

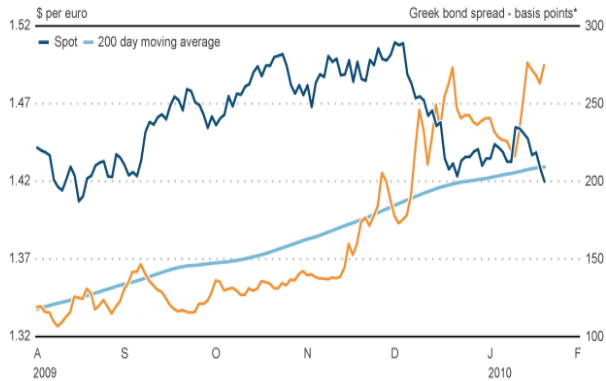
# INSIDE DEBT

PRODUCED BY REUTERS IN PARTNERSHIP WITH ICAP

Wednesday, January 20, 2010

## CHART OF THE DAY

### Euro hit by Greek fiscal worries



The euro hit five-month lows against the dollar as concerns over Greek debt pushed the single currency below a key support level and triggered widespread selling.

## TODAY'S TOP NEWS

- U.S. housing starts fall, but permits at 14-mth high
- Obama urges lawmakers "coalesce" on healthcare deal
- U.S. Treasury warrant buyback proceeds top estimates
- Obama targets 'tax cheats' seeking government work
- China tries to curb lending and avoid overheating
- Bair urges banks to take losses on commercial loans
- [For more stories please click here](#)

## ECON WATCH

FOR THURSDAY JANUARY 21

ET	Indicators	Unit	Reuters	Prior
02:58	FR Markit Mfg FlashPMI	ind	54.9	54.7
02:58	FR Markit Ser FlashPMI	ind	59.0	58.7
03:28	DE Markit mfg Flash PMI	ind	52.9	52.7
03:28	DE Markit Service Flash PMI	ind	53.0	52.7
03:58	EZ Markit Mfg Flash PMI	ind	51.8	51.6
03:58	EZ Markit Serv FlashPMI	ind	53.9	53.6
03:58	EZ Markit Comp FlashPMI	ind	54.5	54.2
04:30	GB PSNCR, mm GBP	bln	26.00	21.625
04:30	GB PSNB, mm GBP	bln	18.75	13.604
08:30	US Initial Claims	k	440	444
08:30	US jobless contin claims	mln	4.6	4.596
08:30	CA Wholesale trade mm	%	0.3	0.3
10:00	US Lead indicators	%	0.7	0.9
10:00	US Phil Fed index	ind	18.0	22.5
10:30	CA Bank of Canada Monetary Policy Report			

## MARKETS TODAY

**TODAY'S TOP STORY:** U.S. home starts unexpectedly fell last month as unusually cold weather hampered construction, but a jump in building permits to a 14-month high indicated the housing market recovery was intact. [For more please click here](#)

**TREASURIES:** U.S. Treasuries rose sending yields to one-month lows, as falling stocks and worries over Greece's fiscal troubles boosted demand for safe-haven government debt.

- 10-yr prices rose 11/32, yielding 3.66 pct from 3.70 pct on Tuesday. Yields fell as far as 3.6358 pct, their lowest since Dec. 21.
- 30-yr bonds rose nearly a point in price and yields also struck a one-month low. It was last up 26/32, yielding 4.54 pct from 4.59 pct. Long bond yields fell as far 4.53 pct, their lowest since Dec. 21.
- Treasury yield curve flattened across the horizon with the 2-10's spread at 277 bps from 281 bps.

**FOREX:** The euro fell to a five-month low against the dollar amid worries about Greece's ability to finance its deficit, while fear that China is trying to slow bank lending dulled demand for commodity currencies.

- The dollar index jumped 1.11 pct at 78.359.
- Euro fell 1.34 pct at \$1.4099 after hitting \$1.4081, a five month low. It fell 0.86 pct at 0.8656 pence.
- Dollar rose 0.13 pct to 91.23 yen.

