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Is Steep Yield Curve Signaling Pain to Come?

Anomaly Suggests, to Some, Investors' Fear of a Possible Downgrade for U.S. Credit Ratings; Moody's Disagrees

By DEBORAH LYNN BLUMBERG

NEW YORK—Some bond experts believe yields in the Treasurys market are signaling the U.S. could one day be stripped of its triple-A status as it confronts a bloated budget deficit with no clear plans to reduce debt.

A peculiar distortion in the benchmark U.S. government-bond yield curve, which is the gap between two-year and 10-year yields, is pointing to worries that the U.S. could see its top-notch credit rating downgraded within several years, according to some experts.

Longer-term yields have been rising at a faster clip than shorter-term rates, even as U.S. economic data have been improving and as market participants have moved up their expectations for an interest-rate increase from the Federal Reserve.

"It's an odd move," said Priya Misra, head of U.S. rates strategy at Bank of America Merrill Lynch, one of the 18 primary-dealer banks. "We've never seen these moves when we've had better economic data, and with Fed [rate] hikes on the way," she said. The yield curve is flashing "concerns about an unsustainable fiscal deficit and an eventual potential ratings downgrade," Ms. Misra said.

Typically, as expectations rise for an interest-rate increase, the curve flattens as shorterterm yields, which are more closely tied to the Fed's official rate, climb more than those for the longer term. Not in this case, though. The benchmark curve was as flat as 2.13 percentage points in early November; on Friday, it was at 2.79 percentage points.

In the past, steep yield curves have been associated with sovereign-debt-ratings downgrades. Japan was stripped of its triple-A status by Moody's in 1998 and Standard & Poor's in 2001. Its benchmark yield curve steepened by 0.40 percentage point in the two months following Standard & Poor's downgrade of its debt from triple-A to double-Aplus, with 10-year rates rising by 0.45 percentage point.

"In the U.S., people are getting ahead of any rating-agency action," Ms. Misra said. A more severe steepening in the U.S. makes sense, she said, because about 50% of U.S. debt is held by overseas investors, who are more likely to sell amid market turbulence, as opposed to 6% of Japanese debt.

For his part, Richard Cantor, chief risk officer at ratings firm Moody's Invesotrs service, said, "For a country like the U.S., changes in the market's perception in credit risk would seem the least likely explanation for a sizable move in its long-term rates."

"Moreover, as a general matter, a rise in any debt issuer's perceived credit risk is more often than not associated with a flattening of its yield curve rather than a steepening of its yield curve," he added.

Standard & Poor's declined to comment on the ratings implications of a steeper yield curve. Fitch Ratings analysts weren't available for comment.

However, earlier this month, analysts at Moody's and S&P warned that the U.S. could be downgraded if it doesn't make progress in shrinking its elevated debt levels. Moody's sai that if the U.S. doesn't act in the next two years, the likelihood of a negative outlook on its rating increases.

The U.S. is grappling with a national debt of about $14 trillion and rising. Its debt is currently 66% of gross domestic product and is projected to hit 85% by 2015, the International Monetary Fund expects. Economists Kenneth Rogoff of Harvard University and Carmen Reinhart of the University of Maryland have argued that the federal debt of developed nations shouldn't exceed 90% of GDP, because they found that countries which topped that level tended have lower growth rates than countries that hadn't crossed that line.

The consequences of a U.S. credit-ratings downgrade could devastate the economy, pushing up borrowing costs and threatening the dollar.

To be sure, better U.S. economic data are also partly to blame for the steep yield curve. The Fed's near-zero interest rates have pegged short-term rates, but longer-term yields are free to rise on more hopeful economic reports. Inflation expectations have also ticked up, curbing demand for longer-maturity Treasurys.

"The creeping concern of the U.S. losing its AAA rating is one of the multiple reasons for a steep yield curve," said Sean Simko, head of fixed-income management at SEI. "The concern of a downgrade is likely to grow over the upcoming years if a change [in the U.S. fiscal situation] doesn't occur."

Even if the U.S. were to be downgraded, a default is highly unlikely. The Fed would be prompted to step in to buy more bonds, analysts said. Such a move could potentially spark runaway inflation and raise concerns that the government was "monetizing the debt," or paying off government debt by rolling out the printing presses.

From the bond market's perspective, a real lack of investor demand at Treasury auctions, and especially from foreign investors, would signal a downgrade risk, Ms. Misra said. Another sign could be a significant narrowing of swap spreads.

Ms. Misra is keeping close tabs on the five-, seven- and 10-year Treasury yields to gauge the possibility of a U.S. default. If yields were to rise to a point that they push mortgage rates up to between 6.5% and 7%, causing the housing market to deteriorate, that could spur the Fed to buy more bonds to head off a default, she said.

"The Fed doesn't want to be in that situation," Ms. Misra said.

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