

MAY 20, 2010, 3:50 P.M. ET

OFF THE RUN: Low Inflation Readings Boost Long-Term Treasurys

By Min Zeng A DOW JONES NEWSWIRES COLUMN  
NEW YORK (Dow Jones)--Long-dated Treasury securities are now the most favored financial assets for global investors fleeing the euro zone's debt crisis, as expectations of record low inflation levels in developed economies have made their returns more attractive.

The 10-year and 30-year Treasurys have garnered strong demand since late April, when concerns about Greece and other heavily indebted countries in the euro zone increased. Until then, investors thought longer-dated Treasurys were vulnerable to a rise in inflation as the global economy recovered. Because inflation erodes the return of fixed-income investment, investors seek other assets when they expect higher rates of inflation.

Now, with yields on short-dated Treasurys trading at low levels thanks to the Federal Reserve's near-zero interest rate policy, and inflation rates moving at the slowest pace in decades, many investors are moving into long-dated maturities to squeeze extra returns.

Data this week showing an unexpected drop in both wholesale and consumer prices added to concerns about an economic outlook already tainted by the ongoing euro-zone sovereign debt problems. A lower rate of growth in prices removes inflation as a main threat to the value of long-dated bonds.

"Treasurys are the assets du jour right now, and the long end is the king," said David Brownlee, head of fixed income at Sentinel Asset Management in Montpelier, Vt., which oversees \$22 billion in fixed income. "The market woke up to the fact that deflation is a bigger short-term risk for the U.S. economy than inflation."

There is no evidence of deflation in the U.S., a scenario that has afflicted Japan since the 1990s. Some investors fear it may affect some of the euro-zone economies facing a downturn in economic activity along with cuts in government spending.

Deflation, a broad decline in price levels, hurts economic growth because it can discourage consumption and investment, and it can raise the cost of servicing debt for companies and governments.

Brownlee said he has bought long-dated Treasuries recently and has a plan to add to his holdings. He notes that the 10-year note's yield, trading at 3.249% Thursday afternoon, could easily fall down to 2.8% in the short term based on technical charts, while the 30-year bond's yield, trading at 4.125%, could drop to 3.65%. Bond prices move inversely to their yields.

While fears of deflation are not imminent in the U.S., fixed-income investors are adapting to an environment of record low inflation expectations. The sentiment was encouraged following Wednesday's release of the April consumer-price index. The annualized CPI excluding energy and food, a closely watched inflation gauge by the Fed, eased to a rise of 0.9%, the lowest level since 1966 and not far from the record low of 0.7% set in 1961.

David Resler, chief economist at Nomura Securities International Inc. in New York, said the core inflation could touch zero over the next year as price pressures will ease further given the U.S. economy is still trapped at a nearly 10% unemployment rate and more than 20% industrial capacity stays idled, he said.

Market participants also noted that the euro-zone debt crisis, which has spurred broad-based selling across assets from stocks to crude oil, has boosted the dollar as a safe haven. A stronger dollar pushes down prices of imported goods in the U.S.

The change in perception of the consumer prices outlook has resulted in a series of changes in investments in the Treasury market.

"We are in the midst of a deflation scare," said Brian Weinstein, who manages the \$3.1 billion BlackRock Inflation Protected Bond fund, the company's flagship TIPS fund, adding that he favors a trade to sell TIPS, or Treasury inflation-protected securities, and buy nominal Treasuries.

Many investors who had wagers betting on a rise in bond yields have rushed back to buy long-dated Treasuries again. Mark MacQueen, partner and portfolio manager in Austin, Texas, at Sage Advisory Services Ltd., which oversees \$8.5 billion in assets, was one of them.

MacQueen said he is now only slightly bearish on Treasuries relative to other fixed-income products such as mortgage-backed securities and corporate bonds.

Besides buying long-dated Treasuries outright, many traders and investors are buying long-dated Treasuries while selling short-dated Treasuries, betting on the yield spreads to tighten.

TIPS, in contrast, have been the losers of late. Those instruments tend to gain value if price pressures rise as both their interest payments and principals are adjusted higher. In contrast, deflation shrinks the value of TIPS.

(Min Zeng, a reporter on the Treasury desk, writes about fixed-income markets for Dow Jones Newswires. He can be reached at 212-416-2229 or via email at: [min.zeng@dowjones.com](mailto:min.zeng@dowjones.com))