Treasury's Best-Performing US Fixed-Income Market On Growth Worries

NEW YORK (Dow Jones)–Treasury securities were the most sought-after U.S. fixed-income asset in the second quarter, as rising worries about the economic outlook and euro-zone debt problems drove investors into safe assets.

As of Tuesday, the Treasury's market has handed investors a return of 4.62% so far this quarter, lifting its gain this year to 5.79%, according to data from Barclays. In contrast, for the whole year of 2009, Treasuries suffered a loss of 3.57%.

Long-dated Treasury's were the best of the bunch. Treasuries with maturity due in more than 20 years have handed investors a whopping 14% return this quarter, while those maturing from 10 years to 20 years have returned 9.27%, according to Barclays.

As demand for Treasury's surged, their yields tumbled. The 10-year note's yield, the benchmark for consumer and corporate borrowings, has dropped more than 100 basis points from this year's 4.017% peak set in early April. For the quarter, the yield was down by more than 80 basis points.

"The plunge in yield tells you that the bond market has priced [itself] out of a strong recovery," said Mark MacQueen, partner and portfolio manager in Austin, Texas, at Sage Advisory Services Ltd., which oversees $9.3 billion in assets.

"We are in a long-term slow growth, high-unemployment and low interest-rate environment, which supports low Treasury yields."

Wednesday, long-dated Treasury's got a lift again on a weaker-than-forecast U.S. private sector jobs report and Moody's warning of a possible downgrade of Spain's credit rating.

As of 4 p.m. EDT, the benchmark 10-year note was 7/32 higher to yield 2.940%, and the 30-year bond was 29/32 higher to yield 3.896%.

MacQueen said he has bought Treasury's in recent weeks, reducing his underweight positions on the Treasury market as his view on the economy changed–a shift that has been evident among many market participants. Bill Gross and his fund managers at Pacific Investment Management Co., or Pimco, which includes the world's largest bond fund by assets, also bought Treasury's during the second quarter after snubbing the market earlier this year.

While the second quarter started with optimism that the U.S. and the global economic recovery would gather speed, the period is ending with a more subdued outlook.

The Federal Reserve cut its outlook on the economy and inflation last week, raising speculation that its key interest rate will be kept at record low levels near zero for longer than many thought.

As a result, the two-year note's yield, among the most sensitive to changes in official rate-policy outlook, hit a record low of 0.582% Tuesday. On Wednesday, the 10-year note's yield touched 2.924%, the weakest level since April 2009, while the 30-year bond yield hit 3.892%, the lowest level since October 2009.

The decline in yields pushed down mortgage rates to historic lows last week. While this should be a boon for home refinancing, so far such activities have been muted as banks remain reluctant to lend. Traders said the 10-year note's yield needs to fall to 2.80% to spur a wave of refinancing.

"The problem in housing isn't low yields," said Stephen Stanley, chief economist at Pierpont Securities LLC in Stamford, Conn. "It's high unemployment and tough underwriting standards. So lower yields from where we were isn't helping all that much."

Michael Franzese, head of Treasury trading at Wunderlich Securities in New York, said Friday's payroll data will be the key driver for Treasury yields. Should the data confirm the markets' fear that the economy recovery is "really falling," the 10-year note's yield could break 2.88% and fall to as low as 2.54% in coming weeks, he said.

The median forecast of economists surveyed by Dow Jones Newswires is that total U.S. payrolls fell 110,000 in June, in contrast with payrolls in May, which rose 431,000, boosted by the hiring of 411,000 Census workers. The Labor Department is scheduled to release the monthly jobs report on Friday at 8:30 a.m. EDT.

David Rosenberg, former chief North America economist at Merrill Lynch and now with Canadian asset manager Gluskin Sheff & Associates Inc. in Toronto, said the 10-year yield could test the record low of 2.034% set on Dec. 18, 2008, following the demise of Lehman Brothers.

There is a "significant chance" that the 10-year yield could fall below 2% in the next six to 12 months, said Rosenberg.

Two-Year Swap Spread Tightens

The two-year U.S. swap spread, a main gauge of credit risks, was 1.25 basis points tighter at 35 basis points. The 10-year swap spread was 1 basis point wider at 7 basis points.

COUPON ISSUE PRICE CHANGE YIELD CHANGE 1% 2-year 100 1/32 flat 0.613% flat 1 3/4% 3-Year 100 13/32 flat 0.980% flat 2 1/2% 5-year 100 14/32 flat 1.785% flat 3 1/8% 7-Year 100 16/32 up 4/32 2.421% -2.0BP 3 5/8% 10-year 104 24/32 up 7/32 2.940% -2.7BP 4 5/8% 30-year 108 13/32 up 29/32 3.896% -5.0BP 2-10-Yr Yield Spread: +232.7 BPS Vs +235.3 BPS Source: Tradeweb

-By Min Zeng, Dow Jones Newswires; 212-416-2229; min.zeng@dowjones.com