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# Monetary*Trends*

# 30-Year Bond Faces Uncertain Future

Market yields on intermediate- and long-term U.S. Government securities, especially the 30-year bond, declined sharply between mid-January and late February 2000. Yields on securities of 10-30 years maturity also fell below those on intermediate-term securities. The decline in yields might signal a decline in expected inflation, as lower inflation makes fixed-income securities more attractive to investors. The decline in yields on long-term securities below those on shorter-term securities also could reflect market expectations that the pace of economic activity will slow, as many forecasters now predict.

Alternatively, the decline in yields might be related to an announcement by the Department of the Treasury of a plan to reduce the average maturity of outstanding U.S. Government debt, which would reduce the expected supply of such securities. Pension funds, and other investors with long-term commitments, buy intermediate- and long-term U.S. Government and other securities to hedge future liabilities. Thus, the recent decline in yields might reflect market purchases in anticipation of a reduction in future supply of such securities.

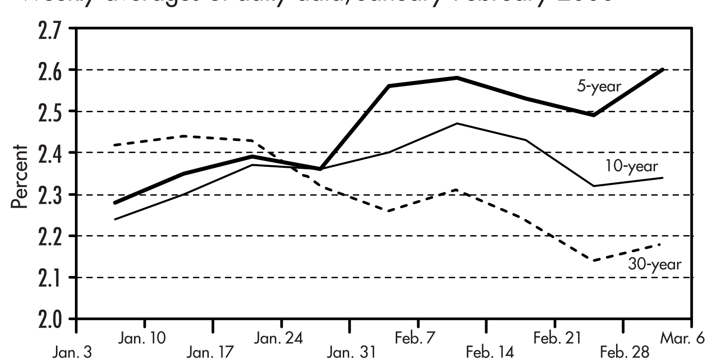
Yield spreads between conventional and inflation-protected Treasury securities (TIPS) offer one clue of the public's inflation expectations, and might help untangle the reasons for the decline in market yields. Other things being equal, a decline in the market yield on a conventional security, relative to the yield on an inflation-protected security of similar maturity, would indicate that expected inflation had fallen. The chart shows that during the last two weeks of January and during February, the spread between 30-year conventional securities and TIPS fell substantially, possibly indicating a decline in expected inflation. Yield spreads for 5- and 10-year securities, however, did not decline–in fact, the spread for 5-year securities increased. Moreover, throughout February, the yield spread for 30-year securities was smaller than those for 5-and 10-year securities–a phenomenon that had not previously occurred since 30-year TIPS were first issued in April 1998 (see chart on page 11).

The divergence of TIPS and conventional security yields across securities of different maturity suggests that the recent behavior of government security prices, especially the price of the 30-year bond, has not been dominated by changes in inflation expectations. It seems doubtful that market expectations of inflation over a 30-year horizon would have declined while expected inflation during the next 10 years stayed the same or even increased. The coincidence of large declines in market yields on conventional Treasury securities, especially the 30-year bond, with the Treasury Department's announcement on February 2 of a planned reduction in the issuance of intermediate and long-term securities, and the repurchase of parts of some outstanding issues, suggests further that yield changes have been driven more by changes in expected supply than by demand. Thus, while bond yields in general reflect market expectations about inflation and economic activity, they also can–at least in the short run–reflect purely idiosyncratic changes in market demand or supply.

—David C. Wheelock

**Inflation-Protected Treasury Yield Spreads**

Weekly averages of daily data, January-February 2000

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