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Current Yield**As Treasury Yields Fall, Other Sectors Beckon**

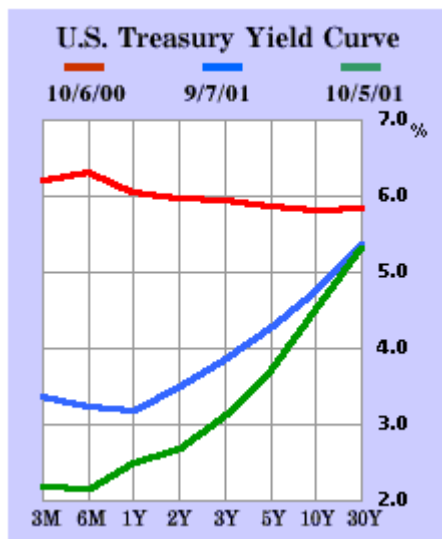
By JOHN PARRY

One of the few things global bond fund managers have been able to count on since September 11 brought tragedy and a deep sense of uncertainty to the world is the allure of U.S. Treasury bonds during such a crisis. And one of the few forecasts global fixed-income strategists will venture right now is that inflationary pressures are ebbing worldwide.

This bodes well for "both the U.S. and European sovereign debt markets," says Karim Basta, global derivatives strategist at Merrill Lynch. "But there is more scope for European yields to decline," he adds.

Traditionally perceived as the world's safest asset in times of turmoil, Treasuries have confirmed that status with assurance, as the U.S. government securities market has tapped a flood of capital fleeing stocks and nongovernment bonds of late.

Helped by two half-point rate cuts from the Federal Reserve since the attacks on New York and Washington -- the latest last week bringing the key overnight federal funds rate target down to 2½% -- Treasuries have also outshone other high-quality sovereign debt, despite originating in the very country most under terrorist threat.



Yet within the next few months, German bunds, a proxy for European government bonds, may start to attract shifts out of Treasuries. Interest-rate differentials will now favor bunds, since the European Central Bank has more margin to cut its key refi rate, currently at 3¾%, than does the Fed to cut the funds rate. Additionally, inflation in both areas could be in the same range -- between 1% and 2% over the next year -- enabling both central banks to cut interest rates to "similar" levels, says Basta.

Jeffrey Palma, global asset-allocation strategist at UBS Warburg, forecasts the ECB will cut rates by at least another 75 basis points (three-quarters of a percentage point) with the first as soon as Thursday's policy meeting. "We would expect bunds to outperform Treasuries over the next six months, with Treasuries' yields staying mostly flat" while bund yields fall, he says.

Charles Van Vleet, director and a global portfolio manager at Credit Suisse Asset Management, estimates that the benchmark 10-year bund's yield could fall by some 20 basis points by yearend, to 4.46%, while its equivalent Treasury yield may remain virtually flat from current levels. In addition, Van Vleet expects that toward the end of October, the euro will resume its rise, generating a currency fillip for dollarbased investors.

Meanwhile, in Asia, the outlook for the yen -- and by extension Japanese government bonds, another

key category of sovereign debt that carries considerable weight in global bond indices -- is less auspicious. The yen is expected to remain weak, with help from global policymakers and the dismal state of Japan's economy.

True, economic contraction should in itself make JGBs a more desirable refuge for money flowing from stocks and nongovernment bonds. But the Achilles' heel for JGBs is the prospect of more government borrowing in order to bail out creditors of Japan's desperately troubled banks.

"We anticipate that more help, more accommodation and support would come from government," says Fred Puorro, managing director, international, with Fitch, the credit-rating agency. "Banks do need it because they cannot resolve their problems on their own," he says, adding that at Fitch, Japan's sovereign rating "is on watch again, and there could be more pressure on it because of the debt load."

The benchmark 10-year JGB yield, at approximately 1.37% Thursday, could rise to between 1.50% and 1.60% by yearend on these expectations of more supply of JGBs entering the market, forecasts Mike Casey, international-bond-fund manager at Federated Investors. A rise in yield of this degree would represent a marked drop in prices.

Despite deep global economic, political and military uncertainty, Treasuries also may lag behind their domestic competition.

