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Debt Markets: Choppy Trading Has No End in Sight

Bond investors are bracing for a turbulent second quarter as they struggle to reconcile surging U.S. employment with some of the lowest bond yields in years

Opposing pressures on Treasury bonds make it tough to predict which way they will go in the second quarter.

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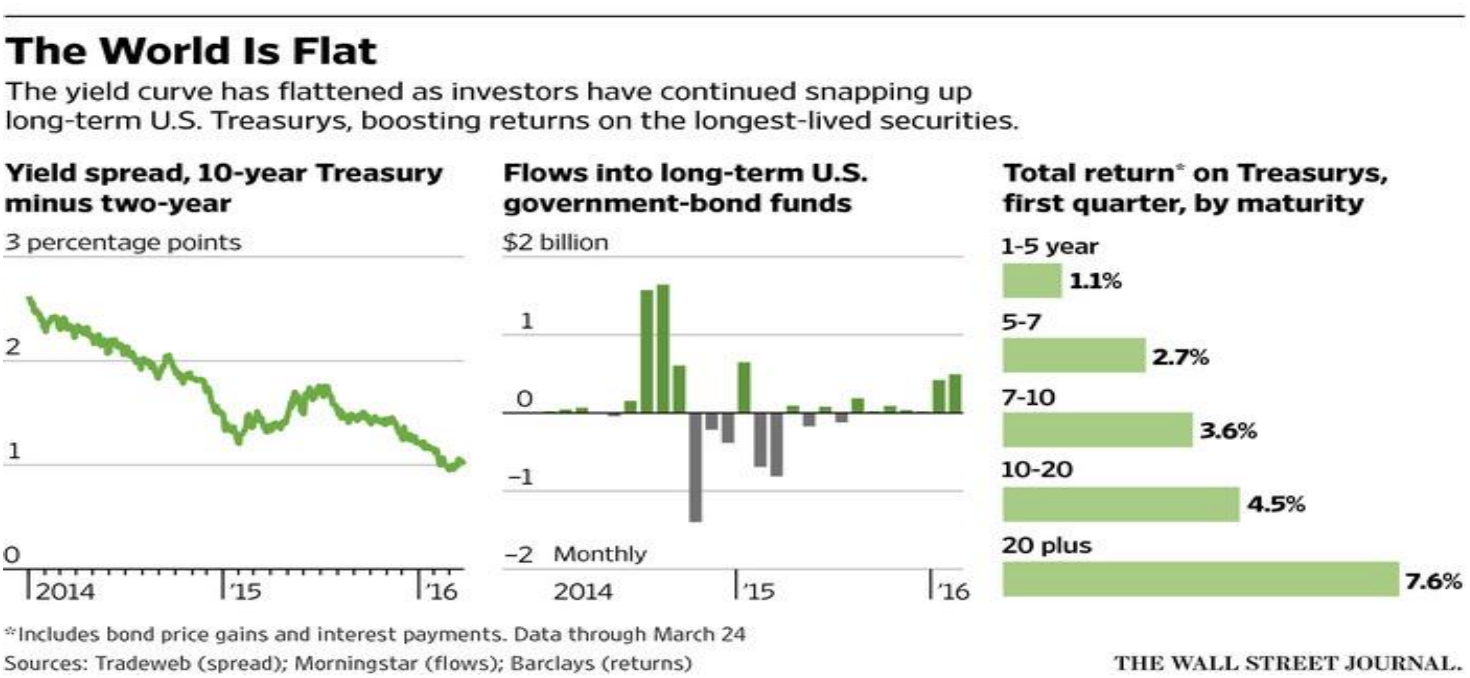
Bond investors are bracing for a turbulent second quarter as they struggle to reconcile surging U.S. employment with some of the lowest bond yields in years.

Long-term U.S. Treasury yields were on pace to post their steepest quarterly decline in more than three years in the first quarter of 2016, poised to close at their lowest quarter-end level since the end of 2012. The yield on the 10-year Treasury note, 1.83%, suggests buyers aren't concerned about the risks of buying and holding bonds for the long term.

