

VAKIFBANK GLOBAL ECONOMY WEEKLY

**Why US treasury yields are increasing
despite of QE2?**



T. Vakıflar Bankası T.A.O

10 January 2011

No: 11

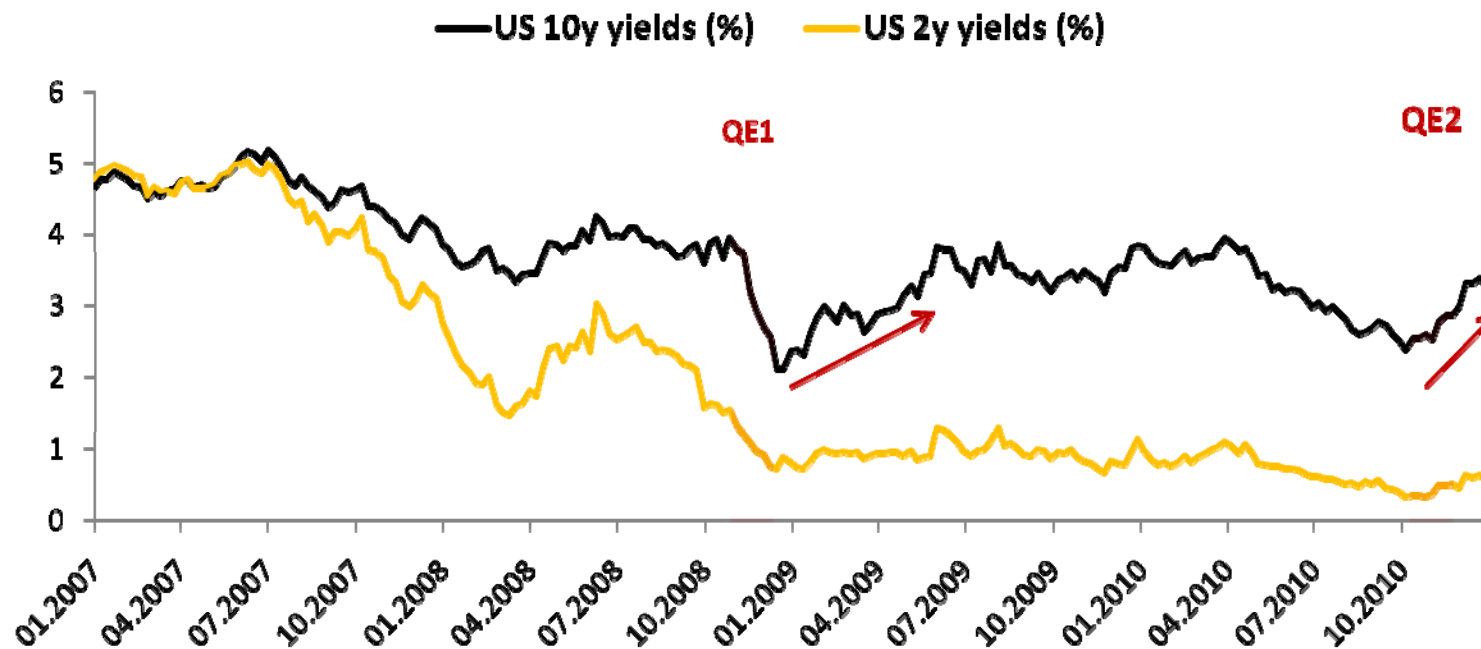
Vakifbank Economic Research



QE1 and QE2...

