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Treasury ‘Butterfly’ Signals Fed to Ease, Mitsubishi UFJ Says
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By Saburo Funabiki

Aug. 9 (Bloomberg) -- The so-called butterfly spread formed by 2-, 5- and 10-year Treasury yields signals the Federal Reserve may ease monetary policy this week, according to the Bank of Tokyo-Mitsubishi UFJ Ltd.

The spread is calculated by doubling the 5-year yield and subtracting it from 2- and 10-year rates. It is near levels last seen in December 2008 following the failure of Lehman Brothers Holdings Inc. and in 2001 after the Internet bubble burst, said Kenichi Imai, chief manager of proprietary trading at the unit of Japan’s largest banking group.

“Even though interest rates are already near zero, the five-year yield, which is sensitive to the prospects of monetary policy, has declined,” Imai said in Tokyo. “That indicates the market has priced in further easing.”

The butterfly spread fell to negative 34 basis points, according to data compiled by Bloomberg. A negative number reflects increasing bets that the Fed will cut borrowing costs or hold interest rates near zero for longer, according to Imai.

Speculation that the Fed will announce additional stimulus at a policy meeting tomorrow increased after a report on Aug. 6 showed U.S. employers cut more jobs than forecast in July. Fed Chairman Ben S. Bernanke said on July 21 the economic outlook remains “unusually uncertain” and the central bank remains “prepared to take further policy actions as needed.”

The butterfly spread will approach levels last seen in 1981 during the U.S.’s only postwar double-dip recession if it drops below the spread reached after the collapse of hedge fund Long- Term Capital Management LP in 1998, Imai said.

“Even if the U.S. avoids a double-dip, it may suffer protracted low growth of just above 1 percent, which will raise deflation risks,” Imai said. “The market is beginning to see the growing possibilities the U.S. will go the way of Japan.”

Japan’s economic contraction and deflation during the early 1990s to 2000 prompted the Bank of Japan to hold interest rates near zero and conduct so-called quantitative easing.

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