No Bear Market for Treasuries After Worst Start Since 2009 (2)

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(Updates with today’s 10-year Treasury yield in sixth paragraph.)

By Liz Capo McCormick and Daniel Kruger

Feb. 4 (Bloomberg) -- Even after the worst start for Treasuries since 2009, derivatives traders are signaling there’s little chance of a bear market in bonds for the next three years as Federal Reserve Chairman Ben S. Bernanke fights unemployment.

Demand for insurance against a steep rise in 10-year note yields, the so-called payer skew in options on swaps, has fallen to about its average since 2009, according to Barclays Plc data.
The gap between volatility on three-year options that allow investors to pay fixed rates on 10-year interest-rate swaps and those that grant the right to receive fixed rates has narrowed to about 15 basis points from 25 points on June 1.

While Treasuries lost 0.95 percent in January as investors sought higher returns in riskier securities, the Fed remains committed to buying about $85 billion of government and mortgage securities a month as long as the jobless rate stays above 6.5 percent and inflation is below 2.5 percent. Unemployment rose to
7.9 percent in January, inflation remains below the central bank’s target and the U.S. economy unexpectedly contracted 0.1 percent in the fourth quarter.

“The concern and focus of the Fed is still unemployment,”
William O’Donnell, the head U.S. government bond strategist at RBS Securities Inc. in Stamford, Connecticut, said in an interview on Jan. 28. “And in the Fed’s eyes it’s not good enough yet, so it’s not at all surprising that people who do see higher rates don’t expect a 1994-like movement” when yields surged as the central bank boosted its target rate for overnight loans between banks from 3 percent to 6 percent over 12 months.

Bond Yields

Benchmark 10-year Treasury note yields rose seven basis points last week to 2.02 percent, according to Bloomberg Bond Trader data. The 1.625 percent note due November 2022 fell 18/32, or $5.63 per $1,000 face amount, to 96 17/32.

The 10-year yield climbed to 2.06 percent at 10:21 a.m. in London, the most since April 12.

January’s decline was the worst start since 2009 when government debt declined by 3.1 percent, according to Bank of America Merrill Lynch bond indexes. Bonds maturing in 10 years or longer fell 3.4 percent, compared with an 8.9 percent decline in 2009, the indexes show.

Yields on the notes, which fell to a record low of 1.379 percent July 25, will increase to about 2.25 percent at year end, according to the median of 77 strategist forecasts compiled by Bloomberg. Even though a rise to that level would cause pre- tax losses of 0.54 percent, the yield would still be below the five-year average of 2.9 percent.

Krugman, Gross

Nobel prize-winning economist Paul Krugman said there is no risk that Treasury yields near historic lows signal a price bubble. Bill Gross, manager of the world’s biggest bond fund at Pacific Investment Management Co., said that what is important, even though prices might appear ’’bubbly,’’ is that unprecedented global central bank monetary stimulus won’t end anytime soon.

“People are well aware they are not going to get a positive real yield,” Krugman, professor of economics and international affairs at Princeton University in New Jersey, said in a Jan. 28 interview on Bloomberg Television. “They just think government bonds are safer than the other stuff that is out there.”

The payer skew was mostly negative from 2006 to 2008, indicating greater relative demand for hedges against lower yields. The Fed cut its benchmark overnight bank lending rate from 5.25 percent in September 2007 to a record low of zero to 0.25 percent in December 2008 as the collapse of the subprime mortgage market triggered the worst financial crisis since the Great Depression.

Little Concern

As the 10-year Treasury yield increased from about 2 percent at the end of 2008 to 4 percent by mid-2009, the payer skew surged to a positive 26.8 basis points by October, its peak since the financial crisis began, Barclays data shows.

“People have been disappointed with the limited sell-offs in rates,” Piyush Goyal, a fixed-income strategist at Barclays in New York, said in a telephone interview Jan. 23. “People are feeling less a need to hedge higher rates, though haven’t stopped entirely.” The bank forecasts the 10-year Treasury yield will end the year at 1.6 percent.

Derivatives traders show little concern about Treasuries falling into a bear market because the central bank continues to flood the financial system with money to boost the economy. Last week, the Federal Open Market Committee reiterated its intention to keep buying bonds. The government reported the steepest drop in defense spending in 40 years brought economic growth to a standstill in the fourth quarter.

Yields Jump

Unemployment, though down from 10 percent in October 2009, is still too high for Bernanke. The FOMC said it “continues to see downside risks to the economic outlook,” in a statement on Jan. 30 at the conclusion of a two-day meeting in Washington.

