next week. **The economy has never avoided a recession when the LEI has been shrinking this much.** The last time the growth rate was this negative prior to recession was December 2007, right before the 2008-09 downturn which was a doozy. Hence, it is not surprising the bond market does not believe the Fed's forecasts.

**Historically, the Fed would be cutting rates with a negative LEI, not raising them.** Admittedly, inflation was contained in many of these prior periods. But here is the rub: If the economy goes into recession next year, then the inflation is going to come down a lot. Our work has found the average peak to trough decline in core inflation from recession onset is nearly 60%. This means the inflation rate will be back close to 2% within the next year or so. Presently, Fed policymakers do not subscribe to this scenario. However, the bond market does, and we do, too.



Source: Conference Board, FRB, Haver, SMBC

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