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## Bonds: Safe Harbor--or Treacherous Waters?

**Low yields could signal a bubble in the Treasury market**

On Sept. 4, the benchmark for long-term U.S. interest rates fell to its lowest point since 1963. Aggressive buying sent the yield of the Treasury Dept.'s 10-year note down to a remarkable 3.96%. Since bond prices rise when their yields fall, the low interest rate spelled huge profits for bond investors. Year-to-date, intermediate government bond funds have returned 7% to investors, vs. a loss of 24% for large-growth stock funds, according to fund tracker Morningstar Inc.

There were other winners, too. People refinancing their homes saved a bundle, since mortgage rates are tied to the 10-year note. And corporate treasurers cheered because their borrowing costs are linked to Treasury yields. From the booming housing market to business spending on new equipment, the superlow yield on the mighty 10 "increases the chances of a strong economic recovery," says Martin J. Mauro, Merrill Lynch & Co.'s manager of financial economics.

But in the week after Sept. 4, yields on 10-year notes edged back above 4%, reaching 4.06% on Sept. 11. The rebound raises an uncomfortable question: Is this the beginning of the end for extremely low Treasury yields--and, conversely, high Treasury prices? In other words, is the Treasury market a speculative bubble that's about to pop?

If there is a bubble and it's deflating, then sub-4% yields on 10-year Treasuries could some day seem as out of whack as 5,000 on the Nasdaq Composite Index now appears. And pity new bond investors if yields do jump; that means prices will fall. There are a lot of such buyers out there: Morningstar says that in June and July alone, investors yanked \$71 billion out of stock funds and pumped \$39 billion into government bond funds.

Some investors may have switched from stocks to bonds in the belief that since Treasuries are default-proof, you can't lose money on them. But unless you hold them until they mature--which many individual investors don't--you can lose money. Rising rates lower the resale value of old bonds, because investors have the option of buying newer issues with higher coupon payments. Predicts Mark MacQueen, a partner at bond manager Sage Advisory Services Ltd. in Austin, Tex.: "The investor who has thrown up his hands and is moving into the bond market as a safe haven now will not be rewarded."

But if rising yields hold peril for bond investors, what would they mean for the economy? That depends on why they're moving up. If they rise because economic growth appears to be accelerating, the increase will be harmless. It's normal for interest rates to rise when economic recovery increases the demand for money. On that score, Standard & Poor's Chief Economist David A. Wyss predicts that the economy

will grow 3.7% next year and 3.5% in 2004--and that the yield from the 10-year note will drift up to 6% by the end of 2004.

But recovery could be hindered if yields jump abruptly for other reasons. Among them: fears that inflation will rise, that Treasuries will lose some appeal as a refuge, or that big deficits will create an oversupply of 10-year notes, which the government issues to raise money.

One factor that has been critical in keeping yields low has been the market's confidence that inflation has been tamed, so that it won't return even if the economy picks up speed. But even bond bull William H. Gross, who runs Pacific Investment Management Co.'s bond portfolio, concedes that there's at least a chance that inflation will accelerate. Says Gross: "If we get...a return to 3%-to-4% inflation, which doesn't sound like much higher than now but it is, then yeah, there's a bubble in bond prices, especially Treasury prices."

Renewed investor confidence, while a good thing in its own right, would also push up bond yields by decreasing the demand for default-proof investments. Today, says Wyss of S&P, "There's a flight to safety. People are more afraid of the accountants than the terrorists right now." But he predicts the fears will recede when the economy begins to gather steam.

What's more, investors may begin to worry that the Bush Administration's budget deficits aren't just temporary. "Federal spending programs, once they get started, are hard to stop," says Prudential Securities Chief Economist Richard D. Rippe. "At some point, the concern about the pressure those will put on Treasury financing will intensify."

Yet another factor that has kept Treasury yields low is the surge in mortgage refinancings. Holders of mortgage-backed securities receive a wad of cash when homeowners refinance. They often use the cash to buy 10-year notes. That pushes down the 10-year's yield, which makes mortgages cheaper. If interest rates rise and refinancings slow, that will amplify a rebound in rates.

One bright spot is that if Treasury yields do rise, corporate bond rates might rise less. That's because corporate bond yields never fell as far as Treasury yields in the first place, since they didn't benefit from the flight to quality and other special factors. In fact, companies with BBB credit ratings are paying about 2.9 percentage points more for 10-year bonds than the government is, vs. a 1.6 percentage point gap in January, 2000, says Merrill Lynch.

Bubbles are hard to detect until they've popped, and bonds are no exception. But if Treasury yields do begin a long climb back up, investors who have already suffered from the stock market blowout will take another hit. And the economic recovery could be slowed as well.

By Peter Coy in New York, with Geoffrey Smith in Boston

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