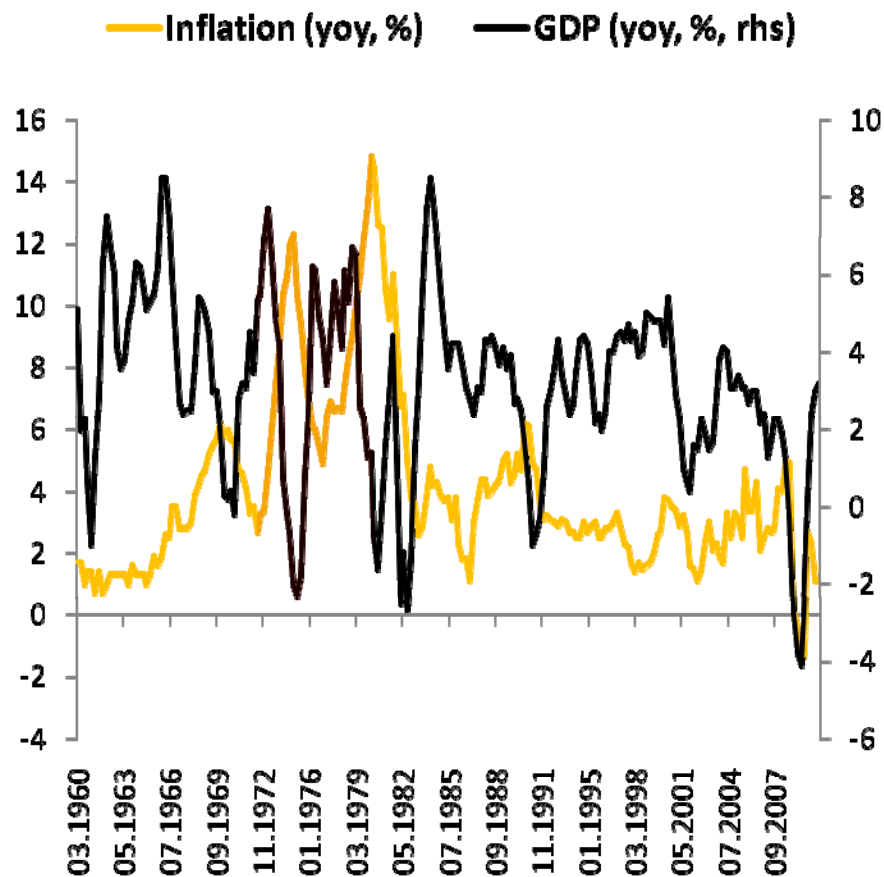
For the FED, the main objective of quantitative easing is to stimulate economic activity by cutting down interest yields on bonds, and thereby forcing investors to invest in more risky assets such as equity. However, the outcome has been so far contrary to expectations. Having briefly fallen, yields started going up with the FED's \$600 billion asset purchasing programme and US 10y yields which decreased to 2.40% in October 2010, rised by 100 bp to 3.40%. In fact similar movements took place after QE1 programme started at the end of 2008.

There are some reasons of this rise that could be categorized under four headlines;



