

Is inflation making a comeback? That concern has been on Wall Street's mind lately. About six months ago, the yield on the benchmark 10-year note was around 2%. In the second week of June, it touched 4%. While still low historically, the rising yield could prove inconvenient for the recovery in the financial and housing sectors.¹

The yield on the 10-year note has slowly risen since March. On June 10, a subpar U.S. Treasury auction took the yield to 3.95%.² Friday, Treasury prices spiked higher, sending the yield to 3.79% at the end of a week in which the U.S. Treasury auctioned off more than \$65 billion in debt.³

Action leads to reaction. Why the concerns here? Let's review what has happened in the last several months. The federal government issued massive amounts of debt to fund its response to the recession and the financial crisis. The government has borrowed to a startling degree and flooded the banking system with money – conditions which can breed inflation.

Also, with so much debt being offered for sale, the fear was that supply would come to outweigh demand in the bond market. When bond prices fall, bond yields rise. When the yield rises on the 10-year Treasury, interest rates rise on mortgages and other types of loans (mortgage rates move in response to the 10-year note).

When interest rates rise, the cost of borrowing increases, mortgages become less attractive, and you have decreased homebuying demand and downward pressure on home prices. That could slow down the economy and negatively affect GDP. While higher Treasury yields and higher interest rates can aid the dollar, there is a considerable downside.

Wasn't the Federal Reserve going to buy billions in Treasury notes? Yes – back in March, that was the plan. The Fed wanted to purchase \$300 billion in long-term Treasury notes and another \$750 billion in mortgage-linked securities.⁴

The idea was to lower mortgage rates and thaw credit markets. Temporarily, it worked – there was more demand in the Treasury market, rates on mortgages fell, and refinancing increased. But the short-term effect faded.



Yields, Rates, and the Rally

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June 15, 2009

The Fed's Open Market Committee will meet June 23-24, and some think the Treasury buyback effort will be renewed around or before that time.¹ An interest rate hike would seem distant. Only 18% of economists polled in June by the *Wall Street Journal*/think the Fed will hike rates this year.⁵



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Citations.

¹ money.cnn.com/2009/06/11/markets/bondcenter/credit/?postversion=2009061113 [6/11/09]

² cnbc.com/id/31204061 [6/10/09]

³ money.cnn.com/2009/06/12/markets/bondcenter/bonds/?postversion=2009061214 [6/12/09]

⁴ money.cnn.com/2009/03/18/news/economy/fed_decision/index.htm?postversion=2009031815 [3/18/09]

⁵ online.wsj.com/article/SB124464007697702065.html [6/11/09]