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Bond Yields Continue Their Climb

By CHRISTINE HAUSER

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Investors sold Treasuries for a second consecutive day on Wednesday, sending interest rates higher in response to the tentative deal to extend Bush-era tax cuts even as the Federal Reserve was trying aggressively to keep borrowing costs low.

The frenzy on the bond market was set off on Tuesday after President Obama announced his tax-cut agreement with Republican lawmakers. Financial markets interpreted the development as likely to hasten the economic recovery but also increase the budget deficit.

The deal on taxes, which would be paired with new cuts to payroll taxes and business taxes, effectively opened up a new channel to stimulate the economy with fiscal policy. At the same time, it appeared to run headlong into the Federal Reserve's program, begun last month, to buy $600 billion in Treasury bonds in an effort to keep borrowing costs low and encourage spending by consumers and businesses.

Yields on the benchmark 10-year bond have been steadily rising since Oct. 7, when they were 2.39 percent.

On Tuesday, after President Obama's announcement, yields shot up, and by Wednesday afternoon they were up 19 basis points from the day before, to 3.318 percent.

They retreated to 3.259 percent on Wednesday after the Treasury Department reported positive results from its $21 billion auction of new 10-year notes.

The yield on the 10-year note ended at 3.27 percent, the highest level since mid-June. The price tumbled again Wednesday, falling 1 5/32, to 94 17/32.

That tax deal "is having the opposite effect to what the Fed wants to do on yields," said Jonathan H. Wright, a former Federal Reserve economist who is now a professor at Johns Hopkins University. "But the end objective is being supported. The Fed objective was to provide stimulus to the economy through bonds."

The government's auction attracted almost three times as many buyers than bonds sold, a ratio characterized as fairly typical. The Treasury plans a $13 billion auction of 30-year notes on Thursday.

Ajay Rajadhyaksha, head of fixed-income strategy at Barclays Capital, said that the tax deal had altered the conditions under which the Fed had devised its bond purchasing program, a move known as quantitative easing.

"Those purchases were meant to push real rates down and inflation expectations up," he said. "Instead the reverse has happened. Real rates are rising and inflation expectations have not risen much since October. I think the Federal Reserve will be a little concerned."

Bernard Baumohl, chief global economist for the Economic Outlook Group, said the economy can still function with Treasuries at 4 percent, but if they rise to 5 percent the recovery could stall.

"What this means is that the Federal Reserve is facing a dilemma," he said in a research note. An increase in quantitative easing, rather than lowering yields and holding down the cost of capital, could have the opposite effect, **Mr. Baumohl** wrote, as bond investors

increasingly worry about the prospect of higher inflation.

In an interview broadcast last weekend, the Fed chairman, Ben S. Bernanke, left open the possibility of expanding the central bank's bond purchases. He defended the purchases as a way to stimulate a sluggish recovery and said the fear that they would cause inflation was "way overstated."

For consumers, the increase in bond yields could mean higher rates for home mortgages, which have already been rising in recent weeks.

"Watch mortgage rates soar and housing activity and prices dive even more in the aftermath of this bond market action," said David Rosenberg, the chief economist for Gluskin Sheff.

The fiscal expansion announced by Mr. Obama appeared to have caught the Fed by surprise, though supporters of the Fed's purchasing program argued that bond yields would be even higher had the Fed not been buying up debt.

Mr. Wright said that one consequence of the tax cut deal could be a curtailing of the Fed's program that was originally planned to last into next summer.

"Fiscal policy is presumably going to have some stimulative effect on the economy, and it lessens the need for further quantitative easing," he said.

But if quantitative easing is, indeed, cut short, the risk premiums on long-term bonds will probably rise even further, because once the Fed is sidelined as a major purchaser, investors will need stronger inducements to hold the securities.

"The cleanest interpretation here is investors are going to demand a higher return on Treasuries in order to compensate them for the greater supply," Mr. Wright said.

European bond yields also rose on Wednesday as their prices dropped. The sale of bonds

by the German government received a weak response. European officials exchanged pointed comments about the need to create euro bonds as a way to pay for more bailouts of struggling countries on the Continent.

While global markets have been unsettled by the financial troubles in the euro zone in recent weeks, some deficit hawks are now turning their attention to the United States.

“This is more worry for the bond market,” said Laura LaRosa, the director of fixed income at Glenmede. “The deficit problem needs to be addressed. It makes yields go higher because we are adding to the deficit and fears of inflation, and the creditworthiness of the United States comes into question.”

Some analysts said fixed-income investors were taking profits in a Treasury market that had become overpriced in reaction to the Fed’s quantitative easing program, which started as they priced in the program before the Nov. 3 announcement, and were possibly rebalancing portfolios.

“The market was overextended,” said Robert S. Gay, the managing partner for Fenwick Advisers and a former Fed economist. “It is evidence that the market was overbought.”

In the equity markets, stocks wavered within a narrow range. The Dow Jones industrial average rose 13.32 points, or 0.12 percent, to end regular trading at 11,372.48. The broader Standard & Poor’s 500-stock index gained 4.53 points, or 0.37 percent, to 1,228.28, while the Nasdaq composite index increased 10.67 points, or 0.41 percent, to 2,609.16.

The FTSE 100 in Britain was down 13.92 points, or 0.24 percent. In Frankfurt, the DAX lost 26.04 points, or 0.37 percent, while the CAC 40 in Paris was up 21.48 points, or 0.56 percent.

The dollar firmed against a range of currencies.