Source: Bloomberg

1) Increase in Economic Growth Expectations and Inflation Concerns



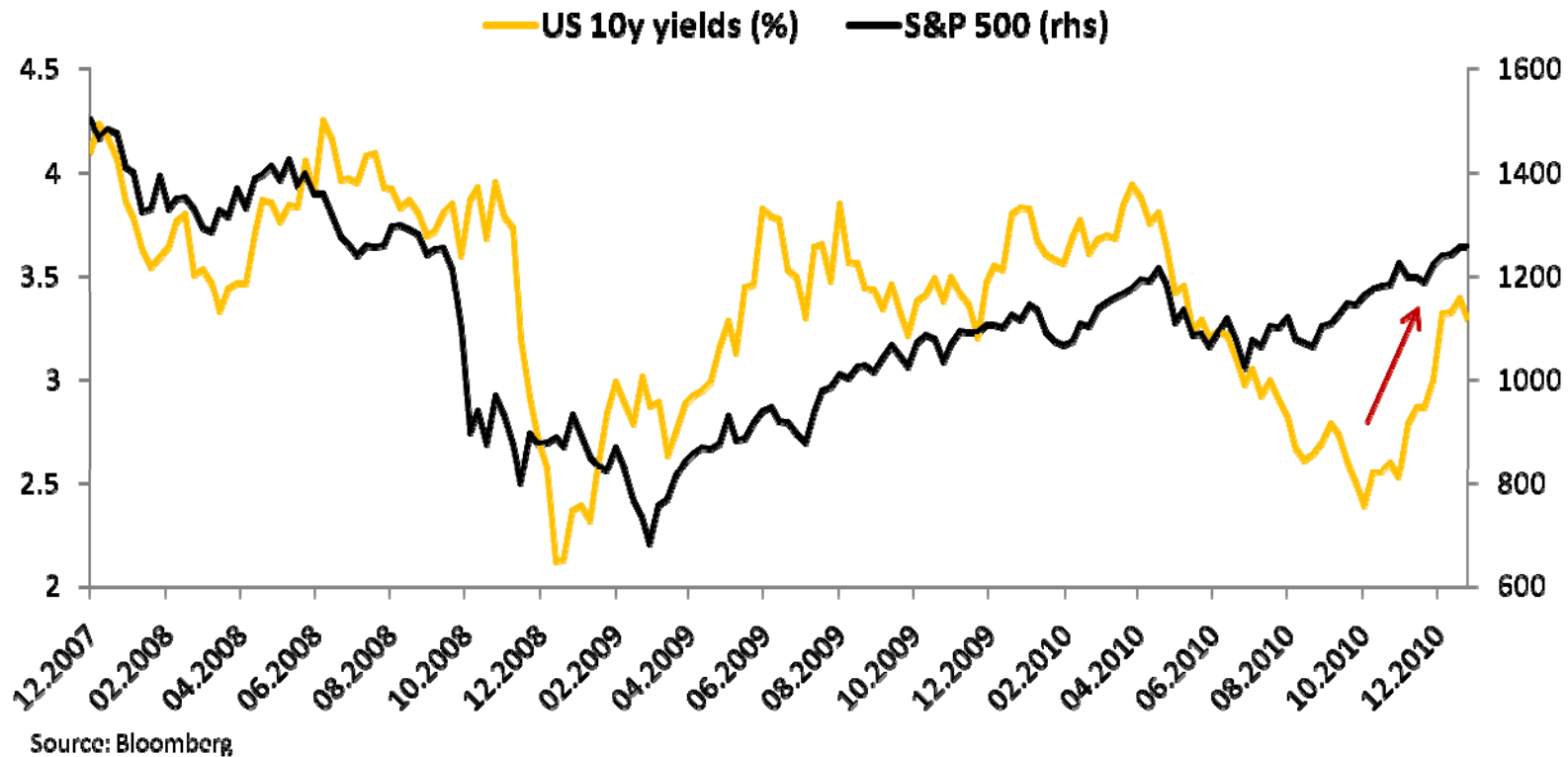
Source: Bloomberg


✎ The latest US economic indicators support the growth expectations. Besides, FED's QE2 programme has increased liquidity in the market. Rising liquidity along with the higher growth expectations diminished the deflation concerns. Hence recent sell-off in the US treasuries is not a surprise.

✎ Due to the economic recovery and increasing global liquidity, commodity prices are expected to go up further. So increasing commodity prices may lead to the rise in inflation during 2011.

✎ But high inflation along with high unemployment rates (providing that natural rate of unemployment is higher than the secular trend) might cause a stagflation (tail risk) as seen in 1970's-1980's. It is quite obvious that economic recovery is still fragile in US.