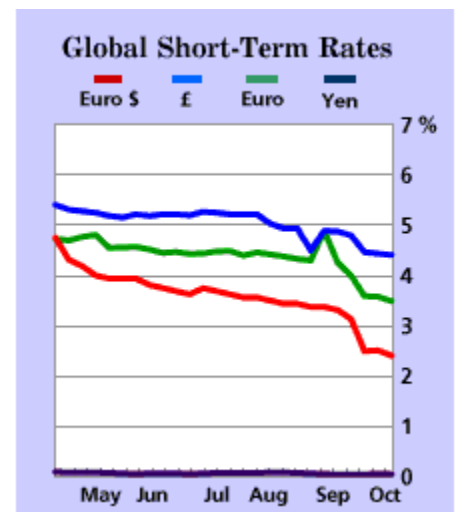
"Although Treasuries are extremely overvalued, yields will stay depressed until the economy is on a recovery path, which is unlikely over the balance of the year," wrote the Bank Credit Analyst Research Group in Grant's Investor, a financial publication and Website.

Yet in advance of any economic rebound, which some say could begin around mid-2002, flows are already shifting back into so-called spread product -- corporate bonds, mortgage-backed securities, agency debt and interest-rate swaps -- which trade at an increment, or spread, over Treasuries.

"We believe that aggressive Fed easing, increasing Treasuries supply, a steeper yield curve and lower rates will drive swap spreads tighter," write analysts at Barclays Capital.

Many bond traders were surprised when last Thursday the Treasury stepped in to inject supply of 10-year Treasuries in an emergency auction. The measure was designed to help free up a partially paralyzed repurchase-agreement market -- a pivotal lending and hedging mechanism for the financial system. More such auctions of 10-year Treasuries and five-year maturities are expected in the coming weeks.

Given a world in which issuance of Treasuries is clearly higher than had been expected, "there's not much price performance left in Treasuries. How low can yields go?" asks Mark MacQueen, a portfolio manager and executive vice president at Sage Advisory Services in Austin, Texas. When the economy bottoms out, "I believe spread product will outperform Treasuries dramatically," he says.



There have been some initial signs of a shift into nongovernment bonds. During the past few weeks "we have already seen agency debt yield spreads narrow to Treasuries; you should continue to see that," says Mary Ann Hurley, senior trader in Seattle at brokerage D.A. Davidson.

Furthermore, some investment-grade corporates have underperformed Treasuries by 187 basis points in September, while mortgage-backed securities lagged behind by 89 basis points, according to Merrill Lynch strategists. These sectors, too, could be in for a rally relative to governments.

With concerns about the economy hurting earnings of many firms, however, "corporates are going to trade more on a name-by-name basis, even if those issues are investment grade," cautions Hurley.

Some corporate bond yields have narrowed from their recent widest point in the wake of the the terrorist attacks. Yield spreads of some 10-year bonds issued by **Ford Motor**, for instance, had tightened back to around 230 basis points Friday from a 260 basis points wide in late September, according to MacQueen. Already, "spread tightening is under way, particularly in high-quality [corporate] names and should continue, barring any major disasters -- in other words, terrorist actions or defaults -- out there," he adds.

But these spreads may not narrow in a sustained fashion before January since "as you go through yearend, risk aversion tends to rise" as portfolio managers look to lighten up on higher-risk spread product and stock up on higher-quality Treasuries towards the year's close, notes Mark Freeman, a portfolio manager at Westwood Management. That seasonal factor "will limit dramatic tightening of spreads" during the fourth quarter, he says.

Nevertheless, many corporate bonds are issued in the 10-year maturity range, and these longer maturities' yield spreads may narrow because of factors now affecting the workings of the Treasury market. Prospects of increased government spending are causing many strategists to redraw their fiscal forecasts. Many now warn that the era of U.S. budget surpluses is all but over. As a result of the U.S. government's need to issue more longer-dated Treasuries in the months and years ahead, yields of these securities may rise relative to those of higher-yielding, nongovernment bonds.

Meanwhile, further rate cuts from the Fed will drive shorter rates lower. These opposing forces, notes Thomas Sowanick, chief global fixed-income strategist with Merrill Lynch, may lead to a steepening of the yield curve, widening the gap between two-year and 30-year Treasury yields. Late Friday that gap stood at 263 basis points. The two-year note ended the week at yielding 2.68%, down 16 basis points on the week, having anticipated much of the impact of the Fed's rate cut. The 30-year Treasury bond ended at 5.31%, down 11 basis points. The benchmark 10-year Treasury note yield fell nine basis points to 4.50% in the face of increased supply.

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