Aug 10, 2010 3:41 PM CT
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Treasuries Rally as Federal Reserve to Buy More U.S. Debt

Treasuries rallied after the Federal Reserve said it would reinvest principal payments on its mortgage holdings into long-term U.S. debt securities.

The 10-year note yield dropped below 2.75 percent for the first time since April 2009 as the central bank said "the pace of recovery in output and employment has slowed in recent months" and the economic recovery will be "more modest" than anticipated. Before the Fed's statement, the Treasury auctioned $34 billion of three-year notes at the lowest yield ever.

"It's a clear indication that the Fed remains committed to get the economy through this rough period," said Steve Rodosky, the head of Treasury and derivatives trading at Newport Beach, California-based Pacific Investment Management Co., which runs the world's largest bond fund. "The market anticipated the move."

The yield on the 10-year note dropped 6 basis points, or 0.06 percentage point, to 2.77 percent at 4:33 p.m. in New York, according to BGCantor Market Data. The price of the 3.5 percent security maturing in May 2020 gained 17/32, or $5.31 per $1,000 face amount, to 106 7/32.

The benchmark yield touched 2.7434 percent, the lowest level since April 2, 2009. The yield on the two-year note fell 1 basis point to 0.53 percent after dropping on Aug. 6 to a record low 0.4977 percent. The difference in yields narrowed 6 basis points to 2.24 percentage points, the lowest level on a closing basis since May 2009.

The Fed retained a commitment to keep its benchmark interest rate close to zero for an "extended period" of time, holding the target lending rate for overnight lending between banks at zero to 0.25 percent.

'Modest' Recovery

"The pace of economic recovery is likely to be more modest in the near term than had been anticipated," the Federal Open Market Committee said in a statement in Washington. "To help support the economic recovery in a context of price stability, the Committee will keep constant the Federal Reserve's holdings of securities at their current level."

The central bank said in a separate statement that it will announce a purchasing schedule tomorrow and that its buying will be concentrated "in the 2- to 10-year sector of the nominal Treasury curve," though it will also buy other maturities as well as Treasury Inflation Protected Securities.

"In order to keep mortgage rates under wraps and any other longer-term borrowing arrangements based off the 10-year note, I guess the Fed feels this is the best way to do it," said Kevin Flanagan, a Purchase, New York-based fixed-income strategist at Morgan Stanley Smith Barney. "They're hoping for a little more bang, if they can get it, by focusing on the longer end."

Fed Portfolio

The central bank's portfolio will have $16 billion of debt from government-supported enterprises such as Fannie Mae and Freddie Mac run off in the six months from September to February 2011 and an additional $33 billion in the following six months from March 2011 to August 2011, according to Jim Vogel, head of agency-debt research at FTN Financial in Memphis, Tennessee.

With the Fed's commitment to hold its securities portfolio at $2.05 trillion and to focus new purchases on securities it doesn't have large positions in, "they'll be looking at the newer issues," Vogel said.

The Fed ended its initial $300 billion of Treasury purchases in October 2009. The government has auctioned $1.83 trillion of notes and bonds since November.

After the Fed's policy statement, futures on the CME Group Inc. exchange showed a reduced 29 percent chance that the Fed will raise its target rate for overnight lending between banks by at least a quarter-percentage point by the August 2011 meeting, compared with 36 percent odds earlier today.

U.S. Payrolls

Treasuries rallied last week after the Labor Department said the economy shed a more-than-forecast 131,000 jobs in July after a revised reduction of 221,000 for the previous month. The two months of job losses came after 2010 began with five months of gains to non-farm payrolls. The economy had lost 8.5 million jobs in 2008 and 2009.

In testimony before the Senate Banking Committee on July 21, Fed Chairman Ben S. Bernanke said the "economic outlook remains unusually uncertain." St. Louis Fed President James Bullard wrote in a paper released July 29 that the central bank should resume purchases of Treasuries if the economy slows and prices fall.

U.S. economic growth slowed to a 2.4 percent annual rate in the second quarter from a 3.7 percent pace in the first three months of the year. Consumer spending, pending home resales and factory orders were weaker in June than projected.

'Depressed Level'

"Housing starts remain at a depressed level," the Fed said today. "Bank lending has continued to contract."

Commercial and industrial lending by banks has fallen 20 percent since the end of 2008 to $1.2 trillion, as of March 31, the latest data available, according to the Federal Deposit Insurance Corp.

"I don't think this will get banks lending more," said Mark MacQueen, partner and portfolio manager in Austin, Texas, at Sage Advisory Services Ltd., which oversees $8.5 billion. "It will probably get banks buying more Treasuries. It's feeling a little like Japan here."

At today's three-year note auction, the securities drew a record low yield of 0.844 percent, compared with the 0.862 percent average forecast in a Bloomberg News survey of 7 of the Fed's 18 primary dealers.

The bid-to-cover ratio, which gauges demand by comparing total bids with the amount of securities offered, was 3.31, compared with an average of 3.08 for the previous 10 offerings. The sale was the first of three note and bond auctions this week totaling $74 billion.

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