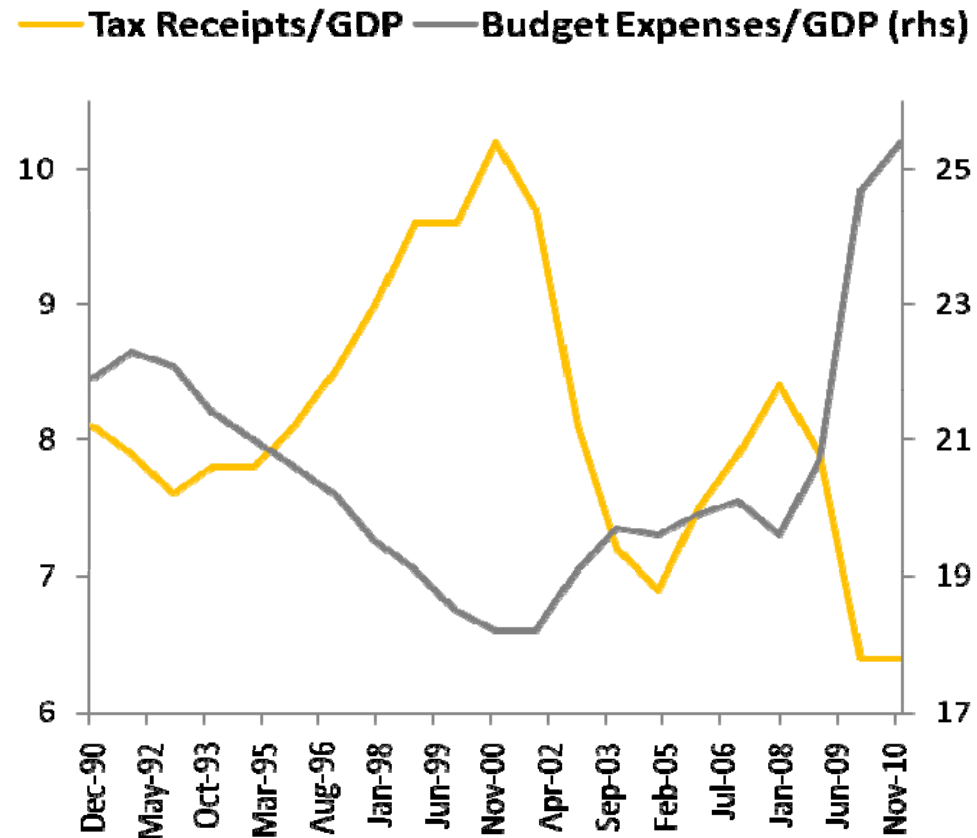
2) Decline in Safe Heaven Demand Depending on Expectations of Improved Economic Growth



-  Due to recent economic recovery and increasing liquidity, safe heaven demand for US treasuries has declined whereas demand for risky assets like equities has increased.

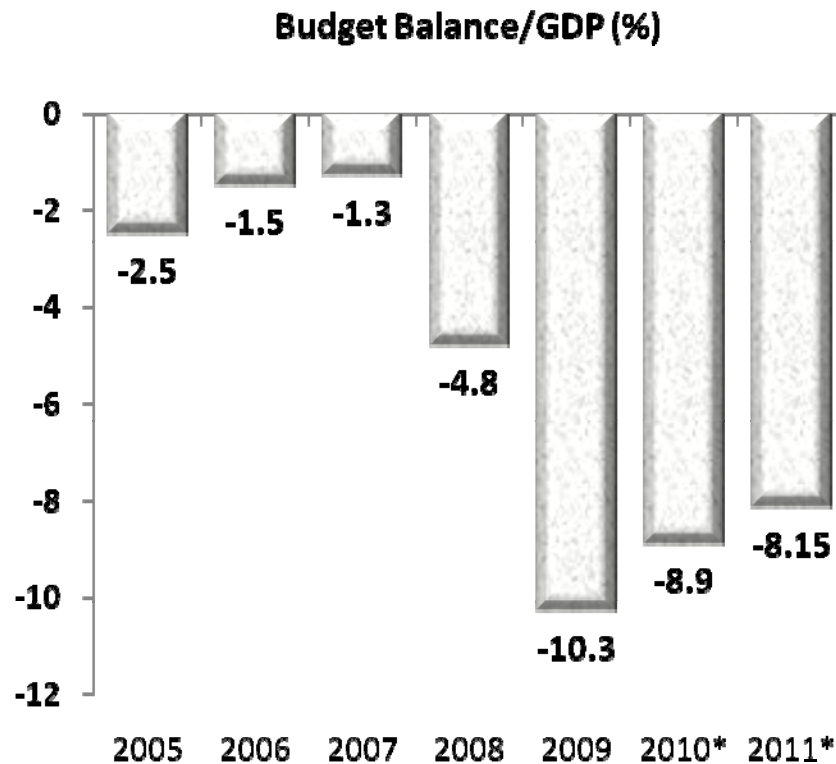
3) Tax cut extension renewed the concerns about US fiscal problems and budget deficit