**CORPORATES:** U.S. corporate bond prices followed stocks lower as investors worried lending restrictions in China could hurt global economic recovery, and bank earnings remained a concern. Spreads on bank bonds continued to lead the overall market wider, with some credits widening as much as 6 bps. Corporate bond spreads overall were between 3 and 5 bps wider.

- The CDX.IG-13 index remains unchanged at 85 bps.
- Cigna Corp's 5-yr CDS tightened by about 10 bps to a mid-level of 85 bps, while Humana's swaps tightened about 30 bps to about 135 bps.
- UnitedHealth Group's swaps tightened by about 20 bps to about 100 bps, while Aetna's swaps tightened by about 3 bps to about 47 bps.

**STOCKS:** U.S. stocks suffered their worst slide of 2010 on fears that China's bank lending curbs might jeopardize the global recovery and IBM's outlook, which dented optimism about technology shares.

- Dow fell 1.14 pct to 10,603.0, S&P shed 1.06 pct to 1,138.04 and Nasdaq was down 1.26 pct to 2,291.25.
- Alcoa was off 2.50 pct at \$15.23, while Caterpillar was down 1.92 pct at \$59.76. Shares of IBM fell 2.90 pct to \$130.25. Chevron Corp fell 1.88 pct at \$78.18.
- The S&P materials sector index fell 1.51 pct, S&P technology index was down 1.46 pct. KBW bank index rose 1.40 pct.

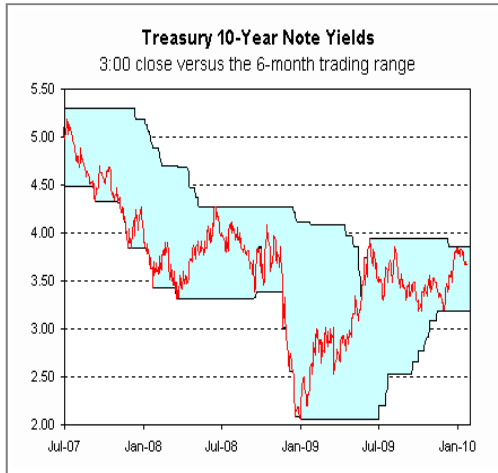
**C & E:** Oil prices fell below \$78 a barrel as the dollar strengthened and Wall Street slipped on worries about domestic bank results and bank lending curbs in China.

- U.S. crude prices shed 1.77 pct to \$77.15 per barrel.
- Gold was down 2.31 pct to \$1,111.7 an ounce.
- Reuters-Jefferies index fell 1.33 pct to 279.48.

- [For MARKET SNAPSHOT click here](#)
- [For NEXT UP click here](#)
- [For DEEP DIVE click here](#)



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.030	-0.005	0.03	-0.005
3-Mo Bill	0.050	0.040	0.051	-0.006
6-Mo Bill	0.140	0.115	0.142	-0.001
1-Year	0.303	0.298	0.307	-0.007
2-Year	100.219	100.250	0.887	0.016
3-Year	99.766	99.797	1.456	0.027
5-Year	100.914	100.961	2.428	0.105
7-Year	100.641	100.688	3.146	0.242
10-Year	97.656	97.719	3.661	0.313
30-Year	97.297	97.359	4.541	0.781

EQUITIES

	INDEX	CHANGE
DJIA	10590.76	-135.88
NASDAQ	2285.37	-35.03
S&P 500	1135.90	-14.31

OIL

	PRICE	CHANGE
NYMEX	77.2	-1.9
BRENT	76.1	-1.5

EURODOLLAR FUTURES

	CLOSE	CHANGE
Feb-10	99.740	0.005
Mar-10	99.720	0.005
Jun-10	99.585	0.010
Sep-10	99.280	0.005

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.190	O/N	0.200
2-Week	0.190	2-Week	0.190
1-Month	0.190	1-Month	0.190
3-Month	0.200	3-Month	0.210
AGENCY REPOS		i-REPO <sup>SM</sup> INDEX	
O/N	0.200	10:00 AM	0.130
2-Week	0.200	3:00 PM	0.144
1-Month	0.200		
3-Month	0.220		

