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CURRENT YIELD

How to Play the Big Easing

QE2 looks like a near certainty, so investors should consider buying TIPS in an environment where inflation will be stoked and the dollar will weaken.

By DEBORAH LYNN BLUMBERG Updated Oct. 11, 2010 12:01 a.m. ET

For the Treasury market, more "quantitative easing" is a done deal: Investors are convinced that the Federal Reserve will have to launch another big bond buying Program by year end to prevent the economy from tumbling into another recession.

The bond market's hefty rally over the past several weeks is a sure sign of that conviction. Investors have watched U.S. economic data deteriorate this year and have taken to heart recent remarks from Fed officials that both unemployment and inflation are at unacceptable levels, suggesting fresh support will be necessary. One goal of bond buying would be to pull Treasury yields down even further, taking borrowing rates, particularly mortgage rates, down, too, and helping to spur growth.

But the cranking up of the printing presses could also hurt the dollar and stoke inflation fears. That scenario, in turn, could stoke fresh interest in Treasury Inflation Protected Securities, or TIPS. Prices of TIPS have climbed steadily for the last two months, getting a sharp boost in mid September.

Even at those levels, TIPS look like pretty good buys, says Sean Simko, head of fixed income at SEI, an Oaks, Pa., investment manager that oversees about $149 billion in assets. TIPS prices are likely to push up even more with the onset of additional QE, as fears intensify that the additional stimulus could spark inflation.

Certainly, investors are "strapped in for another round of Fed asset purchases," said William O'Donnell, head of U.S. government bond strategy at RBS Securities in Stamford, Conn. O'Donnell, in a recent visit to 20-odd clients in the Midwest and Europe, found that all were bullish on the bond market.

Market participants believe the Fed could broadcast more buying within the next few months and are waiting with bated breath for details. Seventy percent of institutional fixed income investors polled in a recent Jefferies & Co. survey expect the central bank to announce more quantitative easing at the Nov. 3 Federal Open Market Committee meeting; 70% also believe that Bernanke & Co. will reveal purchases incrementally, rather than in one sweeping announcement.

"Unless the economy does a 180, QE2 will probably happen," says Simko. "The lingering question is how much and in what form," he adds.

Most market participants are projecting Fed buying will total $500 billion to $1 trillion, which would dwarf the $300 billion in Treasuries the Fed bought during its first large-scale quantitative easing program last year. Just how much Treasury rates move on more QE will depend on the size and frequency of the buying.

The 10-year Treasury yield, which moves inversely to its price, has already fallen by about 25 basis points (a quarter of a percentage point), owing to expectations of another round of large-scale Treasury buying, says Michael Pond, a strategist at Barclays Capital in New York.

The actual announcement by the Federal Reserve could be worth another 15 to 20 basis points for the 10-year yield, on a sustained basis, predicts Tom Porcelli, a vice president and economist at RBC Capital Markets in New York, but the market's initial, kneejerk reaction might be more exaggerated.

The Fed's last announcement of quantitative easing inspired just such a kneejerk rally in the Treasury market, with the 10-year yield falling by about 50 basis points—from 3.01% to 2.54%, on the central bank's announcement that it would buy bonds. This time around, the initial move in Treasuries probably will again be strong.

Friday, the 10-year yield fell to a fresh low for the year, 2.332%, a level last seen in January 2009. The 10-year yield hit a record low of 2.037% in December 2008. •

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