{Talk From The Trenches: Supply/Demand Equation Eyed Warily>}

By Isobel Kennedy

NEW YORK, March 31 (MNI) - The Treasury market moved higher early Thursday on a continuation of month-end and quarter-end buying but came off the highs as some selling came into the market.

The 10-year note reached a low yield of 3.40% early in the session but about mid-morning a slew of selling hit the market and prices retreated. The 10-year hit a high yield of 3.478% at the lows vs. its closing level of 3.455% on Wednesday.

Market sources said there were sellers of 80,000 10-year contracts and 30,000 30-year contracts in a very short span of time. It is unclear if it was all the same seller but the selling was believed to have come from a real money account.

The bond market was also a bit spooked by a move from the New York Fed to unload some assets that were obtained in October 2008 from AIG in the midst of the financial market meltdown.

The NY Fed said late Wednesday it would begin "more extensive asset sales" from its Maiden Lane II portfolio. The sales will take place via a competitive bidding process managed by Blackrock Solutions and the first bidlist should be circulated next week.

The sales will take place gradually so as not to disrupt the financial markets.

Sources were not surprised that the sales would take place on a competitive basis but the idea that, over time, the Fed might consider accepting offers directly from buyside investors was surprising.

And Jesse Litvak, managing director at Jefferies & Co, said fact that the Fed is going to publish the name of the buyer and the exact price paid three months after the sale might deter some investors from bidding directly. He suspects that dealers will end up entering the bids for the ultimate customers.

Dealers will not only be committing capital for the house, he said, "but we are going to be working with partners/accounts in order to try help the process along" and so the small transaction fee that will be paid will have been earned.

Litvak also aptly notes that Fed will be very mindful of not hurting the markets and prices during the process and that "they are not a forced seller."

He notes the Maiden Lane II portfolio is comprised of subprime, fixed, hybrids, MTA, and CDOs.

He said it is "mostly top of the capital structure paper, and then a decent smattering of" subordinated paper.

Litvak thinks the initial sale next week will probably include "a little bit of everything" or a good representation of the entire portfolio.

The Maiden Lane II portfolio has a market value of about $16.5 billion and a face value of about $30 billion.

Intellectually, people don't really view this Fed selling as marking a change in monetary policy. But any seat of the pants bond trader would admit that this clearly changes the supply and demand fundamentals.

And the money to buy the paper that is being sold has to come from somewhere.

In other words, the Fed will be taking money from the private sector and putting it back on its own balance sheet - an unwind of some of the emergency steps they took in 2008 and 2009.

"It may not be a change in monetary policy via interest rates," one market expert says, "but they are draining money from the system."

Adam Murphy, president of Empirasign Strategies, agrees and says the sales will affect spreads in the non-agency MBS market.

"First the Treasury starts unwinding it mortgages holdings, now the Maiden Lane sales," he said.

"I'd say the major reason non-agencies have performed so well is because they're not making any more of them, and thus supply is capped," Murphy said.

"This fundamentally changes that equation," he added. "Another way to look at these sales is as a pre-hiking by the Fed."

But on positive side, Murphy said the sales will bring "much needed transparency to the non-agency market" if Blackrock conducts these auctions in the "same open manner" Treasury has sold its agency MBS holdings.

"More transparency will bring in more market participants and that can't be anything but good for spreads," he said.

Looking at the broader bond markets, market players are in a quandary about where interest rates are headed.

On the one hand, the bond markets are queasy because:

1) Treasury announced on March 21 that it would begin selling its agency MBS portfolio over the next year or so. The estimated market value is $142 billion;

2) Wednesday's decision to unwind Maiden Lane II;

3) Some recent testing of reverse repo operations by the Fed has been in larger sizes;

4) The belief that the QE2 buying will end on June 30 even though reinvesting of MBS prepayment will likely continue after that;

5) There has been a tremendous amount of Fedspeak recently whether

it be hawkish, dovish or middle of the road;

6) There has been more disagreement from the public about the Fed's perception that inflation is not a problem. Higher oil and food prices are rankling consumers;

7) Sales from Treasury and Maiden Lane II could take demand away from corporates and Treasuries;

8) Japan's nuclear/earthquake disaster is likely reducing demand from this area for US assets in general;

9) The municipal bond market could get a raft of supply soon that might force yields higher and bring in crossover buyers from other sectors;

10) There is concern about a potential rate hike from the European Central Bank next week.

On the other hand, there is also concern that higher oil prices and unsettling news from Europe, Japan and the Middle East could affect growth in the U.S.

There are also worries about the politicians in Washington, the debt ceiling and a possible government shutdown.

Although in the minority, some people firmly believe the Fed might have to be more accommodative not less even though a QE3 is probably not politically feasible.

Net to net, most analysts believe the 10-year will stay in the range of 3.25% to 3.77% for some time.

No actual interest rate hike from the Fed is expected until at least the beginning of 2012. But if history is any guide, the bond markets will price in hikes long before they occur.

There are plenty of opinions on stocks, bonds, the Fed and inflation and no one is 100% sure how Treasury prices and the various curves will move.

But there is no doubt that if and when the Fed begins selling its agency MBS holdings, the 5-year part of the curve should come under pressure.

On the data front, initial jobless claims -6k to 388k in Mar. 26 wk, slightly above expectations of 380k. Previous week revised up to 394k from prev. reported 382k, with annual revisions affecting data back to 2006. Seasonal factors expected 1.3% rise in NSA claims, but actual NSA claims near flat, falling only 156, to 354,301. 4-wk moving avg +3,250 to 394,250. Continuing claims -51k to 3.714m in Mar. 19 wk, the lowest since the Oct. 11, 2008 week.

The Chicago Purchasing Managers Index came in at 70.6 vs. 71.2 in February. But prices paid rose to 83.4 from 81.2. And employment rose to 65.6 vs. 59.8.

Keep your seat belts fastened as tomorrow is the big jobs report.

NOTE: Talk From the Trenches is a daily compendium of chatter from Treasury trading rooms, as well as some sister market trading rooms, and is offered as a gauge of the mood the financial markets. It is not necessarily hard, verified news. Email isobelk@marketnews.com

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