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Current Yield: Watch Your Assets, Mr. G Warns Yet Again

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In another blunt warning about asset values, Federal Reserve chief Alan Greenspan said bubbles fueled by "market exuberance" invariably burst, but for policy makers to buffer them successfully is "simply not realistic."

Investors and economists took his comments, made at an economics conference in Chicago sent out by satellite, as an indication that several more rate hikes lie ahead, to prevent further overheating in both the housing and bond markets.

But there are signs that Greenspan's words and deeds are serving their purpose. Many mortgage lenders, from giant Countrywide Financial (ticker: CFC) to New Century Financial (NEW), which focuses on borrowers with blemished credit records, have seen their share prices drop markedly since the summer. In 11 consecutive meetings since June 2004, the Fed has raised the federal-funds rate, taking it to 3.75% from 1%.

Daniel Dektar, the chief investment officer at Smith Breeden Associates, says the jump in energy prices also is helping to do the Fed's job in tightening financial conditions. "The energy shock is doing some of the work for the Fed, taking money out of consumers' pockets," he says.

Even so, Greenspan has and will continue to talk tough -- as he did last week on asset values -- until the end of his 18-year tenure as chairman in January. "History cautions that extended periods of low concern about credit risk have invariably been followed by reversal, with an attendant fall in the prices of risky assets," he said Tuesday.

Someone was listening: Mutual funds that invest in risky high-yield junk bonds saw outflows of \$1.30 billion in the week ended Wednesday.

Dektar says a fed-funds rate of 4.25% seems reasonable, given how "rate-sensitive" the economy has become.

Meanwhile, the short end of the yield curve is largely pricing in some amount of forward Fed tightening. On Friday, the new two-year note ended at 4.18%, up from its auction yield of 4.095% Wednesday, while the yield on the benchmark 10-year note settled at 4.33%, up eight basis points (hundredths of a percentage point) on the week. The yield on the 30-year Treasury bond closed the week at 4.57%, up five basis points.

One hundred and fifty basis points. That's how much higher the yield on the 10-year benchmark T-note, currently around 4.30%, might be if foreigners had not purchased Treasury securities over the 12 months ended May, according to a Federal Reserve study.

University of Virginia researchers Veronica Cacdac Warnock and Francis E. Warnock say that capital inflows from foreigners have had a "significant" impact on U.S. long rates over a decade. Even a "step-down" to average inflows would imply an increase of 105 basis points, the husband-and-wife team said. (He worked on the the study, which can be found at www.federalreserve.gov/pubs/ifdp/2005/840/default.htm, while he was at the Fed.)

Greenspan has expressed heightened concern that low bond yields -- which largely set mortgage rates -- might

have helped produce "froth" in the housing market. Foreign demand has helped hold down long-term rates. Overseas investors held a record 45% of all outstanding U.S. Treasuries at the end of June, up from 43.5% at the end of 2004. And purchases of corporate bonds and agencies by private global investors have accelerated to 83% of the total outstanding, from 54% in 2003.

The Warnocks assert that bond purchases from private foreign investors are in the aggregate "much larger than the headline-grabbing foreign official institutions," such as central banks. That's worrisome, because private foreign investors seek to maximize total returns and are more prone to reallocate their holdings than central banks, such as the Bank of Japan, which seek to maintain stability. "Foreign ownership of U.S. assets has never been higher," writes Joseph Quinlan, chief market strategist at Bank of America, in a recent research report. "The extent to which foreign investors are willing to underwrite America's financial obligations will be increasingly critical to the health and long-term viability of the U.S. financial markets."

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