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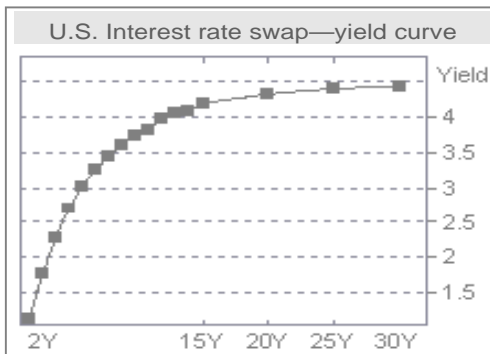
	SPREAD		RATE	
2-Year	25.50	29.50	1.14	1.16
3-Year	30.25	34.25	1.75	1.77
5-Year	27.25	31.25	2.70	2.70
7-Year	12.25	16.25	3.27	3.26
10-Year	8.50	12.50	3.74	3.73
30-Year	-12.25	-8.25	4.42	4.39

FUTURES

	PRICE	CHANGE
CBOT 5 yr	115.76	0.19
CBOT 10 yr	117.41	0.33
CBOT 30 yr	117.97	0.78

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.120	0.160	-	-
1-Month	0.220	0.300	0.127	0.137
3-Month	0.240	0.400	0.140	0.150
6-Month	0.300	0.500	0.171	0.181
12-Month	0.800	1.100	0.355	0.365



CURRENCIES

	BID	ASK
Euro	1.4108	1.4110
Sterling	1.6287	1.6292
JP Yen	91.18	91.20
Swiss Franc	1.0437	1.0440
Can Dollar	1.0469	1.0474
Mexico	12.7453	12.7514

FED FUNDS NYFR<sup>SM</sup> - 10AM

Open	0.1300	1m	0.2225
High	0.1400	3m	0.2506
Low	0.0800		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.875	12/01/2012	14	13.5	1.01
3-Year	1.375	09/01/2013	0	20.5	-
5-Year	2.875	09/02/2015	32.5	32	2.72
7-Year	5.125	18/10/2016	0	16	-
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	36.25	35.75	4.9

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	11.5	11	1
3-Year	1.75	22/02/2013	0	28.5	-
5-Year	2.625	20/11/2014	21	20	2.64
7-Year	5.25	15/09/2016	14	13.5	3.29
10-Year	3.75	27/03/2019	21.5	20	3.86
30-Year	6.25	15/07/2032	36.25	35.75	4.9

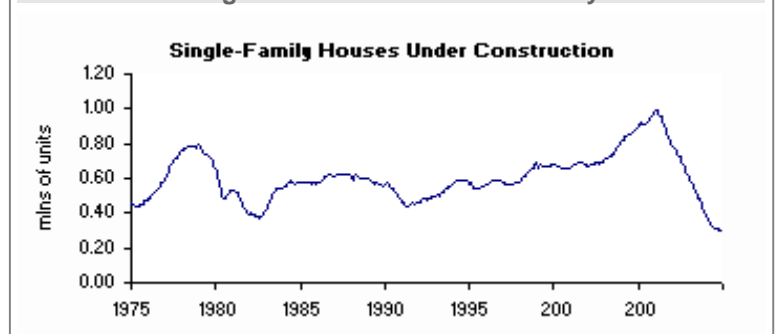
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	105.1200	105.1400	2.640
FHLMC	5.0	105.1200	105.1400	2.640

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.1800	105.2000	2.956
FHLMC	5.5	105.2200	105.2400	2.848
GNMA	5.5	105.1600	105.1800	3.615

Wrightson ICAP<sup>SM</sup> Chart of the Day



## TODAY'S TOP NEWS

**U.S. housing starts fall, but permits at 14-mth high**

U.S. home starts unexpectedly fell last month as unusually cold weather hampered construction, but a jump in building permits to a 14-month high indicated the housing market recovery was intact.

The Commerce Department said housing starts fell 4 percent to a seasonally adjusted annual rate of 557,000 units, pulled down by a drop in groundbreaking activity for single-family dwellings. Analysts polled by Reuters had expected housing starts to rise to 580,000 units.

However, building permits soared 10.9 percent to 653,000 units last month, the highest level since October 2008. That was above market expectations for a rise to 590,000 units.

