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ECONOMIC TALKING POINTS

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A Warning Shot From The Bond Vigilantes

The bond vigilantes today fired their first big shot across the Federal Reserve's bow. The Treasury sold $21 billion worth of 10-year Treasuries today and it has driven yields up to 3.29%, a six-month peak. In just the past 30 days, rates on the 10-yr note have climbed some 75 basis points, which means that at this pace, the yield could exceed 4% by January and 5% before the end of the first quarter.

Though the economy can still function with 10-year Treasuries at 4%, once it surpasses the 5% threshold, the recovery is in danger of stalling. Higher borrowing costs will cool business and consumer spending, and further damage the hurt the housing market. Employers could, once again, place hiring plans on hold as talk of a double-dip recession is revisited. Yes, it can get that ugly, that quickly in 2011.

What this means is that the Federal Reserve is facing a dilemma. Instead of lowering yields and keeping the cost of capital down, implementing QE2 ***now*** may produce exactly the opposite as bond investors increasingly worry that additional monetary stimulus --- in conjunction with the latest stimulative tax deal President Obama just struck with Republicans ---will cause inflation expectations to flare up.

Let's be clear what is meant here. We're not talking about consumer prices spiking in 2011. That won't happen given the current slack in labor and industrial resources in the economy. What we, and investors around the world, will nervously monitor in

coming weeks is how soon the Federal Reserve will act to end QE 2 and how adroit the central bank will be in removing the emergency liquidity it already pumped into the economy.

If the Fed does proceed with another round of quantitative easing in the coming weeks, it will likely agitate bond vigilantes, trigger a sell-off in fixed income securities which would drive interest rates sharply higher and end up hurting the economy.

That's the warning we got from today's steep rise in yields. The core question now? Will the Federal Reserve move fast enough next year to sop up the excess cash and keep **inflation expectations anchored**? Any hint that Bernanke and the New York Fed are late or inept in taking back that liquidity will kick up market rates. Remember, the central bank is in uncharted waters here. We have never seen the Fed conduct a reversal of quantitative easing before. Never before has it even come close to tightening on such a scale.

Ultimately, the fate of the economy and employment next year comes down to investor confidence in the Fed. We believe it is vital for the Fed Chairman to publicly state that if the economy continues to improve as it recently has, ***QE 2 may not need to be implemented.*** That comment, plus **s*ome concrete steps to absorb the excess liquidity,*** will go a long way to keep inflation expectations under control and allow the economic expansion to remain on track.

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