Economic Commentary

July 22, 2003

Bond Prices Have Taken a Big Hit Since Last Week

In my July 14th Economic Commentary I warned about a steep fall in bond prices. It took few days as opposed to few weeks to materialize. Read the attached report from Bloomberg.

Kenneth Matziorinis, Ph.D.
Canbek Economic Consultants Inc.

U.S. Treasuries Decline on Investor Expectations for Economic Expansion July 21 (Bloomberg) –

U.S. Treasuries plunged, sending the yield on the 10-year note to its highest since December, as speculation that the Treasury will sell more debt to finance the budget deficit damped demand for government bonds. The losses extended a tumble that has pushed the note's yield to 4.2 percent from 3.07 percent on June 16, the biggest gain over a 26-day trading period since 1987, according to Deutsche Bank AG. The sell-off is being exacerbated by investors in mortgage-backed securities hedging against an anticipated drop in home-loan refinancing by selling Treasuries, traders said. ``Investors should be very cautious about holding Treasuries at this point,'' Paul Calvetti, head of Treasury trading at Barclays Capital Inc., told Bloomberg News in a televised interview. The Federal Reserve's ``policy right now of holding rates low makes owning longer maturity Treasuries dangerous,'' he said. The 3 5/8 percent note maturing in May 2013 fell 1 9/16, or $15.63 per $1,000 face amount, to 95 13/32 at 5:05 p.m. in New York, according to Cantor Fitzgerald LP. The note's yield rose 20 basis points to 4.20 percent, the highest since Dec. 5. The 1 1/8 percent note due June 2005 fell 7/32 to 99 1/16, while its yield rose 12 basis points to 1.61 percent, its highest since April 29. A basis point equals 0.01 percentage point. An investor who bought $10 million of the benchmark 10-year note when the yield hit a 45-year low of 3.07 percent on June 16 has a loss of about $850,000. The last time the yield has risen by as much in such a short time period was May 1987, when it gained 119 basis points, according to Deutsche Bank.

Mortgages

Some investors are selling Treasuries to offset rising duration, or the sensitivity to changes in yields, of their mortgage-backed bonds. Rising Treasury yields increase duration for mortgage-backed securities because home-loan refinancing typically falls as a result, meaning mortgages backing the securities are in existence for a longer period. Those sellers are ``back at it today,'' said Jeff Given, who manages $10 billion at John

Hancock Funds in Boston. Alex Li, a fixed-income strategist at Credit Suisse First Boston in New York, said that with a 50 basis-point increase in yields, mortgage investors would need to sell $25 billion of 10- year Treasuries to protect themselves from the higher rates, assuming that 10 percent of the mortgage market is hedged against changes in interest rates. Two weeks ago, a similar move would only have required $16 billion in selling, he said. Some traders said volume was lighter than average, which can add to the size of price moves. ``There's no one willing to step in the way of the marketplace right now,'' said Bill Quan, director of research at Mizuho Securities USA in Hoboken, New Jersey. ``There's no inquiries.''

Budget Deficit

Demand for government securities may decline as the Treasury is likely to increase the sale of debt securities to finance a record budget deficit, some investors said. The Treasury will announce on July 30 how much it will sell of three, five and 10- year notes over the next three months. Economists at Wrightson ICAP LLC estimate the Treasury will sell as much as $56 billion in securities, while Lehman Brothers Inc. forecast $65 billion. The government sold $25 billion of two-year securities in June. It said Tuesday the budget deficit will reach $455 billion, the largest in U.S. history, in the fiscal year that ends Sept. 30, and widen to $475 billion the following year. ``That's a lot of bonds,'' said George Adell, director of fixed-income research at Philadelphia-based Starboard Capital. ``The upside will be limited'' for bonds, he said. Investors may be less willing to buy Treasuries after Fed Chairman Alan Greenspan suggested the central bank is unlikely to purchase government debt to lower long-term yields, a Ried, Thunberg & Co. survey found.

Greenspan

Greenspan's comments were the biggest factor in a 45 basis- point plunge last week that sent the 10-year note to its steepest weekly drop since the invasion of Iraq in March, according to the survey. The remarks took away one of the reasons to own Treasuries amid signs the economy is gaining strength. Greenspan also suggested interest rates will remain low in coming months. Bill Gross, manager of the world's largest bond fund for Pacific Investment Management Co., warned last week the best times for Treasury buyers have passed after Greenspan forecast accelerating growth. U.S. corporations including Coca-Cola Co., General Motors Corp. and Citigroup Inc. are exceeding earnings estimates at the fastest pace in three years. Second-quarter profits for the Standard & Poor's 500 are expected to rise by 6.9 percent, revised from 5.2 percent in early July, according to analysts surveyed by Thomson Financial. The index of leading U.S. economic indicators rose 0.1 percent in June, the third straight increase, reflecting higher stock prices, a rise in the money supply and more permits for home construction.

ECB Rates

``On any strength we're seeing selling,'' in Treasuries, said Vincent Verterano, head of government bond trading at Nomura Securities International, one of the 22 largest bond trading firms. Interest rates are ``still pretty low,'' he said. The increase in the New York-based Conference Board's gauge of how the economy will perform over the next three to six months followed a 1.1 percent increase in May and a 0.1 percent rise in April. The rising 10-year Treasury note yield has helped narrow the gap between U.S. and European bond yields, making U.S. debt more attractive, analysts said. The German 3 3/4 percent bund due July 2013 yields 4.07 percent. Three weeks ago the German bund yielded an extra 25 basis points. The ECB last month lowered its benchmark interest rate to 2 percent, the lowest for any of the euro nations in more than half a century. Growth in the region's $7.8 trillion economy may stagnate in the second and third quarters of this year, the European Commission said this month. In comparison, the U.S. economy is expected to expand 2.4 percent this year, according to the latest Blue Chip Economic Indicators, survey.

Last Updated: July 21, 2003 17:12 EDT