A separate report from the Labor Department showed producer prices rose 0.2 percent in December as food prices surged, and recorded their largest year-on-year gain in 14 months.

But core prices, which exclude food and energy, were unchanged on the month and up just 0.9 percent on the year, showing inflation pressures remained tame.

**U.S. Treasury warrant buyback proceeds top estimates**

The U.S. Treasury said proceeds from repurchases of stock warrants by bailed-out banks last year in aggregate exceeded market indications, boosting gains for taxpayers.

In a new report on its warrant dispositions, the Treasury said through Dec. 31, 2009, it realized gross proceeds of \$2.9 billion from 31 privately negotiated warrant repurchases.

This compares to initial bids from the banks of \$1.7 billion, estimates of aggregate value of \$2.2 billion based on market indications, \$2.7 billion based on third-party estimates and \$2.6 billion based on Treasury's internal financial models.

The Treasury said the warrant repurchases were combined with \$1.1 billion from warrant auctions for total warrant proceeds of about \$4 billion in 2009 from 34 banks that have completely exited the Treasury's Capital Purchase Program.

Combined with dividends collected on preferred shares, the Treasury said it earned an 8.8 percent return on its investments in these banks.

Among larger banks, the Treasury is still holding warrants in Citigroup, Bank of America, and Wells Fargo & Co.

**China tries to curb lending and avoid overheating**

Chinese authorities ordered some big banks to curb lending for the rest of January, intensifying their efforts to prevent the world's third-largest economy from overheating.

The news weighed down stocks in Asia and Europe and oil fell towards \$78 a barrel on fears that demand in China, the world economy's main source of growth, may now slow down as authorities tighten policy.

China's central bank told some banks, including Citic Bank and Everbright Bank, to increase their reserve requirement ratio by half a percentage point, banking sources told Reuters.

A surge of new lending in January has triggered a series of intensifying steps by authorities to rid the financial system of excess cash that can fuel inflation and asset bubbles.

Chinese banks lent 1.1 trillion yuan (\$161 billion) in the first half of January, sources said, citing central bank data. That puts total new loans in January on track for the highest since June 2009, when banks doled out 1.5 trillion yuan in new lending. The top four banks together lent more than 500 billion yuan during the same period, the sources said. The surge, combined with Beijing's 4 trillion yuan stimulus plan, helped kick-start the economy after a slump, but aroused investor fears of overheating.

**Obama urges lawmakers "coalesce" on healthcare deal**

President Barack Obama urged lawmakers to come to quick agreement on core elements of healthcare reform, signaling he might support a scaled-back overhaul after a Democratic loss of a key Senate seat.

Obama acknowledged that voter anger helped carry Republican Scott Brown to a stunning victory in Tuesday's Massachusetts election, an outcome that has imperiled the president's healthcare effort and the rest of his legislative agenda.

"People are angry, they are frustrated. Not just because of what's happened in the last year or two years, but what's happened over the last eight years," Obama told ABC News as he reached the anniversary of his first year in office.

The White House said it may rethink its strategy for selling Obama's agenda as it presses ahead with its priorities, including not only healthcare but job creation, climate change and financial regulatory reform. Brown's win deprived Democrats of a crucial 60th Senate vote they need to pass the healthcare bill, Obama's top legislative priority, and push through other big measures.

Obama made clear he sticking with his healthcare push but showed signs of a willingness to give ground. "I would advise that we try to move quickly to coalesce around those elements in the package that people agree on," he told ABC.

**Obama targets 'tax cheats' seeking government work**

U.S. President Barack Obama ordered federal agencies to take measures to prevent companies that are delinquent in paying taxes from obtaining new government contracts.

Obama also instructed the IRS to review the accuracy of companies' reports on their tax obligations to be sure they are truthful. The measures are meant to fire up Obama's political base and help move the spotlight back to the economy after intense public focus on security threats, the devastating earthquake in Haiti and, now, the shock election in Massachusetts.

Obama said there were tens of thousands of companies that were not paying their taxes but still receiving government contracts. Unpaid taxes from such firms were estimated at more than \$5 billion, he said.

