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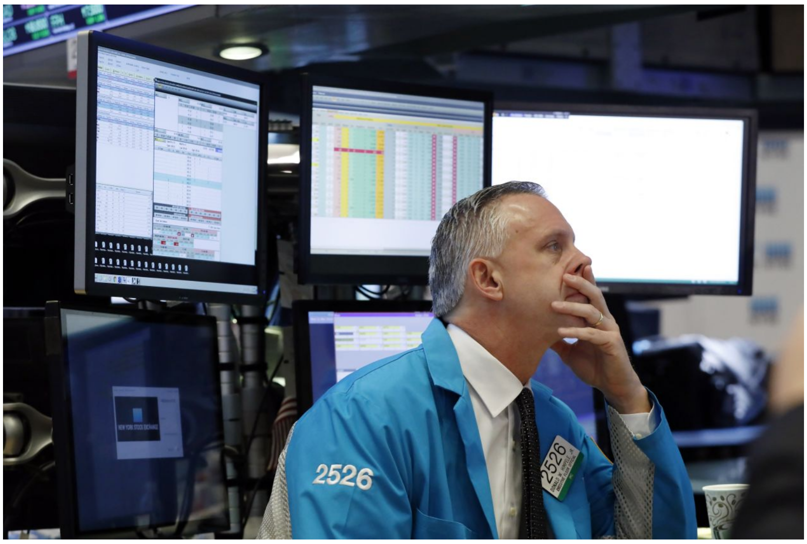
CREDIT MARKETS

Weak Economic Data Spurs U.S. Government Bond Rally

Indicators help lower expectations for inflation, Fed rate increases



The yield on the 10-year Treasury note broke through the bottom of its recent trading range. It settled at 2.594%, from 2.628% Thursday. **PHOTO:** RICHARD DREW/ASSOCIATED PRESS

By Daniel Kruger and Sam Goldfarb

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A key U.S. government bond yield fell near its lowest levels of the year Friday after a series of reports showed signs of weakness throughout the manufacturing sector, adding to concerns about the U.S. economy.

The yield on the 10-year Treasury note, which helps set borrowing costs for consumers, businesses and state and local governments, broke through the bottom of its recent trading range. It settled at 2.594%, the lowest close since Jan. 3. The yield had been at 2.628% Thursday. Yields fall as bond prices rise.

The 10-year yield began declining at the start of U.S. trading, a fall that accelerated after reports showing manufacturing output, factory orders and other measures of production were weaker than economists had forecast. The data boosted traders' expectations that weaker growth and muted inflation will keep the Federal Reserve from further interest-rate increases this year.

Bond yields have retreated from multiyear highs near 3.25% reached in November as investors have become increasingly concerned that global growth is slowing. Inflation and interest-rate increases by the Fed are two of the biggest threats to Treasurys. Inflation erodes the purchasing power of bonds' fixed payments, while rising short-term interest rates typically have a knock on effect on Treasury yields, pushing prices lower.

Investors will get a fresh look at the Fed's outlook for the economy next week at the central bank's regularly scheduled meeting at which it is expected to hold interest rates steady for a second consecutive meeting. JPMorgan economists Thursday said they no longer expect policy makers to raise interest rates this year.

"The Fed is data dependent, and the data is weakening," said Thomas di Galoma, head of Treasury trading and a managing director at Seaport Global Holdings.

Investors Friday increased their wagers that the Fed will lower interest rates this year. Fed-funds futures, which investors use to bet on central bank policy, showed the probability of a rate cut by year end had climbed to 26% from 17% a week ago. Odds currently show no chance of a rate increase.

Demand for U.S. government debt picked up after the 10-year yield fell below 2.6%, which had been a closely watched level among investors, said Larry Milstein, head of U.S. Treasury and agency trading at R.W. Pressprich & Co. Investors had been testing that barrier for a few trading sessions, starting with the release of weaker-than-expected inflation data on Tuesday.

"It's almost a snowball effect," Mr. Pressprich said. "These things take on a life of their own as more people pay attention to them."

The persistence of muted inflation, together with a relatively clear message from Fed officials that they won't raise rates in the absence of strong inflation, has given investors confidence to buy Treasurys despite yields remaining near the bottom of their recent trading range, analysts said.

"Even though we are getting reasonable growth, there's just no inflation pressure on the economy," said Zhiwei Ren, portfolio manager at Penn Mutual Asset Management, who has recently been buying five-year Treasurys on the belief that the Fed will be extremely cautious about raising interest rates.

While investors have been concerned about signs the U.S. economy is decelerating, the outlook has been worse elsewhere in the developed world, particularly in the eurozone. The European Central Bank recently slashed its forecast for 2019 growth to 1.1% from 1.7% and signaled that it no longer expects to raise interest rates this year.

Responding to the faltering economy, the ECB even announced plans for a fresh batch of cheap long-term loans for banks—a return to the type of monetary stimulus many investors thought had been left behind last year when developed-market economies appeared to be strengthening together.

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