

By Susanne Walker and Cordell Eddings

Dec. 16 (Bloomberg) -- Treasuries were little changed as Federal Reserve officials left interest rates at record lows while saying the U.S. economic recovery is gaining strength.

Yields on 10-year notes were steady after five straight day of gains as central bankers kept the target rate for overnight loans between banks in a range of zero to 0.25 percent and reiterated a pledge to keep the target at almost zero for an "extended period." Traders had speculated that Fed officials would change the language of its policy statement because of improvements in areas of the economy such as employment.

"There were not high expectations for a change in policy from the Fed, and they delivered on that," said George Goncalves, chief fixed-income rates strategist at Cantor Fitzgerald LP, one of 18 primary dealers that trade directly with the Fed. "They will see how things unfold early next year. Until then their stance will be pretty benign with no major change."

Two-year note yields, more sensitive to changes in interest expectations than longer-maturity debt, were little changed at 0.85 percent at 2:49 p.m. in New York, according to BGCantor Market Data. The 10-year note yield rose 1 basis point to 3.60 percent, after touched 3.62 percent yesterday, the highest level since Aug. 13.

#### 'Weak Labor Market'

Policy makers are considering how to withdraw the more than \$1 trillion they pumped into the financial system to combat the deepest recession since the 1930s. Along with raising the overnight bank lending rate, Fed officials have said they may use reverse repos, pay interest on excess bank reserves and sell securities directly to investors to withdraw or neutralize cash in the banking system.

"Household spending appears to be expanding at a moderate rate, though it remains constrained by a weak labor market, modest income growth, lower housing wealth, and tight credit," the Federal Open Market Committee said in a statement today after meeting in Washington. "Businesses are still cutting back on fixed investment" and "remain reluctant to add to payrolls." Deterioration in the labor market is "abating."

After its previous meeting on Nov. 4 the Fed indicated its benchmark interest rate, which it cut to a range of zero to 0.25 percent in December, would remain low as long as inflation is subdued and the unemployment rate fails to decline. Treasuries fell that day as Fed officials said they are more optimistic about the economic outlook.

## ‘Self-Sustaining’

“The message in this is that the fed is not prepared to budge on rates and that we should to prejudge any shift in the Fed stance,” said Eric Lascelles, chief rates strategist and economist at TD Securities Inc. in Toronto.

Fed Chairman Ben S. Bernanke said on Dec. 7 that conditions warranting a low interest rate have not changed even as a Labor Department report on Dec. 4 showed the jobless rate fell to 10 percent in November from a 26-year high of 10.2 percent the previous month.

Employers cut 11,000 jobs last month, the fewest jobs since the recession began in December 2007 and far below the median forecast for a loss of 125,000 positions in a Bloomberg News survey.

“We still have some way to go before we can be assured that the recovery will be self-sustaining,” Bernanke on Dec. 7 told the Economic Club of Washington. The U.S. economy faces “formidable headwinds,” he said, including a weak labor market and tight credit that are likely to produce a “moderate” pace of expansion.

The Fed’s Nov. 4 statement noted that it “continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the Federal Funds rate for an extended period.”

## Fed Funds Futures

November’s employment report prompted some investors to raise bets the Fed would increase rates by the third quarter of 2010.

Fed funds futures contracts on the Chicago Board of Trade before the Fed statement was released showed a 48 percent chance the central bank will increase rates by at least 25 basis points by the June policy meeting, up from 36 percent one month ago.

Expectations for inflation have increased with consumer and producer prices rising in November.

“The market is saying the Fed is tilted to an inflationary bias,” said Mark MacQueen, partner and portfolio manager in Austin, Texas, at Sage Advisory Services Ltd., which oversees \$7.5 billion.

The difference in yield between 10-year inflation-protected Treasury notes and nominal Treasury notes was 229 basis points, indicating that investors see consumer prices rising by 2.29 percent per year over that time. In November, consumers anticipated inflation of 2.16 percent over the next 10 years.

## Consumer, Producer Prices

Consumer prices rose 0.4 percent in November, after a 0.3 percent gain in October, figures from the Labor Department

showed today. Producer prices in the U.S. increased by 1.8 percent in November, more than twice as large as anticipated, figures from the Labor Department showed yesterday.

U.S. industrial production climbed 0.8 percent, the fourth gain in the past five months, the Fed said yesterday, the fourth gain in the past five months.

Treasuries lost 2.77 percent this year, according to Merrill Lynch & Co.'s U.S. Treasury Master Index, as President Barack Obama had increased marketable debt to a record \$7.17 trillion through unprecedented borrowing. The figure is equivalent to almost half of the \$14.2 trillion economy, according to data compiled by Bloomberg.

"The labor market issues are abating," said William Larkin, a fixed-income portfolio manager in Salem, Massachusetts at Cabot Money Management, which manages \$500 million. "They are positive on an economic standpoint and negative for bond holders."

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