Country Analyst

URL: www.uobgroup.com/research
Email: EcoTreasury.Research@uobgroup.com
Bloomberg: UOBR

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The Recent Up-Move in US Treasury Yields: Signals and Implications

Thomas Lam
(65) 6538 2169
Thomas.LamTL@UOBgroup.com

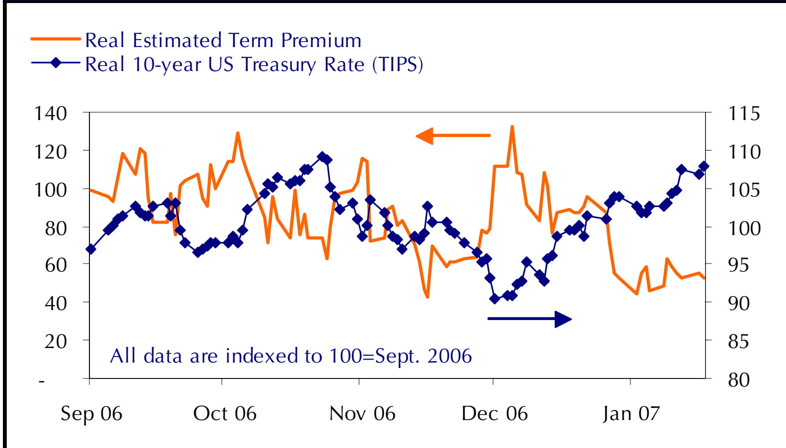
Jimmy Koh
(65) 6539 3545
Jimmy.KohCT@UOBgroup.com

- The 10-year US Treasury yield has recently increased by more than 30bps to around 4.80% from its low in early December 2006. Evidently, the up-move in yields was in response to the inspiring tone of the latest batch of economic releases, which apparently led to some degree of pullback in Fed rate cut expectations as well.

- To be sure, the rise in longer-term Treasury yields (5-year and over) was entirely due to the increase in the real interest rate component, while the implied inflation expectations component either edged marginally lower or remained roughly flat. One interpretation of the foregoing development is that market participants on balance might have revised up their expectations of future growth prospects. And, as a corollary, revised down their outlook on the need for monetary policy accommodation. It is important to emphasize, however, that insofar as the longer-term implied inflation expectations component remains well-anchored, and that the upward trajectory in core inflation has begun to lose some momentum, there is no pressing need for the Fed to talk-up the likelihood for further policy firming in the near-term.

- Since the real interest rate component also consists of a term premium variable, it is necessary to extend the analysis further. Indeed, the term premium variable has been an important driver in keeping long-term interest rates low, even as the Fed continued to tighten policy from June 2004 through June 2006. By the author's calculation, the downward drift in the implied real term premium measure from early December through the latest week of this month further reaffirms the aforementioned message on the increased possibility of an orderly growth trajectory (or decreased possibility of a pronounced downshift in growth prospects).

Real Rate & Term Premium



Source: US Treasury, Fed and proprietary data

- On the whole, the foregoing developments in longer-term real US Treasury yields suggest that the Fed is not likely to signal on any imminent rate cut or rate hike moves at this juncture. This is because the goods sector--in particular housing and select industries within manufacturing--is still going through some adjustments, and it is not entirely clear if the weakness in the goods sector might spillover into the services sector. In addition, the different measures of longer-term inflation expectations and core inflation have either receded or displayed less upside momentum.

- Nonetheless, it is important to bear in mind that the sizable magnitude of positive contributions to overall GDP growth in 4q06 from consumer spending and net exports specifically is not expected to be sustained in the subsequent quarters in 2007. On the other hand, some degree of improvement in the subdued pace of business fixed investment on equipment and software and the inventory drag in 4q06, however, should provide some positive offset. Essentially, if the tone of the incoming economic releases in early 2007 suggests less downside risks from the goods sector (manufacturing and construction in particular) and continued support from the services sector, then it is necessary to revisit our existing Fed policy forecast.

- At this juncture, however, we continue to expect the Fed to reduce the target fed funds rate--perhaps as early as the middle of this year--on the assumption that real GDP growth softens below 2% and core inflation (as measured by the core PCE price index) recedes gradually towards 2% or slightly lower in the second-half of 2007.