The president called on Congress to build on legislation that would allow the IRS to share information about tax delinquency with contracting officials. He also promised to renew a proposal in his upcoming budget that the government has the right to pay back taxpayers before it pays delinquent contractors.

**Bair urges banks to take losses on commercial loans**

A top regulator told banks to stop dragging their feet and recognize losses on commercial real estate loans, a sector that is due to deteriorate in the coming quarters and drive bank failures.

Sheila Bair, chairman of the Federal Deposit Insurance Corp, said banks should try to modify troubled commercial real estate loans, but must recognize losses if such a workout does not maximize value. She said that she expects the rates of noncurrent CRE loans to continue to rise "in the coming quarters," and reiterated her belief that the troubles in the sector will increasingly be a driver of bank failures this year.

Bair said failed banks with high concentrations of CRE may be difficult to sell as a whole bank.

Bair said that problems on the commercial side started later than in the residential markets, but in some respects have been more pronounced. Declines in CRE prices have been larger on average, Bair said, with price indices down by more than 40 percent from their 2007 peak.

## TODAY'S TOP NEWS

**Japan supports collective G7 message to China on yuan**

Japan supports sending a "collective message" to China at a G7 meeting next month to allow more flexibility in the yuan, a government official said.

China has come under heavy pressure from the Group of Seven leading industrialized nations to revalue its currency, giving it a unfair export advantage and hindering more balanced economic growth. Reform of China's exchange rate policy will be gradual, as exports will likely to take a long time to return to pre-crisis levels, the country's commerce minister said.

The disagreement has highlighted the failure of big countries to resolve currency tensions which were thrown into focus by the global economic crisis, despite calls at a summit meeting last September for those issues to be tackled.

Separately, Canada has agreed to Japan's request to discuss the need for a stronger Chinese yuan at a Feb. 5-6 meeting of G7 finance ministers and central bankers, Finance Minister Jim Flaherty said. Flaherty told reporters that Japan's finance minister had asked for the item to be on the agenda and that, as host nation, Canada would oblige.

**U.S. mortgage demand up for third week as rates drop**

Demand for U.S. home loans rose last week for the third straight week as mortgage rates fell to a one-month low and stoked refinancing, an industry group said.

The MBA's index of total home loan applications rose 9.1 percent in the week ended Jan. 15 to 575.9 on a seasonally adjusted basis. The increase was driven by a 10.7 percent jump in the refinancing index, while home purchase demand rose 4.4 percent to 223.0 last week.

Average 30-year mortgage rates dropped to 5 percent last week, the group said, baiting consumers to apply to refinance and purchase homes before borrowing costs rise again.

An extended and expanded federal tax credit will also disappear this spring. Consumers who qualify for an \$8,000 first-time buyer credit or a \$6,500 move-up buyer credit need to sign purchase contracts by April 30 and close on home loans by June 30.

**Japan PM says wants to avoid sharp bond yield rises**

Japanese Prime Minister Yukio Hatoyama said he wanted to avoid sharp rises in bond yields when compiling spending plans to support the economy, in a bid to reassure markets that Tokyo will maintain fiscal discipline.

Bond investors are worried about Japan's bulging debt, which is

approaching 200 percent of gross domestic product, and fear the 4-month-old government will spend more to bolster the economy ahead of a mid-year election.

"It's important to ensure bond yields remain stable," Hatoyama said as he tried to convince the upper house of parliament of the need to swiftly pass an extra budget for this fiscal year ending in March to fund measures to stimulate the economy.

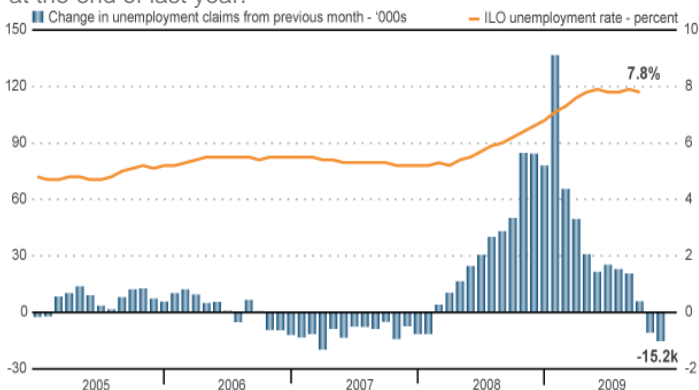
Short- and medium-term JGBs have outperformed on the back of the BOJ's low interest rate policy, while longer-term bonds have been more sensitive to concern about rising government debt issuance. The spread between five- and 20-year JGB yields is currently near a decade-high.

