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Dealer U.S. Bond Holdings Top Corporates for First Time

Jan. 17 (Bloomberg) -- For the first time, Wall Street's biggest bond-trading firms hold more U.S. Treasuries than corporate securities, signaling concern the economy's rebound will be too slow to sustain record demand for riskier assets.

The 21 primary dealers that trade directly with the Federal Reserve held a total of $74.7 billion of Treasuries as of Dec. 28, compared with $61.1 billion of company debt, according to Fed data. The aggregate position in U.S. government bonds has increased from a $38.6 billion bet against the securities in May, while corporate holdings have tumbled 50 percent from $121.8 billion.

While the Standard & Poor's 500 Index rose 15 percent since the start of the fourth quarter, corporate bond sales worldwide are off to a record start and the U.S. jobless rate is the lowest since February 2009, Fed policy makers say more monetary easing may be needed to ensure growth sticks. JPMorgan Chase & Co. economists said Jan. 13 that they see gross domestic growth slowing to 2 percent this quarter from 3.5 percent in the final three months of 2011.

"Dealers, at least, don't think the economy's going to pick up speed in a hurry," Ira Jersey, an interest-rate strategist at Credit Suisse Group AG in New York, a primary dealer, said in a Jan. 10 telephone interview. The economy isn't heading "into recession, but more of the same, meandering growth instead of a significant pickup in growth and inflation," he said.

Economic Headwinds

The tilt to Treasuries reflects sentiment that the U.S. economic recovery will be held back by sovereign-debt turmoil in Europe, weakness in domestic housing prices and only a partial recovery of jobs lost since 2008. That the economy still needs a boost is underscored by the Fed's pledge to keep its target interest rates for overnight loans between banks at historic lows of zero to 0.25 percent through mid-2013.

Treasuries outpaced company securities last year, returning 9.8 percent including reinvested interest, compared with 6.8 percent for the Bank of America Merrill Lynch U.S. Corporate & High Yield Master Index. Since the start of the credit crisis in mid-2007, Treasuries have returned 38 percent, just more than the 37 percent for companies.

Yields on company debt average 2.43 percentage points more than Treasuries, compared with a range of about 2.35 percentage points to 3.25 percentage points last year.

Bets Limited

The shift is also being influenced by new rules following the financial crisis that limit bets dealers can place while they enjoy government guarantees and access to the Fed's discount window. The regulations limit banks' investments in corporate bonds, while allowing them to hold and trade government securities.

Primary dealers held $28 billion more Treasuries than corporate securities due in more than one year on Dec. 28, the biggest gap in favor of government debt since the Fed began releasing the data in 2001. Wall Street held an average $159.1 billion more in longer-term company holdings than Treasuries during that period.

"A lot of it is stocking up on Treasuries in anticipation of selling them at hopefully reasonable, if not richer, levels," William O'Donnell, head U.S. government bond strategist at primary dealer Royal Bank of Scotland Group Plc in Stamford, Connecticut, said by phone Jan. 12. "Institutional investors are underinvested. Dealers know that on any dip they expect to see buyers, both domestically and overseas."

Falling Yields

Treasuries rallied last week, with 10-year note yields falling nine basis points, or 0.09 percentage point, to 1.87 percent. The benchmark 2 percent security due November 2021 gained 27/32, or $8.44 per $1,000 face amount, to 101 6/32. The week ended with Standard & Poor's cutting France's AAA credit rating to AA+ with a negative outlook.

The yield was 1.86 percent at 10:23 a.m. in New York. Yields reached a 2011 high of 3.77 percent in February amid signs of the economy was accelerating before plunging to a record low of 1.67 percent in September as GDP growth slowed to annual rates of 1.3 percent in the second quarter and 1.8 percent in the third quarter.

Traders expect 10-year yields to remain contained, rising to 2.25 percent by year-end, based on forward contracts that use current trading levels to predict future rates. Economists are more bearish, forecasting a climb to 2.59 percent, according to the median of 65 estimates in a Bloomberg survey.

Stocks, Corporates

Bond investors contrast with equity traders, who pushed the S&P 500 to its biggest gain last quarter since it rose 15 percent in the three months ended June 2009.

