

# The us government role in the bond market in 2011

[Finance](#)



Finance and Accounting submitted The US government role in the bond market in a. Article US Treasuries / United States Bonds Outlook & 2010 Year-End Review” Measures of underlying inflation have trended lower during the first few months of 2010, which raised fears of Japan style deflation (economically worse than high inflation). However, European debt downgrades have caused investors to move back into “ safe” US treasuries particularly starting in the second of 2010, which pushed the yield closer to two year lows (prices closer to two year highs). In August the US Federal Open Market Committee stated that the Federal Reserve will help stimulate the slow & weak economy by purchasing more Treasuries, using funds from agency debt and mortgage-backed securities. Buying back Treasuries increases the money supply in the country, which is meant to help loosen credit/lending and encourage spending. This fueled bond investors’ purchase of US government debt. During the week of 8/23/2010 investors continued to buy large amounts of US government bonds (treasuries), while selling off stocks. Investors can usually buy treasuries directly or more commonly through bond funds. Bond funds had attracted US\$559 billion industry-wide in the past 30 months through June 2010. Bonds returned 16% within that 30 month period, while stocks returned -26%. Investors had removed US\$209.4 billion from domestic (US) equity funds, as well US\$24.4 billion from funds that purchase non-US stocks. With the increase in price, the yield on the 10 year US Treasury note had declined to 2.41% in October of 2010, the lowest level since Dec 2008 (when it was less than 2.20% during the height of the financial crisis). This meant that equities had become cheap (i. e. stocks were selling for much less than they should have been) as investors

retreated from the volatile stock markets in search of stability in US bonds. On 10/5/2010 Warren Buffett, who was a guest speaker at Fortune's Most Powerful Women Summit in Washington, had said that it is "quite clear stocks are cheaper than bonds". He also stated that he "can't imagine" the rationale for adding bonds to your portfolio at the then current prices. "We are following policies that unless changed will eventually lead to lots of inflation down the road". "We have started down a path you don't want to go down." Despite the Oracle of Omaha's direct warning, US bond purchasing continued, causing yields on 10 year US treasuries to reach near record lows at 2.17% in November 2010 (US treasuries reached near record high prices). In November the US Federal Reserve announced it is committing \$600 billion to buy more government bonds/treasuries in order to stimulate the weak US economy. This was the second massively large and unconventional program of quantitative easing (money printing). US treasury prices began to fall as investor confidence began to wane. In December, US Federal Reserve chair Ben Bernanke defended the \$600-billion US Treasury bond purchase plan on national television. He said the economy was still struggling to become "self-sustaining" without government help and also indicated further stimulus may be required in 2011. In the days following Bernanke's comments, yields on 10 year US treasuries rose sharply to a six month high of 3.27%, after prices dropped in the largest two day sell off since September 2008 (when Lehman Brothers collapsed). US treasuries continued to fall through the month of December as investors reduced their bond holdings after government data (prices and trade) suggested stronger than expected economic growth in the fourth

quarter and easing deflation risk. Investors had started to put money back into US equities. The yield on 10 year US treasuries rose to six month highs (prices dropped to six month lows). Retail investors withdrew a record net \$US8. 6 billion from bond funds during the week ended December 15. This was on top of the US \$1. 7 billion of outflows during the prior week. This downward bond trend is likely to continue, as corporate earnings are expected to continue improving at a moderate pace. At the state and local government levels, fiscal strains have been increasing, particularly with high pension liabilities. As more of these issues surface, investors will continue to push American bond prices lower, including municipal and state debt. With the stabilizing economy, investors' appetite for US equities and more riskier assets will increase, while bond demand drops. However, it will be at a more moderate pace in 2011 than we've seen in the past few months (paralleling the pace of corporate earnings and surfacing state/local government problems).

b. Comments on the article The role of the US FED in the bond market is seen as a government resolve to stimulate the weak economy of the United States. By using FED's funds, the agency is charged of buying back treasuries to increase the money supply of the country. This move is intended to encourage spending and loosen the tight credit condition prevailing in the United States. The result of this policy, as I have observed, is that it encouraged investors to invest in US Bonds. With the intervention of the US FED, a new investment scenario has been created wherein investors shed off their equity investments in favor of the low risk bonds. Investors feel that in the long run, they are better off with treasuries that give them a fixed rate of return as against the high risks stocks and equities. Records shown in

the article indicated huge investments that have been poured by investors to the bond market of the United States showing their confidence in US FED policy in 2010. The article also reported that foreign countries have also considered the US treasuries as safe investments as they moved their investments from Europe to US in 2010 because of the downgrade of its economy. However, the influx of investments pressured a lower yield of bonds. This means that investors would have lesser rate of return for their investments as investments in bonds increases. I think that investment is a game of chance, one bets on the likely winner taking into consideration the consequences of the high and low risks scenario. In the present setting, government bonds investments is more favorable to investors because it gives a fixed rate of return although in a relatively smaller rate than would be in equity. Under a favorable economy, investors would stake their investments in equity that gives better rate of return than bonds in a short term. Thus, as I have observed, the investments in bonds is a reflection of government policies that could either attract or reduce investments. As shown in the article, when the government announces buying of treasuries, interests on bond investment increases that eventually reduces the rate of return. On the other hand, any economic indicator that shows economic improvement would result to investment in equities and a reduction in bond investments. Conclusion The role of the United States as a stabilizer is clearly seen from its efforts in buying back treasuries in order to flood the market with money to stimulate economy. This cushions the effect of the slowing down of equity trading when investors turn of treasury investments. The bond market provided a safe haven from foreign investors who need a

place to deposit their investments as shown in the case of European investors. When the European economy weakened, they chose to deposit their money to the US bond market. However, in conclusion, the bond investment trend is also subject to fluctuation because when the economy clears up, a downward bond trend is most likely to be seen. Why, because equity offers a higher rate of return in a short range than bonds that takes years to mature. Reference " 2011 Bond Market Outlook & 2010 Year End Bond Summary". The Investment Blog. 26 Dec. 2010. 18 July 2011