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The Long-term Risks to US Financial Markets

1 Introduction

Bond yields are likely to rise gently this year, thereby causing a threat neither to equities nor to an overvalued housing market, as inflation is likely to dissipate for most part of 2004 and the Fed might delay its monetary tightening. In spite of market worries, both bonds and equities are near their respective equilibrium. However, there are serious risks to financial markets and the economy as a whole from fiscal policy turning once more easy in 2004. The Fed, then, would have a difficult job in keeping the economy on a sustained path to recovery. With strong growth, above potential, the Fed can afford to wait before tightening, as growth is likely to decelerate in 2005 and inflation is likely to remain muted. But the Fed would be forced to tighten more aggressively after the presidential election. Bond yields will rise in 2005 but not to levels that would undermine the housing market. The victim might be the equity market with prices falling precipitously revisiting the March 2003 levels, if the slowdown of the economy were sharp.

With growth at potential in 2004 the Fed should tighten moderately and pre-emptively towards the end of the first half of 2004, but a bit more aggressively thereafter. Bond yields will rise gently in 2004, but even more sharply in 2005, as inflation accelerates with growth continuing at around potential. The housing market would be the victim of rising interest rates, but equities might be spared. We investigate these possibilities in the final chapter of this book. We begin in section 2 by looking into bond market valuation before we examine the theoretical aspects of the issue in hand. This covers both the bond and equity markets separately (sections 3 and 4 respectively). We provide relevant empirical investigation in section 5, before we summarise and conclude in section 6.

2 Bond market valuation

The bond market holds the key not only to the equity market, but also to the economy as a whole. The imbalances in the private sector are dormant
at the moment, as the economy is recovering. However, if long-term interest rates were to rise to critical levels, then these imbalances would reawaken and threaten not only the sustainability of the recovery, but may also trigger another recession. The really interesting question then is the extent to which, and how fast, bond yields rise in the next two years.

The ten-year bond yield peaked at the beginning of 2000 at 6.75% and fell for the following three and a half years hitting a low of 3.12% in mid-2003. The bond market rally was caused by the burst of the new economy bubble and the ensued recession for the economy as a whole and double-dip recession for the industrial sector that lasted until the spring of 2003. Hence, the bond market correctly discounted the recent downturn and the false dawns in the last three and a half years. However, bond yields rose relentlessly in the three months to September 2003 with the ten-year climbing some 150 basis points (bps) to 4.6%, as evidence of an emerging sustained US recovery mounted. Since then bond yields have abated somewhat with the ten-year hovering just above 4.0%. There are currently two polar views on the bond market. According to the first view the bond market is undervalued, as long-term interest rates are still too high, given that the Fed funds rate is only 1%. In other words, the yield curve is too steep and is unlikely to become steeper in the course of 2004. Figure 10.1 provides support for this hypothesis. The spread between the ten-year yield and three-month Treasury bill rate has always reached 3.0%–3.75% at the beginning of a typical recovery, with the exception of 1982, when it hit 4.5%. At the beginning of the current recovery the spread hit 3.5% in August 2003, in line with other

![Figure 10.1 Yield curve (ten-year Treasury less three-month TB)](image.png)