WEAK DATA LIFT TREASURY PRICES

Mortgage Investors' Fear: Falling Yields Spark Refinancings

By MIN ZENG and PRABHA NATARAJAN

Long-dated Treasury prices rose Wednesday, led by the 30-year bond, as economic worries, fueled by a weak reading on private sector jobs growth in June, continued to haunt investors.

The sharp decline in yields on government debt in recent sessions is starting to worry mortgage bond investors, who fear that further drops could spark a wave of home-loan refinancings. Mortgage rates are keyed to the 10-year Treasury yield, which Wednesday touched a low of 2.924%, its lowest since April 2009. Refinancings have already begun to rise as mortgage rates have fallen, with the Mortgage Bankers Association's refinancing index rising 12.6% in the week to June 25.

Strategists say 2.8% on the 10-year benchmark is a threshold. If it is breached, mortgage rates would likely dip below 4.5%, encouraging homeowners to refinance the 5% to 6% loans they took out over the last 12 to 18 months. Wednesday afternoon, the 10-year note was up 3/32 point, or $0.9375 for every $1,000 invested to 104 20/32. Its yield stood at 2.965% from 2.967% Tuesday as bond yields fall when prices rise. The 30-year bond's yield hit 3.892%, the lowest level since October 2009.

Faced with the possibility of faster mortgage pay downs—on top of worries about the global economy and high unemployment in the U.S.—mortgage investors have braced for a painful summer. They have plenty of cash to invest but expect low yields to remain low.

"It's frustrating," said Gary Greenberg, portfolio manager at Payden & Rygel, who manages its $605 million mortgage-backed securities fund. "The speed of the move from high rates to low rates is so quick and challenging, it's scary."

The fast drop in Treasury yields damped the mortgage bond market Wednesday. The 5% coupon mortgage security, which is likely to be one of the most affected securities should a refinancing wave emerge, saw prices decline to 105.75 after reaching a historic high of 106.0625 Tuesday morning. Risk premiums have also widened. On Wednesday, they were 0.08 percentage point wider at 1.39 points over comparable Treasury yields.

Despite the lofty prices, returns on mortgage bonds in the second quarter have lagged the Treasury market's performance: as of Tuesday, Treasury's had returned 4.62%, compared with 2.97% for mortgage-backed securities, according to Barclays. Long-dated Treasury's due in 20 years and more returned a stellar 14% in the quarter, while those maturing between 10 and 20 years returned 9.27%.

"The plunge in yield (in the second quarter) tells you that the bond market has priced out of a strong recovery," said Mark MacQueen, partner and portfolio manager at Sage Advisory Services Ltd. in Austin, Texas 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."

Mr. MacQueen has bought Treasury's in recent weeks, cutting his underweight positions on the Treasury market as his view on the economy changed—an evident shift among many market participants. Bill Gross and his fund managers at Pacific Investment Management Co., 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 it began with optimism that the U.S. and the global economic recoveries would gather speed, the second quarter 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 stay at record-low levels near zero for longer than many thought.

The two-year note, among the most sensitive to changes in official rate policy outlook, lost some ground Wednesday after hitting a record low of 0.582% in the prior session. It fell 2/32 point, sending its yield to 0.633%.

Wal-Mart, Others Tap Corporate Debt Market

Three household-name companies, Wal-Mart Stores Inc., Campbell Soup Co. and Fidelity Investments tapped the corporate debt markets Wednesday to take advantage of low borrowing costs, despite the volatile market conditions.

Wal-Mart was in the market with $3 billion in senior unsecured five-, 10-, and 30-year securities; Campbell with $400 million in seven-year senior unsecured notes; while Fidelity sold $400 million in 30-year senior unsecured notes. Wal-Mart was expected to pay around 0.53 percentage point over comparable Treasury yields on its five-year note, 0.70 point over Treasury's on its 10-year note and 1.08 points over Treasury's on its 30-year securities. Campbell Soup's seven-year bonds pay 0.65 point over Treasury's, and Fidelity's 30-year bonds pay a 2.625-point premium.

"These are companies with very solid balance sheets," said David James, vice president in fixed income at broker-dealer Wall Street Access. "I don't think anyone was expecting them to come to market this week given all the volatility."

—Katy Burne

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