

DJ US MONEY WEEK AHEAD: Steepening Yield Curve Trade Steamrolls

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By Min Zeng
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NEW YORK (Dow Jones)--The party for the steepening yield curve trade is far from over.

The benchmark yield curve, the gap between the two- and 10-year Treasury yields, has steepened this week to its widest level since July 2004, solidifying a trend that has been alive and kicking since late last year.

Investors are buying the two-year notes, which are sensitive to changes in interest-rate policies, believing that credit-market stress and slowing growth will force the Federal Reserve to cut interest rates further.

On the other hand, they are dumping 10- and 30-year Treasuries out of concern that aggressive Fed easing and the \$168 billion economic stimulus from the government will fuel price pressure longer term. The long bonds, most sensitive to inflation risk, have seen their yield shoot up by 48 basis points from the record low set last month.

Bond investors and strategists expected the yield curve to widen to 250 basis points by midyear and some even bet that the curve has the potential to retest the high of 274 basis points set Aug. 13, 2003, following the Fed's rate cut that June to 1%.

"I believe the yield curve can continue to steepen as the Fed continues to pump stimulus into the economy, attempting to avert a recession rather than fighting inflation," said Derek Brown, a bond fund manager in Los Angeles at Transamerica Investment Management, which oversees \$8 billion in fixed-income assets.

"The level of stimulus has dramatically increased, and that can be inflationary," he said. "The long end of the curve just got too rich."

Brown said he has been positioned for a steeper yield curve for quite some time and has been underweighting the 10- and 30-year sections of the curve.

The benchmark yield curve has steepened dramatically over the past few months. As late as July last year, when the fed-funds rate stood at 5.25%, the yield curve was actually inverted - with the two-year note yielding three basis points more than the 10-year notes.

Friday, the two-year note yielded 185 basis points less than its 10-year peer. The spread touched 193 basis points Thursday.

Flight To Quality

The subprime mortgage turmoil that started last summer has escalated into a global credit crunch. It has raised fear of recession, fueling flight-to-quality flows into short-dated Treasuries and pushing down the two-year yield Friday to 1.82%, the weakest point since April 2004.

Already, other segments of credit markets have been infected, with trouble popping up in commercial real estate, leveraged loans, consumer credit and bond insurance.

"We are seeing huge flows from real money - banks, money funds, foreign reserve managers - into the short end of the curve," said William O'Donnell, head of U.S. government bond strategy at UBS Securities LLC in Stamford, Conn.

"Sources of funding in credit markets continue to shut down" even though the Fed has cut the fed-funds rates 225 basis points to 3% since September, added O'Donnell, who advised investors to sell the 30-year bonds against the two-year notes.

Fed Chairman Ben Bernanke and Treasury Secretary Henry Paulson told senators Thursday the market is working its way through the complexities of the credit turmoil, with the Fed chief promising to act if conditions worsen.

Mark MacQueen, partner and portfolio manager in Austin, Texas, at Sage Advisory Services Ltd., which oversees \$5.5 billion in assets, said the yield on the two-year notes suggested the market has priced in a fed funds rate of 2%. MacQueen said that further loosening of monetary policy would be viewed as inflationary.

With aggressive easing from the Fed, the dollar has lost ground against currencies like the euro, and Australian and New Zealand dollars, which threatens to push up import prices. Compared with a year ago, import prices soared 13.7% in January, the highest reading since the government began compiling the data in 1982.

Meanwhile, oil reached a record high last month. Rising energy and food prices will eventually spill into labor costs, MacQueen said.

"It is going to boost inflation premium in the 10- and 30- year sectors," said MacQueen, who expects the yield spread between two- and 10-year notes to widen to 250 basis points by June.

The U.S. consumer price index for January will be released Wednesday.

Risk To Steepening Curve Trade

Steven Abrahams, head of global liquid product strategy in New York at Bear Stearns Cos., pointed out two wild cards against the steepening yield curve: fresh inflows of foreign capital from the likes of foreign central banks and sovereign wealth funds, or federal legislation to rescue the crumbling housing market.

If home prices continue to fall and foreclosures continue to rise, a federal rescue may come in place, especially as elections approach, said Abrahams in a Feb. 12 research note.

Already, Sen. Christopher Dodd, D-Conn., chairman of the Senate Banking Committee, has been working on a plan that would resurrect a federal agency - the Home Owners' Loan Corp. The agency was created during the 1930s to buy up distressed mortgages at steep discounts and help borrowers refinance into more-affordable loans.

The HOLC made about 1 million low-interest loans between June of 1933 and June of 1936. When the HOLC ended its operations in the 1960s, the corporation not only paid all its bills, it even returned a small profit to the federal government.

"The yield curve steepening trade should keep running into the summer or until all the news about bank capital gets priced into the market," Abrahams said. "But if the unexpected comes along in the meantime, a little insurance can keep a portfolio out of the news."

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