“The higher yield trade is premature,” Scott Graham, head of government bond trading at Bank of Montreal’s BMO Capital Markets unit in Chicago, said in an interview on Jan. 30. “If you buy these levels, you will be well rewarded in due time.”

Bond bears figured that the rally in Treasuries -- which returned an average 6.19 percent a year since the financial crisis began in 2007, according to Bank of America Merrill Lynch indexes -- was ready to crack when minutes from the Fed’s December policy meeting were released Jan. 3 and showed some policy makers favored ending bond purchases around midyear.

The 10-year yield jumped to what was then a seven-month high that day and later rose above 2 percent as traders speculated that the improving U.S. economy would drive investors out of bonds and into higher-yielding securities.

Rate ’Cap’

“The Fed’s action and activity within the market is going to put a cap on interest rates,” said Sean Simko, who oversees $8 billion at SEI Investments Co. in Oaks, Pennsylvania, in a telephone interview on Feb. 1. “You’re not going to see a massive sell-off and a bear market within the bond market at this point.”

The Standard & Poor’s 500 Index returned 5.2 percent in January for the strongest start to a year since 1997. House prices in 20 U.S. cities rose 5.5 percent in November from a year earlier, the most in more than six years, according to the S&P/Case-Shiller index of property values.

Yields on investment-grade corporate bonds dropped to a record low 2.73 percent on Nov. 8, compared with the 10-year average of 5.02 percent, before rising to 2.85 percent as of Jan. 30. The extra yield investors demand to hold investment- grade securities rather than government debentures on Jan. 28 reached the lowest level since October 2007.

Gross's Note

Pimco's Gross wrote in a commentary published Jan. 3 that investors should avoid longer-maturity debt, because inflationary effects of the Fed actions are likely to persist many years in the future. They should instead focus on short to intermediate securities that will be supported by the central bank's record low target rate, he wrote. "Sell long-term bonds, own 5-7 yr maturities," Gross wrote in a Feb. 1 Twitter message.

"Near-term, you really want to watch inflation much more than unemployment because it's going to be difficult for unemployment to move down to the 6.5 percent number they're comfortable with, whereas it would be more reasonable for inflation to accelerate beyond the 2.5 percent level in the near term," Tom Graff, who manages $3.6 billion of fixed-income assets at Brown Advisory Inc. in Baltimore, said in a Jan. 30 telephone interview.

Consumer Prices

So far, consumer prices haven't been an issue. Inflation last year was 1.3 percent, according to the Fed's preferred gauge, the personal consumption expenditure index. That's below the central bank's 2 percent goal. Fed policy makers have said they will allow inflation to drift as much as 0.5 percentage points above their inflation target as they try to push the unemployment rate lower.

Investors anticipate the consumer price index, which rose 2.08 percent last year, will average 2.36 percent in the next five years, as measured by the gap between yields on Treasury Inflation Protected Securities and those on notes that aren't indexed to price increases.

Even as incomes grew in December by the most in eight years, Bernanke has cited weak wage growth as one reason why he'll continue stimulating the economy. While payrolls rose 157,000 in January, and revisions to the previous two months added 127,000 more jobs, average hourly earnings rose only 0.2 percent to $23.78 from $23.74 in the prior month, for an annualized gain of 2.1 percent, a Feb. 1 Labor Department report showed.

'Free Money'

"The things it will take to create inflation in this environment are clearly more than cheap and free money," Ian Lyngen, a government bond strategist at CRT Capital in Stamford, Connecticut, said in a Jan. 22 telephone interview. "You need to get more stabilization on the job front, you need to see wage gain increases."

The Bloomberg Consumer Comfort Index on Jan. 27 dropped for a fourth straight week as Americans' outlook on spending soured, a sign the payroll tax increase that began in at the start of the year is already starting to ripple through the economy.

Fed bond purchases will reach $1.14 trillion before the current stimulus program expires in the first quarter of 2014, according to the median estimate of 44 economists in a Bloomberg survey. In prior rounds of bond purchases, which began in 2008, the central bank bought $2.3 trillion in securities. Its balance sheet topped $3 trillion for the first time last month.

"The Fed has been very explicit. They want to see the unemployment rate decline on a more sustained basis," said Richard Schlanger, who helps invest $20 billion in fixed-income securities as a vice president at Pioneer Investments in Boston, during an interview on Feb. 1.

“With the Fed being the 800-pound gorilla, and being the ultimate buyer, long-term rates are not going to move dramatically higher,” Schlanger said.

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