Treasuries drop back to earth with a bump

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This week's **sell-off in US Treasury bonds** has been acute. Over the course of two frenetic days prices suffered their biggest falls since **Lehman's collapse**. Government debt markets around the world tumbled, sending yields on bonds back to their highest levels since June.

The sharp falls, triggered by US **President Barack Obama**'s deal with Republicans to extend **Bush-era tax cuts** for millions of Americans, have divided investors, strategists and dealers.

Does the slide mark the beginning of the end of the 30-year bull market in bonds amid fears that budget deficits will spiral out of control – or is it a more modest retracement, reflecting growing hopes for economic recovery?

Only weeks ago, the debate dominating financial markets was over whether America would slide back into recession. The threat of the "double-dip", and a period of falling prices, helped underpin the bond markets' charge. Not so now.

"There is a new mood in bond markets," says Stephen Lewis, chief economist at Monument Securities. "Whereas a month ago investors were focusing on the dual risks of inflation and deflation, they are now focusing much more on fiscal deficits. We don't get moves as sharp as we have seen this week just because of growth projections."

The 10-year Treasury yield, which moves inversely to prices, rose to as much as 3.33 per cent this week, one percentage point above a two-year low touched in October when investors were betting the Federal Reserve would start another round of "**quantitative easing**", or buying bonds, to pump-prime the recovery.

One survey of dealers, released on Thursday, suggested that budget worries were the main concern weighing on bond prices. Knight Capital found that 54 per cent of 90 Treasury market participants thought the rise in yields was due to fears about the US deficit after the announcement of another sizeable government stimulus. Only 29 per cent cited higher growth prospects or a jump in inflation.

The distinction matters when judging how much further bond prices might fall.

The experiences of **Greece and Ireland** have raised questions about whether any government bond can be seen as risk-free. If investors begin to lose faith in **US fiscal policy**, then yields on Treasuries could rise a good deal further. Equally, a return to more normal yields should be expected if investors believe the threat of deflation has receded, recovery is gaining momentum and interest rate rises could follow at some point.

Bill Blain, joint head of fixed income at Matrix, the investment bank, is convinced bonds have turned: "This week was a big moment for the market, when people realised the policymakers in the US will do everything to spark a recovery. Recovery is bond negative. I won't be buying US Treasuries."

Market interest rates for the UK, Germany, Japan and the US have risen since the Fed's decision to launch "QE2". But benchmark yields remain low by recent historical standards. Indeed, Treasury yields have fallen consistently since they hit 15 per cent in the early 1980s. At 3.27 per cent, they are hardly soaring.

Tony Crescenzi, portfolio manager at Pimco, one of the world's largest bond investors, says: "One could say rates are normalising now that the economy is, and that the range has merely been reset from an abnormally low level." This more benign explanation seems to be the one favoured by equity investors. The S&P 500 this week hit its highest level since September 2008. European share indices have been trading at similar highs.

"This is not a major turning point. This is not 1994 when there was a bond market rout that hit equities," says Mike Lenhoff, chief strategist at investment manager Brewin Dolphin. "We are expecting stocks to gain support from the reflationary moves in the US, which will drive global equities higher."

Dominic Konstam, head of interest rate strategy at Deutsche Bank, says: "Stocks are forward looking, whereas bonds are still caught looking back at the world of QE2." If stock markets are right that extended tax cuts will boost

the US economy, then bond yields will keep rising, he believes.

The **eurozone crisis**, though, is a big complicating factor. Some have blamed the recent rise in German Bund yields on fears that its contribution to the rescue of indebted member states could rise. Others point to Germany enjoying lower yields than the UK or the US, suggesting it will remain a haven for nervous investors.

Worries about Germany have coincided with the heightened concern about the US deficit, adding to unease. Joe Balestrino, strategist at Federated Investors, says the projected cost of $1,000bn for the tax cuts “has spooked the fixed income market”.

Whether it is pessimism about public debt levels or optimism about recovery that is driving bond prices lower – and this week’s survey evidence suggests both are influential – a sustained sell-off could have far-reaching consequences.

Ed Yardeni, head of Yardeni Research, says his rough model of comparing nominal gross domestic product growth to where Treasury yields should be points to a level of about 4.5 per cent. Market rates at that level could start to drag on economic activity.

Bernard Baumohl, chief global economist at The Economic Outlook Group, says: “Though the economy can still function with Treasuries at 4 per cent, once it exceeds the 5 per cent threshold, the recovery is in danger of stalling.” Hardly the outcome the Fed would want.

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