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Bond market worried about inflation?

By [Mark Hulbert](#), MarketWatch

Last Update: 12:01 AM ET July 20, 2005

ANNANDLE, Va. (MarketWatch) -- I have another conundrum to add to the one that Federal Reserve Chairman Alan Greenspan complained about six months ago.

Greenspan, of course, was referring to the puzzling behavior of long-term interest rates. Even though the Fed has been steadily raising short-term rates, long-term rates have been falling -- unexpectedly flattening the yield curve.

The additional conundrum I have in mind has materialized more recently. The bond market has fallen markedly over the past month even while bond investors appear to have become less concerned about inflation.

It's usually the other way around, of course. Bonds more typically rally in the face of a lessening of inflationary fears, on the theory that the Fed will thereby feel less pressure to raise interest rates.

Marvin Appel, editor of the Systems & Forecasts newsletter, pointed out this unusual behavior in his telephone hotline Monday night: "Long term bond yields continue to climb, supposedly reflecting fears that Federal Reserve Chairman Alan Greenspan will testify later this week as to ongoing strength in the economy."

Yet "inflation fears are apparently not on the bond market's collective mind, as Treasury Inflation Protected Securities have been significantly weaker than regular Treasury notes. Today the ETF that reflects the pool of available TIPS, with the ticker symbol ([TIP: news](#), [chart](#), [profile](#)) TIP, closed at a nine-month low."

What's the bond market trying to say with this unusual behavior?

You might think that it's telling us that near-term inflationary expectations are coming down even while longer term expectations are rising.

But this interpretation doesn't fit very well with other data. The price of the 10-year TIPS takes into account investors' expectations of inflation over the next 10 years, not just over the next month or two. And those expectations have been steadily declining of late.

Consider the market's implicit inflation forecast for the next 10 years, as measured by the difference between the ([TNX: news](#), [chart](#), [profile](#)) 10-year Treasury note yield and the 10-year TIPS yield. According to data from the Federal Reserve, this spread has declined from a three-year high of 2.72% in March of this year to a current spread of 2.25%.

My take on these data is that the various parts of the bond market are not of one mind about who will win the struggle between inflation and deflation.

And who can blame them, since there are powerful forces on both sides?

What light on this struggle is shed by a contrarian analysis of sentiment among investment newsletters? The latest reading of the Hulbert Bond Newsletter Sentiment Index (HBNSI) would

appear to favor deflation.

The HBNSI represents the average exposure to the bond market among a subset of short-term bond market timing newsletters monitored by the Hulbert Financial Digest. As of Tuesday's close, the HBNSI stood at negative 30.5%. That means that, on average, these bond timing newsletters are recommending that subscribers allocate 30.5% of their bond portfolios to going short the bond market -- in effect betting that interest rates will go up and bonds down.

On the contrarian grounds that the markets rarely accommodate the majority, this would seemingly bode well for bonds and deflation.

To be sure, contrarian analysis led to the same bullish conclusion earlier this month. [Read related column](#). Yet bonds have been in a fairly relentless decline since then.

But no timing system, even one that adds value over the long term, is perfect. So contrarian analysis' misstep over the past couple of weeks is not a reason in and of itself to ignore its current bullishness.

Editor's note: The most recent edition of the Hulbert Financial Digest is available by e-mail or regular mail. Highlights include:

-- *Fortunes of Fidelity: How have investment newsletters fared when recommending Fidelity's funds?*

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