

Caving to Congress Creeps Into Market Views on Obama (Update1)
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(Updates China holdings of Treasuries in 31st paragraph.)

By Rich Miller and Mike Dorning

Feb. 16 (Bloomberg) -- President Barack Obama may be heading for a clash with the bond vigilantes who plagued Bill Clinton, the last Democratic president.

Edward Yardeni, the economist who coined the term almost 27 years ago, says these institutional investors must come out of hiding and push Obama and Congress into confronting budget deficits that the administration estimates will total \$4.3 trillion during the next five years.

"Politicians don't make hard choices unless they're forced to," said Yardeni, president of Yardeni Investments, a consulting firm in Great Neck, New York. "What we really need are the bond vigilantes to push up yields" by paring purchases of Treasury securities. "That would threaten economic growth and put pressure on the politicians to act."

There are signs the vigilantes are starting to stir. The cost of insuring U.S. bonds from default for five years using credit default swaps rose as high as 62.1 basis points on Feb. 8 before slipping back to 53.6 basis points on Feb. 12, according to CMA DataVision prices. The cost was 43.8 basis points on Feb. 1, when Obama presented a 10-year budget plan with cumulative deficits of \$8.5 trillion.

The yield on the Treasury's 10-year note rose to 3.69 percent on Feb. 12 from 3.57 on Feb. 5 after the government auctioned a record \$81 billion of three- and 10-year notes and 30-year bonds last week.

Higher Yields

"At some point, people are going to look at the finances of the U.S.," Niall Ferguson, history professor at Harvard University in Cambridge, Massachusetts, and author of "The Ascent of Money," said in a Feb. 5 interview on Bloomberg Television. "Then you will see a decline in growth" as investors push up bond yields.

Former Federal Reserve Governor Laurence H. Meyer warned of the risk of an eventual "fiscal catastrophe" if Congress fails to rein in the deficit, with interest rates shooting higher and the dollar collapsing.

"Investors, especially those with longer horizons, might

want to protect themselves or at least monitor the markets for early signs of angst,” Meyer, who is now vice chairman of St. Louis-based Macroeconomic Advisers, wrote in a Feb. 10 report co-authored with economist Antulio Bomfim.

The bond-market vigilantes had their heyday in the late 1980s and the early 1990s when they succeeded in forcing President George H.W. Bush and then Clinton into adopting politically unpopular tax increases and spending cuts to close the budget deficit.

Reversing a Rally

A return of that posse now might push bond yields up, as investors worried about mounting debt sell Treasuries, reversing a rally. Treasuries have returned 1.36 percent this year, compared with a decline of 3.7 percent in 2009.

Some institutions are already positioning themselves for higher yields and lower prices later this year as the market strains under what Morgan Stanley & Co. of New York estimates will be a record \$2.4 trillion of government debt issued in 2010.

Investors underweighting Treasuries in their portfolios include Joe Balestrino, fixed-income strategist at Pittsburgh-based Federated Investors Inc., which manages some \$318 billion, and Mitchell Stapley, fixed-income officer at Grand Rapids, Mich.-based Fifth Third Asset Management, which oversees \$13 billion.

It’s “a no brainer” to sell short Treasuries, Nassim Nicholas Taleb, a principal at Universa Investments LP in Santa Monica, California, and author of the book “The Black Swan,” told a conference in Moscow on Feb. 4. “Every single human being should have that trade.”

Record Deficit

Lawrence H. Summers, director of Obama’s National Economic Council, defended the administration’s efforts to rein in a budget deficit the White House estimates will hit a record \$1.6 trillion in the year ending Sept. 30.

“The president’s concrete actions are showing the way,” Summers said in a Feb. 9 interview with Bloomberg Television, pointing to Obama’s proposal for a three-year freeze on discretionary spending outside of defense and homeland security.

Some lawmakers are already chafing at the proposal. At a Senate Budget Committee meeting on Feb. 4, Senator Bill Nelson, a Florida Democrat, said the administration’s planned reductions

in spending by the National Aeronautics and Space Administration “have got to be changed.” Washington Democrat Patty Murray questioned cuts to the budget of the Army Corps of Engineers, and Oregon Democrat Jeff Merkley said he was concerned about funding for housing programs for the elderly.

Spending Freeze

The spending freeze may not have much impact as it covers only a small portion of the budget, Balestrino said. By the administration’s reckoning, it would save \$249 billion over 10 years that otherwise would have been spent.

The freeze will come in the wake of a planned \$116 billion increase in such spending this year, driven partly by the stimulus program Obama worked out with Congress at the start of his administration in 2009.

“The problem was that right from the get-go, the president handed control of everything to Congress,” said John Ryding, chief economist at RDQ Economics in New York. “So what did you get? You got a package that had massive increases in government spending in 2010 and 2011 when the recession was in 2009.”