After a two-year extension of tax cuts in US, widening US budget deficit in future has become a concern in credit market. On the other hand, there is a high sense that recent tax extension will stimulate the economic activity. Therefore market players' risk appetite have increased and leads investors to switch from US treasuries to equity and commodities.



Source: Bloomberg

Budget deficit is higher than the pre-crisis levels...



Source: Bloomberg
*: Forecast

- US Budget deficit/GDP increased to 10.3% in 2009. It is subsequently expected to be around 8.9% and 8.15% in 2010 and 2011 (higher than pre-crisis levels)
- If that will be the case, tax cuts might increase US debt burden in future thus overshadowing underlying economic recovery. Therefore the cost of this tax cuts may exceed its benefits.

4) Although FED was expected to buy \$2 trillion treasuries, declared asset purchasing programme was \$600 billion

- 📌 In September 2010, Fed gave the market a first signal of QE2 programme. At the beginning, the total amount of programme was expected to be \$2 trillion. Since market was pricing such an amount, treasury yields declined to the lowest levels of 2010.
- 📌 Reducing the amount of QE2 programme is another reason for the increasing rates.
- 📌 As the economic indicators denominated recovery, market expectation of the amount of the QE2 was reduced and market suspects that FED may stop QE2 with only \$600 billion announced in November 2010.

As a result after the QE2, the rates moved upward in contrary to FED's expectations.

How will the rates move in 2011?



- Due to an increase in personal income, consumption and wages as well as tax cuts, there will be a good support for an economic growth.
- Industrial production begin to increase in China. So positive expectations about EM's will feed rising interest rates in 2011.
- Under these assumptions, US treasuries sell-off will continue in 2011.



- Heavy debt burden that impedes US consumers' wealth and upward movement in rates may worsen the environment for households and firms due to higher borrowing costs, this may restrict the positive contribution of asset purchasing programme to the economy.
- In this situation, investors may increase the treasury purchases with an expectation of an prolonged recession.

Serkan Özcan
Chief Economist
+ 90 312 455 7087
serkan.ozcan@vakifbank.com.tr

Cem Erođlu
Senior Economist
+ 90 312 455 8480
cem.eroglu@vakifbank.com.tr

Bilge Özlap Türkarıslan
Economist
+ 90 312 455 8488
bilgeozalp.turkarıslan@vakifbank.com.tr

Fatma Özlem Kanbur
Researcher
+ 90 312 455 8482
fatmaozlem.kanbur@vakifbank.com.tr

Elif Artman
Researcher
+ 90 312 455 8490
elif.artman@vakifbank.com.tr

T. Vakıflar Bankası T.A.O
Ataturk Bulvari No: 207
Kavaklıdere 06683 Ankara, Turkey
www.vakifbank.com.tr

Vakıfbank Economic Research
ekonomik.arastirmalar@vakifbank.com.tr

The information in this report has been obtained by Türkiye Vakıflar Bankası T.A.O. from sources believed to be reliable. However, Türkiye Vakıflar Bankası T.A.O. cannot guarantee the accuracy, adequacy, or completeness of such information, and cannot be responsible for the results of investment decisions made on account of this report. This document is not a solicitation to buy or sell any of the securities mentioned. All opinions and estimates included in this report constitute our judgment as of this date and are subject to change without notice. This report is to be distributed to professional emerging markets investors only.