**BoE unanimous on steady policy in Jan, focus on Feb**

The BoE's MPC voted unanimously to keep policy unchanged earlier this month, saying February's inflation forecasts would give a better idea of the economic outlook.

Minutes to the Jan. 6-7 meeting, published showed all nine members of the MPC wanted to keep interest rates at a record low of 0.5 percent and to maintain its 200 billion pound (\$326.5 billion) asset-buying scheme. Most analysts expect the BoE to halt its asset-buying program once its 200 billion pound target has been met in the next few weeks but are split over when monetary policy might be tightened.

Separately, Britain's labor market showed signs of stabilization at the end of last year.



The Office for National Statistics said the number of jobless benefit claims fell by 15,200 in December to 1.6065 million, bigger than the forecast fall of 2,500. The broader ILO jobless rate also fell, dropping to 7.8 percent for the three months to November from October's 7.9 percent after the number of people looking for work shrank by 7,000 to 2.458 million, the first decline in 18 months.

## NEXT UP

**POLL-U.S. crude stocks seen up as runs dip, imports rise**

U.S. crude oil inventories rose last week as refinery utilization fell and imports increased, an expanded Reuters poll of analysts showed.

Analysts made their forecasts ahead of weekly U.S. industry and government inventory reports due out a day later than usual this week due to the federal Martin Luther King Jr. holiday on Monday.

On average, crude supplies were projected up 2.4 million barrels, the poll of 16 analysts showed, which would mark the third straight week of inventory gains.

Distillate stocks declined by 100,000 barrels, on average, the poll predicted. Forecasts were mixed, however, with nine ana-

lysts expecting a drawdown and seven a build.

Those expecting a drawdown noted that recent extreme cold in the U.S. Northeast, the biggest regional market for heating oil, could have boosted demand. The analysts forecasting a build said heating oil demand declined due to moderating winter temperatures in the region.

Gasoline stocks were projected up 1.7 million barrels on average, with demand remaining weak against the backdrop of a continuing high rate of unemployment, analysts said.

Refinery utilization was forecast to have fallen 0.4 percentage point to 80.9 percent of capacity, after a sharp increase the week before. In the comparable week a year ago, refinery utilization fell 1.9 percentage points to 83.3 percent of capacity.

## DEEP DIVE Commentary and Analysis

**Fed's MBS exit could lift U.S. Treasury yields**

By Emily Flitter and Julie Haviv

The end of the Federal Reserve's program to buy mortgages backed by Fannie Mae and Freddie Mac could have a ripple effect on the market for U.S. government bonds.

Once the Fed stops buying mortgage-backed securities at the end of March, private buyers will need to step in and take over in a market that the government has propped up since the financial crisis reached its peak. But they won't want to buy MBS unless the securities offer a better return than the current rate, so mortgage rates will likely rise.

Higher rates could, in turn, spur a hedging practice in the Treasury market that has been largely absent in recent months. As a result, longer-dated U.S. debt could cheapen and yields could climb.

A jump in yields would increase the cost of borrowing for the U.S. government. The cost of mortgages would also rise, threatening the fragile housing recovery. And a sharp, sudden spike in Treasury yields could spook regular government debt buyers such as foreign central banks.

Some signs in the marketplace are already pointing to this possibility. The Treasury yield curve has steepened and the prices of bond options have risen.

"Some feel that the recent market moves reflect investor positioning for the end of several unconventional Fed facilities," said Mohamed El-Erian, co-chief investment officer at Pacific Investment Management Co., in an e-mail.

