As Treasurys Rally, Investors Reassess

By Min Zeng and Katy Burne

U.S. Treasury bonds are staging a comeback after a rocky start for financial markets around the world this year.

Investors are returning to the $11.8 trillion market amid selloffs in stocks and emerging-market currencies. Investor confidence in the outlook for the U.S. economy has also become more mixed as China's growth slows and U.S. employment progress founders.

The turnaround is upending investors and prognosticators' consensus view at the end of 2013 that the Federal Reserve's pullback from its bond-buying program and an improving economy would set interest rates on a steady path upward.

Instead, the 10-year Treasury note's yield has dropped more than 0.3 percentage point this month, heading for its biggest monthly decline since May 2012. Bond yields move inversely to prices.

Many expected the 10-year Treasury note yield to be over 3% for most of this year. The rate sets the cost of borrowing for consumers, corporations and other nations. In December, wagers that Treasury bond prices would fall and yields would rise hit multiyear highs.

The 10-year note's price fell Thursday as U.S. stocks rose on the back of a strong report of U.S. fourth-quarter gross-domestic-product growth, sending its yield up to 2.693% from 2.675% late Wednesday. Still, the yield is lower now than on Dec. 18, when the Fed announced that it would start cutting back its purchases of government and mortgage bonds. On Wednesday, when the Fed announced another cutback, Treasury yields fell.

"Many of the bond market dynamics this year may be distinctly different, in fact almost the opposite of what happened in 2013, and you have seen that playing out somewhat this month," said Rick Rieder, co-head of Americas fixed income at BlackRock Inc.

BlackRock is piling into Treasury bonds this month, as is Pacific Investment Management Co., or Pimco, two of the world's biggest asset-management firms.

Mr. Rieder said his company has bought 30-year Treasury bonds in the past few weeks. BlackRock is the world's largest money manager, with $4.32 trillion of assets under management at the end of December.

Bill Gross, who runs the world's largest bond fund by assets at Pimco, wrote on the company's official Twitter account Wednesday that he has been buying Treasury bonds.

Mr. Gross said earlier this month in his investment outlook letter that he expects bonds this year to post 3% to 4% in total returns, which include interest payments and price appreciation.

Treasury bonds overall have handed investors a return of 1.3% this month, with U.S. government debt maturing in a decade or more gaining more than 5%, a jolt that has helped drive up prices in other bond markets that take cues from Treasury rates. The Barclays U.S. Aggregate Bond Index, which measures performance of U.S. fixed-income markets, has posted a total return of 1.5% this month through Wednesday, according to Barclays. The index lost 2% in 2013, the biggest annual decline since 1994.

Strategists across Wall Street are rethinking their views for Treasurys and interest rates after the shift this month.

Michael Swell, co-head of global portfolio management at Goldman Sachs Asset Management, which oversees $360 billion of fixed-income assets, said he previously expected the 10-year Treasury to yield 3.5% to 4% by the end of 2014, but in light of recent market jitters said "it's probably more 3.5% to 3.75%."

"There is more volatility in the markets [so] the outcomes could be more dispersed than we originally thought," he said.

Ian Lyngen, a government bond strategist at broker-dealer CRT Capital Group LLC, said the emerging-markets selloff and a minimal reaction to the Fed's bond-buying pullback led his firm to shift its forecast for the 10-year yield from between 2.75% and 3.25% for the first half of 2014 to between 2.50% and 2.95%.

Investors have also dialed back bets that interest rates will rise.

As of Jan. 21, the market's bets that 10-year Treasury prices would fall dropped 21%, to $35.2 billion, from $44.6 billion at the end of December, according to an RBS Securities Inc. analysis of the weekly data from the Commodity Futures Trading Commission.

Still, some investors said the race to the safety of U.S. government debt is overdone, and they are betting yields will change course and soon move above 3% again.

Jason Graybill, a senior managing director at Carret Asset Management, who oversees $1.2 billion of fixed-income assets, said that over the past two weeks he has been increasing his position in an exchange-traded fund that will pay off if the 10-year Treasury yield rises to 3.25% or more.

UBS AG two weeks ago raised its forecast for the 10-year Treasury yield in 2014. Michael Schumacher, head of rates and credit strategy globally at the Swiss bank, said investors have been too complacent about the impact of rising rates this year. Going into January, his target was for a year-end yield of 3.20%, but he raised it to 3.50%, largely because the emerging-markets selloff is "not a complete meltdown," he said.

Still, some investors and strategists are sticking with their predictions, but they said recent headwinds might change the course of interest rates in the near term.

"There is a big wall of worry out there right now and that is keeping rates low, and some of the bricks need to be knocked out of that wall before we see rates go higher," said Alex Roever, head of U.S. interest rates strategy at J.P. Morgan Chase & Co. He said the bank's forecast of 3.65% by year-end on the 10-year Treasury note hasn't changed, despite recent moves.

Mr. Rieder said he still thinks Treasury bond yields may drift higher this year, but he said the biggest increase will be led by yields on bonds that mature in three to five years. Last year, most investors sold 10-year and 30-year bonds, driving their yields higher, as they are the most affected by the Fed's decision to cut back on its stimulus efforts.

"With yields rising over the past year, buyers such as pension funds, insurance companies and money managers have been buying longer-dated bonds at more attractive and less distorted yield levels," said Mr. Rieder. Pension funds and insurers need to buy safe but higher yielding assets to fund their obligations.

Write to Min Zeng at min.zeng@wsj.com and Katy Burne at katy.burne@wsj.com