Company executives are also showing confidence, issuing $186.3 billion of bonds worldwide this year, up from $182.8 billion in the same period of 2011, according to data compiled by Bloomberg. London-based brewer SABMiller Plc sold $7 billion of debt securities on Jan. 10, and U.S. department-store chain Macy's Inc. offered $550 million of 10-year notes the same day.

America's labor market is showing signs of firming, with 200,000 jobs added in December as the unemployment rate dropped to 8.5 percent, according to U.S. government reports. The Labor Department may say this week that the cost of living remains in check, with consumer prices rising 0.1 percent in December, according to the median forecast of 65 economists surveyed by Bloomberg News.

" All the forward-looking economic data is showing improvement," said Mark MacQueen, a partner and money manager in Austin, Texas, at Sage Advisory Services Ltd., which oversees $10 billion. "Corporate bonds are going to outperform Treasuries. That's the way I'm placing my bets."

Housing Concern

While the central bank has helped push 30-year fixed mortgage rates to record lows of less than 4 percent, the Fed forecasts that home-loan borrowing in 2012 will decline to the least in 15 years. Americans who might refinance and buy properties are getting shut out by stricter lending standards or avoiding transactions as values tumble amid mounting foreclosures, a Jan. 4 report to Congress by the Fed showed.

The latest S&P/Case-Shiller index of property values in 20 cities shows a decline of 3.4 percent in October from a year earlier, the New York-based group said Dec. 27.

"Continued weakness in the housing market poses a significant barrier to a more vigorous economic recovery," the Fed said in the report. Fed Bank of New York President William Dudley said in a Jan. 6 speech that it's "appropriate" for the central bank to consider steps to ease monetary policy.

Jobs Picture

While the economy created 1.6 million jobs in 2011, the most since 2006, there have still been 6.6 million of net job losses since the start of 2008, Labor Department data show.

Bill Gross, who runs the world's biggest bond fund at Pacific Investment Management Co., said the global economy and financial markets are at risk in 2012.

The $244 billion Total Return Fund run by Gross increased its holdings of U.S. government debt in December to 30 percent, the highest level in 13 months and up from 23 percent in November, Pimco said Jan. 11 in a statement on its website.

"Banks should be eight-to-one or nine-to-one in terms of leverage," Gross said in a Jan. 12 Bloomberg Television interview with Trish Regan. "Right now, the system is an 18- times to 20-times overleveraged system, and that's producing the risk in terms of tipping one way or the other."

The U.S. government will finance about a $1.1 trillion federal deficit this year, adding to the $9.94 trillion of marketable securities outstanding. U.S. corporate bonds, which are priced based on Treasuries, total $7.3 trillion.

Interest Expense

Low yields mean that U.S. interest expense accounted for 3 percent of the economy in fiscal 2011 ended Sept. 30, down from 4 percent in 1999, when the U.S. ran budget surpluses.

Banks in the U.S. have boosted their holdings of Treasuries and agency securities to $1.7 trillion, from $1.13 trillion in August 2008. Banks will be required to comply with the Volcker Rule, named after former Fed Chairman Paul Volcker, which prohibits the companies from most proprietary trading and investing in hedge funds.

Treasuries reached a record 29 percent of debt assets on the balance sheets of the primary dealers Dec. 28, more than any other category of fixed-income. That compares with an average short position equal to 33 percent of their other holdings, according to data the central bank began releasing in 2001.

'Serious' Implications

"The potential implications for how we make markets are serious and would likely result in the shift in inventories being a more permanent feature of the market," Jeffrey Meli, head of credit strategy in New York at Barclays Plc, a primary dealer, said in a Jan. 9 telephone interview. "The relentless decline in dealer inventories even in months where markets felt better would indicate the regulatory component of this is real."

Mutual funds managers, seeking to match index weightings, may boost demand for Treasuries, according to Bank of America Merrill Lynch indexes.

Morningstar Inc. data show taxable bond funds maintain an average 14 percent allocation to Treasuries. The Barclays U.S. Aggregate index, which many funds use as a benchmark, has a 35 percent weighting to Treasuries, up from 22 percent in 2007.

"The knock-on effects from all this should be a stronger Treasury market," Eric Pellicciaro, head of global rates investment at New York-based BlackRock Inc., which manages $1.14 trillion in fixed-income assets, said in a Jan. 10 telephone interview.

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