Even with the spending freeze -- and a proposed \$970 billion tax increase during the next decade on Americans making more than \$200,000 -- the administration still projects a deficit of \$752 billion in 2015, equivalent to 3.9 percent of gross domestic product.

Government Debt

That’s above the 3 percent mark that White House budget director Peter Orszag has said is necessary to stop the rise in government debt as a proportion of GDP.

The White House is counting on a bipartisan presidential commission to come up with ways to close the gap. Obama, in an interview with Bloomberg BusinessWeek on Feb. 9, said the panel he will set up needs to consider all options for reducing the deficit, including tax increases and cuts in spending on entitlement programs such as Social Security and Medicare.

The administration decided to establish the group on its own after the Senate blocked a measure to form a congressional panel whose recommendations would have been guaranteed a vote by lawmakers. Opponents complained the plan would result in higher taxes and spending cuts and Congress wouldn’t have a chance to amend the panel’s recommendations. Under a presidentially appointed commission, Congress could ignore any panel recommendations.

Seeking Assurances

House Republican leader John Boehner has sought assurances from the White House that the makeup of the Obama commission will be bipartisan and not predisposed to tax increases. The Ohio Republican is still considering whether to appoint members from his party to the panel, he said after a Feb. 9 meeting with the president.

The bond-market vigilantes have been largely quiescent in the face of the mounting deficits because they've been anesthetized by the Fed's zero interest rate, Yardeni said, adding that the policy has encouraged investors to buy longer-dated, higher-yielding Treasury securities.

Other developments have helped depress Treasury yields, including safe-haven buying by investors worried that Greece may default on its debt; diminished demand for credit from U.S. consumers and companies still shellshocked from the recession, leaving more money available for the government to borrow; and purchases by China and other foreign investors.

Higher Interest Rates

Some of that may change as the year progresses. Fed Vice Chairman Donald Kohn warned financial institutions on Jan. 29 that they should be alert to the possibility of higher interest rates as the economic recovery progresses. Traders in the federal-funds futures market in Chicago put the odds of a rate increase by September at close to 50 percent.

The continued revival is also likely to bring increased loan demand from the private sector, Balestrino said. The U.S. economy expanded at a 5.7 percent annual rate in the fourth quarter, the fastest pace in six years, after rising 2.2 percent in the third quarter.

Consumer credit fell \$1.7 billion in December, the smallest decline since a gain in January 2009, as consumers took out car loans, Fed figures show. Credit dropped a record \$21.8 billion in November.

On the international front, concerns about a debt default by Greece ebbed last week after European Union leaders pledged to take "determined and coordinated action" if needed to contain the crisis. The cost of insuring Greek bonds from default using credit default swaps fell to 354.9 basis points Feb. 12 from 425.6 on Feb. 8.

China Cuts Holdings

China, the second-biggest foreign owner of Treasuries, cut its holdings for the second straight month in December, reducing them by \$34.2 billion to \$755.4 billion, the lowest level since February 2009, according to a U.S. Treasury Department report today.

“China may reduce purchases of U.S. Treasuries because there has been no sign the dollar’s long-term trend of weakness will change,” Liu Yuhui, an economist at the Chinese Academy of Social Sciences, said Jan. 20. “But it won’t likely make a big adjustment to its existing holdings,” added Liu, director of the Center for Chinese Economic Evaluation in Beijing at the academy, a government-backed research body.

An index that measures the dollar’s strength against six other major currencies has fallen 7.2 percent in the past year.

The U.S. currency “is going to be weaker,” agreed Mark MacQueen, partner and portfolio manager at Austin, Texas-based Sage Advisory Services, which oversees \$8.5 trillion.

‘Pressure Valve’

“The dollar is the pressure valve,” he said, referring to the strategy he thinks the U.S. will pursue in handling its debt. “If I owe a trillion dollars, why not pay it back with 50 cents?” A weaker dollar will lead to higher inflation in the future, reducing the real value of the debt, as it pushes up import prices. It will also depress bond prices, McQueen said.

That makes purchases of Treasury-Inflation Protection Securities attractive in the longer term, said Third Asset Management’s Stapley. TIPS have gained 0.36 percent this year; they rose 10 percent in 2009.

What happens to the U.S. budget deficit will ultimately be decided by bond investors, said David Rosenberg, chief economist at Toronto, Canada-based Gluskin Sheff & Associates.

“It’s Mr. Bond that is going to be the final arbiter,” said Rosenberg, the former chief North American economist at New York-based Merrill Lynch & Co., the broker bought by Bank of America Corp. “Right now bond yields are really stuck in a range. So it’s not a problem today. But it doesn’t mean it’s not going to be a problem six or 12 or 24 months from now. We are really headed into uncharted territory” with deficits and debt.

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