**VOLATILITY TO RETURN**

Treasury strategists have also warned that wider swings in bond prices lie ahead. They will be driven in part by hedging practices MBS investors are known to use that the Fed, as the largest MBS buyer since the financial crisis began, did not employ.

"In essence, the Fed has taken a lot of volatility out of the marketplace," said William O'Donnell, the head of U.S. Treasury strategy at RBS Securities in Stamford, Connecticut. "Any subsequent mortgage issuance is likely to fall into the hands of portfolios likely to be somewhat dynamically more hedged. It'll have the prospect and almost the certainty of adding volatility back into the rates markets."

The practice is known as convexity hedging. Investors holding MBS can actually find themselves losing money if mortgage or interest rates rise suddenly and they cannot get rid of their lower-yielding securities. They often try to offset unexpected increases in mortgage and interest rates by selling Treasury notes.

"If you look at option prices presently, we have the implied volatility for longer-dated options trading 25 percent over their long-term historical levels. One could argue the reason for this is that people anticipate uncertainty after March 31 end date of the Fed's MBS program," said Harley Bassman, a managing director at Bank of America Merrill Lynch.

"People are concerned about what might happen when the Fed starts to drain liquidity. This is why the volatility surface is so steep from one month to two years expiries."

**BEWARE OF CONVEXITY**

Convexity hedging often feeds on itself, causing Treasury yields to rise even faster.

Ajay Rajadhyaksha, head of U.S. fixed income and securitized products research at Barclays Capital in New York, said if rates rise sharply, agency MBS could extend and trade to much longer durations.

"It is not a risk for the next 30 basis points or so in interest rates, but at a 4.10 percent (10-year) Treasury yield, the market will

start to worry," he said.

Arthur Frank, director and head of MBS research at Deutsche Bank Securities in New York, said while a 4 percent Treasury yield could spark a big pick-up in convexity hedging, he noted that hedging by mortgage servicers, the banks that manage mortgage loans and collect payments from borrowers, is driven more by MBS prices.

"Servicers have varied trigger points, but it is safe to say, they might start selling mortgage duration at 99-1/2 or at 99," he said.

The Fannie Mae 30-year 4.50 percent coupon is priced at 100-8/32, with a yield of 4.438 percent.

The relationship between interest rates and MBS prepayment rates directly influences MBS pricing. More mortgage borrowers are likely to quickly pay off their old loans when interest rates are low and they can get a better deal by refinancing.

In a bond market rally, prepayment rates rise, reducing the price gains of MBS, while in a bear market, prepayment rates slow, resulting in increased price losses. This price movement is commonly referred to as "negative convexity."

**For U.S. bonds, economy may trump supply/demand rule**

By Burton Frierson

The heavily indebted U.S. government is challenging the law of supply and demand this year by issuing trillions of dollars in new bonds, but it's the economy that will decide how high its borrowing costs rise.

The budget deficit, a record \$1.4 trillion last year, has become a major fault line of financial market debate, with some fearing it will drive Treasury yields up sharply and cause an exodus of investors from U.S. government debt.

Others see limited damage. With the worst financial crisis in seven decades still a fresh memory, companies and consumers will not borrow and spend the way they used to, reducing the amount of private sector debt that could compete with Treasuries for investors' dollars.

Both sides agree the \$1.5 trillion to \$2 trillion worth of new government issuance due this fiscal year would normally raise Treasuries' yields and government borrowing costs.

But these are not normal times, and even analysts predicting higher yields say their forecasts depend on the U.S. economy recovering enough to compel companies to issue bonds to fund the construction of new factories or other investments.

"The most important thing for interest rates, for whether people make or lose money on a total return basis in Treasuries this year, has to do with the strength of the economy," said Jerry Webman, senior investment officer at OppenheimerFunds in New York.

"My view is it's going to be strong enough that it won't be a particularly attractive year for Treasuries, given where yields are now," added Webman, who is also chief economist at OppenheimerFunds, which has \$167 billion in assets under management.

Benchmark 10-year yields are around 3.65 percent. A recent Reuters poll showed big banks that deal directly with the central bank expected a rise to 4.35 percent by the end of the year.