Yet analysts broadly view the domestic economic picture as more fraught with peril for bondholders than it has been since peak of the housing boom a decade ago. Joblessness has tumbled to levels last seen in 2008 and wages are showing signs of picking up, potentially unleashing the long-awaited return of inflation, which hits bondholders hard by reducing the purchasing power of their fixed periodic payments. These dynamics make predicting the next quarter's action especially difficult.

"It is hard to figure out what is really going on with the disconnect between data and the bond market,'' said David Coard, head of



fixed-income trading in New York at Williams Capital Group. ”Am I missing something?’’

Some investors say they believe the coming months could bring an intense shakeout in the bond market, echoing the “taper tantrum” of mid-2013, as a pickup in economic growth pushes inflation higher and spurs a selloff in longer-term government debt, sending U.S. Treasury yields higher.

Others look around the world and predict Europe and Japan will move deeper into negative interest rates, spurring greater demand for U.S. securities even as the Federal Reserve prepares to raise short-term rates.

Fed Chairwoman [Janet Yellen] said Tuesday that the central bank would be very slow in raising rates given the uncertain global growth outlook. Analysts say the cautious stance may keep a lid on U.S. bond yields.

Nevertheless, the forces are substantial on both sides, and many analysts and traders have resigned themselves to large swings that they say aren’t necessarily driven by fundamental economic shifts.

Large shifts in Treasury yields, like changes in the value of the U.S. dollar, tend to ripple through the global economy and create feedback loops that often limit the depth of any given swing, analysts said.

Indeed, global demand for U.S. long-term bonds has been so strong recently that the premium of a 10-year note’s yield over that of a two-year note fell to an eight-year low at the end of February. A larger premium means a flatter yield curve, a warning in the eyes of many forecasters that a period of weaker economic growth could be ahead. Yields fall when bond prices rise.

The yield premium on the 10-year note over the two-year note tumbled to 0.95 percentage point on Feb. 29, the lowest since December 2007. That was a steep fall from 2.62 percentage point at the end of 2013, as hedge funds and money managers have been piling into long-Treasury trades.

In addition, the term premium investors demand to hold the 10-year note rather than invest in a series of short-term securities tumbled in mid-February to minus-0.396%, the lowest level since 1962.

Stubbornly low yields have been partly driven by large bets by hedge funds and money managers over major central banks’ monetary-policy outlooks over recent years, analysts say.

While a flat yield curve and low term premium often signal economic difficulty, there are few signs of that now. The U.S. unemployment rate was 4.9% in February and some inflation indicators have recently risen above the Fed’s 2% target.

Some investors are concerned that the sharp decline in the 10-year note’s yield premium may have overstated the downside risk facing the U.S. economy.

"I don’t think the Treasury yield curve is sending purely economic signals these days as the U.S. economy is likely stronger than the curve suggests,’’ said Christopher Sullivan,who manages $2.3 billion as chief investment officer at United Nations Federal Credit Union.

James Sarni, senior managing partner at Payden & Rygel in Los Angeles, which manages more than $95 billion, said that movements in long-dated Treasury yields “are increasingly disconnected from short-maturity yield movements.’’

Some analysts even said the Fed could face the paradox of rising short-term rates failing to push long-term ones higher, a situation that confounded [Alan Greenspan] more than a decade ago when he headed the central bank.

Back then, U.S. long-term bond yields barely budged even after a series of rate increases by the Fed between June 2004 and June 2006. Big purchases by central banks from China and many other large developing countries as a way to recycle their dollar reserves were blamed as the factor capping a lid on U.S. yields.

This time, support from China, the largest foreign owner of U.S. government debt, is no longer there. China has begun shedding Treasury debt holdings over the past year to raise cash and prevent a deep fall in the value of the yuan, a practice that few analysts expect to suddenly end.

China net sold $212 billion Treasury notes and bonds during 2015, according to Shyam Rajan, head of U.S. rates strategy research at Bank of America Merrill Lynch in New York. The data include those from Belgium, seen by many analysts as an intermediary for China to park its Treasury debt investments.

The days of nonstop foreign-exchange-reserve accumulation by developing countries is over, said George Goncalves, head of U.S. rates strategy at Nomura. "That will add to volatility,'' in Treasurys, he said.