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U.S. Government Bonds Suffer Biggest Weekly Selloff Since June 2013

Yield on 10-year note closes at highest level since October

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Fresh signs of solid U.S. jobs growth and an uptick in wage inflation sparked a wave of selling in U.S. Treasury bonds, sending the yield on the benchmark 10-year note to an eight-month high.

Friday's price decline capped the biggest one-week selloff of the bond market since June 2013 when the bond market was rattled by the taper tantrum, or fears over reduced bond buying from the Federal Reserve.

The yield on the benchmark 10-year Treasury note rose to 2.402%, compared with 2.309% on Thursday. It is the highest closing level since Oct. 6. Bond prices fall as their yields rise.

For the week, the yield climbed by 0.305 percentage point.

Government bonds in the U.S. and Germany have sold off since late April after a strong run-up in price over the past year. Many investors are recasting portfolios as they believe the rise in bond yields reflects improving economic and inflation outlooks in the eurozone and the U.S.

The May nonfarm jobs report Friday bolstered the Fed's case to raise interest rates sometime this year, a shift investors say would shrink the value of outstanding bonds.

"The rise in bond yields is a natural process and it is a sign that the U.S. economy is moving in the right direction," said Poul Kristensen, portfolio manager with New York Life Investment Management's strategic asset allocation & solutions group, which has $9.84 billion assets under management.

Mr. Kristensen said he has been positioned for a rise in U.S. interest rates by underweighing Treasury bonds and holding a small underweight position on U.S. stocks.

U.S. Treasury bond yields have been held at historically low levels driven by an uneven pace of global economic growth, deflation concerns and monetary stimulus from the Fed and other major central banks following the 2008 financial crisis.

Investors and analysts say bonds' valuations have been stretched, especially as the Fed is moving closer to tighten monetary policy for the first time since 2006.

Higher bond yields push up long-term borrowing costs for U.S. consumers and businesses. But higher yields are a boon for long-term investors such as pension funds and life insurance firms, which have been struggling to obtain yields to match their long-term obligations such as payments to future retirees. Many have been forced to dabble into risky markets and invested in hedge funds for returns over the past few years.

Friday's report showed the world's largest economy added 280,000 nonfarm jobs in May, compared with 225,000 forecast by economists polled by The Wall Street Journal. A gauge of wage inflation in May picked up speed. Deflation scares that prevailed earlier this year have been receding. Inflation chips away bonds' returns over time.

Investors are demanding higher compensation to own longer-term Treasury bonds. The 10-year note's term premium rose to 0.384 percentage point on Wednesday, the highest since October, and doubling the level a month ago, according to data from the Federal Reserve Bank of New York.

The term premium measures the extra return a bond buyer demands to hold a longer-term bond rather than investing in a series of short-term securities.

"If growth continues to improve and wage inflation ticks higher," bond yields have room to rise, said Christopher Sullivan, who oversees $2.4 billion as chief investment officer at the United Nations Federal Credit Union in New York.

Fed-funds futures, used by investors and traders to place bets on central bank policy, showed Friday that investors and traders see a 31% likelihood of a rate increase at the September 2015 meeting, compared with 27% right before the jobs report and 26.2% Thursday, according to data from the CME Group.

The odds of a rate increase at the June 16-17 policy meeting remain at zero.

Investors pulled money out of Treasury bond funds and exchange-traded funds for a second consecutive week, but the pace of redemption slowed. The fund group saw a net withdrawal of $89 million cash for the week that ended June 3, according to fund tracking company Lipper, following an outflow of $2.187 billion in the previous week.

This year through June 3, the fund group has attracted a net cash inflow of $7.465 billion.

Many investors don’t expect bond yields to jump sharply from here. While jobs growth has been solid, consumer spending has been lackluster. An inflation gauge closely tracked by the Fed has stayed below the central bank’s 2% target for years.

Complicating the Fed’s tightening plan is a stronger dollar. The jobs report Friday sent the dollar to the strongest level against the yen since June 2002. The dollar’s strong rally in the first quarter attributed to the pullback of the U.S. economy. A higher dollar hurts U.S. exports and earnings by U.S. multinational companies from overseas operations.

“The odds of a rate increase in September are increasing,” said Mike Lorizio, senior fixed income trader at Manulife Asset Management. “But the question is could the economy withstand much higher bond yields from here? The economy is not overheating, so the Fed is right to be patient.”

The International Monetary Fund on Thursday called for the Fed to hold off on its first rate increase until 2016 as it slashed its forecasts for U.S. economic growth.