Analysts at Morgan Stanley recently predicted yields would hit 5.5 percent in the second half of this year, driven in part by budget deficit concerns.

**JUDGES AND VIGILANTES**

Fund managers are also bracing for a rise in yields.

"The first thing that will drive rates up is growth," said Jim Swanson, chief investment strategist at MFS Investment Management in Boston. "The second piece to that is the inflation risk,



## DEEP DIVE Commentary and Analysis

but now we have a supply problem on top of all that." Indeed, there are well-founded worries over the historic rise in government borrowing, brought on by a costly bailout of the financial sector and a recessionary spending surge.

The record 2009 deficit led investors briefly to question the longevity of the United States' prized AAA rating in May and contributed to the worst year for Treasuries in a decade.

Some commentators now talk of a return of bond market "vigilantes," deficit-averse investors credited by some with spurring President Bill Clinton in the 1990s to produce federal budget surpluses.

Pacific Investment Management Co, the world's biggest bond fund, is cutting U.S. exposure over deficit concerns and its founder, Bill Gross, has urged investors to be "vigilant."

Ultimately, though, the vigilantes may conflict with the Federal Reserve, which will play the roles of judge and jury in deciding where interest rates should go.

It has promised to keep rates at historic lows near zero until the recovery takes root. Analysts say vigilantes will find it difficult to fight the Fed.

"Even with the increase in inflation expectations and even with the increase in supply, it's very difficult to get long-term yields too far ahead of the Fed," said Chris Rupkey, chief financial economist at Bank of Tokyo-Mitsubishi UFJ in New York.

"The spread between 10-year yields and the Fed target doesn't tend to run much higher than where it is now. It doesn't tend to run much more than 375 basis points."

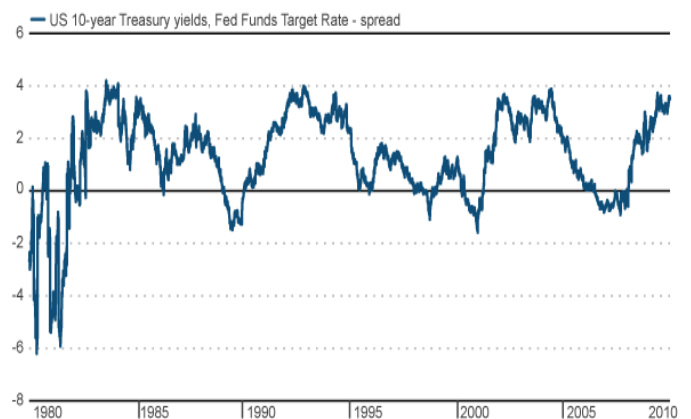
## IT'S DIFFERENT THIS TIME

Many outside the Fed say the recovery will be too weak to allow vigilantes to act on their deficit fears, however well founded they may be.

Consumers, heavily indebted after the credit craze of recent decades, have watched in shock as the economy shed 7 million jobs and home values plummeted. They are unlikely to be big borrowers again any time soon.

"I do not believe that 20-plus years of excesses in borrowing

The spread between 10-year Treasury yields and the Fed funds rarely exceeds 3.75 percent



and spending can be worked off in just 18 months," said William O'Donnell, head of U.S. Treasury strategy at RBS Securities in Stamford, Connecticut.

"What's critical to our view is an outlook that private-sector borrowing will remain weak -- leaving Treasuries as the 'only game in town' for fixed income managers -- despite the rising weight of Treasury supply."

A massive bond sell-off also risks stalling the recovery, since Treasuries set benchmark rates throughout the economy.

"I think if 10-year Treasuries were really to start getting above 4.5 to 5.0 percent you would see a serious weakening in the economy," said OppenheimerFunds' Webman.

A double-dip recession would quash already subdued inflation by forestalling jobs growth and consumer spending.

In such an environment, businesses would also balk at new capital spending, damping issuance of corporate bonds.

"Supply in and of itself is an argument for higher yields," said Marty Mitchell, head of government bond trading at Stifel Nicolaus in Baltimore. "It's just that this U.S. government supply is really the only game in town."

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(Compiled by Anil Kumar and Pronita Naidu in Bangalore)

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