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Obama Wins Low Yield as Markets Shrink Aiding Deficit

Aug. 16 (Bloomberg) -- Bond investors seeking top-rated securities face fewer alternatives to Treasuries, allowing President Barack Obama to sell unprecedented sums of debt at ever lower rates to finance a \$1.47 trillion deficit.

While net issuance of Treasuries will rise by \$1.2 trillion this year, the net supply of corporate bonds, mortgage-backed securities and debt tied to consumer loans may recede by \$1.3 trillion, according to Jeffrey Rosenberg, a fixed-income strategist at Bank of America Merrill Lynch in New York.

Shrinking credit markets help explain why some Treasury yields are at record lows even after the amount of marketable government debt outstanding increased by 21 percent from a year earlier to \$8.18 trillion. Last week, the U.S. government auctioned \$34 billion of three-year notes at a yield of 0.844 percent, the lowest ever for that maturity.

"The number-one fixed-income conundrum is 'Where do I go?'" said Mitchell Stapley, the chief fixed-income officer for Fifth Third Asset Management, who oversees \$22 billion in assets. In credit markets, "the supply of sleep-at-night quality bonds has just collapsed," he said in an interview from Grand Rapids, Michigan.

Less competition for bondholders' funds may make it easier for Obama to finance future stimulus needed to boost the economy after the Federal Reserve said Aug. 10 that the pace of the "recovery is likely to be more modest in the near term than had been anticipated."

Room for More

While the Treasury sold \$74 billion of bonds last week, yields on 10-year notes declined 14.5 basis points, or 0.145 percentage point, to 2.675 percent in New York, according to BGCantor Market Data. The price of the 2.625 percent note due August 2020, which was auctioned Aug. 11, ended at 99 19/32.

The yield fell to 2.63 percent as of 12:11 p.m. in London.

"It would seem there's room for the federal government to raise more debt," said John Lonski, the chief economist at Moody's Capital Markets Group in New York.

Net issuance of asset-backed securities, after taking into account reinvested coupons, will decline by \$684 billion this year, according to Bank of America's Rosenberg. The supply of residential mortgage-backed securities issued by government-sponsored companies such as Fannie Mae and Freddie Mac is projected to be negative \$320 billion, while the debt they sell directly will shrink by \$164 billion. Investment-grade corporate bonds will decrease \$132 billion.

“The constriction in supply is all about deleveraging,” Rosenberg said.

Increased Savings

Spending by companies and consumers has slowed as the economy has shown signs of weakening. Companies in the Standard & Poor’s 500 Index have stockpiled a record \$2.3 trillion of cash and equivalents. Company borrowing slid 29 percent in the first half of the year to \$528 billion amid a dearth of business investment, Bloomberg data shows.

Individuals are also hoarding cash. The U.S. savings rate reached 6.4 percent in June, up from 1.7 percent in August 2007, the start of the financial crisis.

“There’s been a collapse in both consumer and business credit demand,” said James Kochan, the chief fixed-income strategist at Menomonee Falls, Wisconsin-based Wells Fargo Fund Management, which oversees \$179 billion. “To see both categories so weak for such an extended period of time, you’d probably have to go back to the Depression.”

Corporate Issuance

Before 2008, bankers created trillions of dollars of securities out of mortgages, credit-card receivables, auto loans, equipment trust certificates, loans on commercial property and even other bonds. In 2007, issuance of securities backed by corporate and consumer debt exceeded maturing securities by \$1.45 trillion, before slipping to \$562 billion in 2008 and \$257 billion in 2009, according to Bank of America.

Most of the securities received top AAA ratings before collapsing in value as home-loan delinquencies and foreclosures surged to record highs. Financial institutions around the world have taken about \$1.8 trillion in writedowns and losses related to the securities since the start of 2007, Bloomberg data show.

“Banks got burned on private-label mortgage securities and other bonds that are illiquid in terms of marketability,” Jeffrey Caughron, chief market analyst in Oklahoma City at The Baker Group LP, which advises community banks on investing assets totaling \$23 billion.

As a result, banks have made credit harder to get. Commercial and industrial lending by banks has fallen by 25 percent to \$1.24 trillion at the end of July from the peak of \$1.65 trillion in 2008, according to the Fed.

Buying Bonds

Instead of lending money, banks are investing in Treasury and agency securities to take advantage of the historically wide spread between their cost to borrow and the returns on the debt. Their holdings of such assets increased to \$1.57 trillion at the end of July, up 40 percent from \$1.12 trillion in mid-2008, the same Fed report shows.

“The government is borrowing because no one else is,” said George Goncalves, head of interest-rate strategy at Nomura Holdings Inc., one of 18 primary dealers that trade directly with the Fed. “We borrowed in the last 10 years what we should have borrowed over the last 25

years so the lack of consumer credit and lack of securitization is shrinking the fixed-income universe and helping the Treasury market.”

Debt Grows

Treasury debt grew by 24.2 percent in 2008 and 22.7 percent in 2009, according to Fed data, paying for Obama’s tax cuts to people buying cars, homes and appliances, funding payments to the growing ranks of the unemployed and financing infrastructure projects such as the repaving of roads. The projected 2010 deficit of \$1.47 trillion would be a record, and equivalent to 10 percent of the economy.

“The diminishing supply” of alternatives to Treasuries “is giving Washington an opportunity to continue with its fiscal irresponsibilities,” said Mark MacQueen, partner and portfolio manager at Austin, Texas-based Sage Advisory Services, which oversees \$8.5 billion. “The only way to tell Washington and America ‘no more’ is a weak dollar, which eventually leads to higher interest rates.”

A weaker dollar is also bad because it has the potential to deter foreign investment in the U.S., further raising borrowing costs. The U.S. Dollar Index, which measures the currency against a basket consisting of the euro, yen, British pound, Canadian dollar, Swedish krona and Swiss franc, fell to 82.30 as of Aug. 11 from a 17-month high of 88.41 on June 7.

‘Fool’s Game’

“We are slowly playing a fool’s game as rates go further down to unsustainably low levels,” said Dan Shackelford, a money manager who helps oversee \$15 billion in fixed-income assets at T. Rowe Price Group Inc. in Baltimore.

Even with the amount of Treasuries outstanding rising 17 percent this fiscal year that started Oct. 1, total interest expense through July was \$375.2 billion, compared with \$383.4 billion in all of 2009 and \$451.2 billion in 2008. As a percent of GDP, it was 3.2 percent in 2009, compared with 4.1 percent in 2001, the last time there was a budget surplus.

Interest expense is being tempered by low yields. The yield on the Merrill Lynch U.S. Treasury Master Index dropped to 1.534 percent on Aug. 11, the lowest level since it reached 1.49 percent on Dec. 18, 2008, at the height of the credit crisis. The yield on the two-year note fell to a record low of 0.489 on Aug. 11 after the Fed said it would reinvest principal payments on its mortgage holdings into long-term U.S. debt securities.

‘Very Inexpensive’

The deficit is “very inexpensive relative to the debt we have,” said William Larkin, a fixed-income money manager in Salem, Massachusetts at Cabot Money Management, which oversees \$500 million. “That means if the Treasury is going to borrow money, I’d rather them borrow it now, at a cheaper level for longer.”

The government isn’t the only one getting a good deal. Armonk, New York-based International Business Machines Corp., the world’s biggest computer services provider, sold \$1.5 billion of three-year notes on Aug. 2 with a coupon of 1 percent, the lowest of the more than 3,400 securities in the Barclays Capital U.S. Corporate Index of investment-grade company debt.

Johnson & Johnson issued \$1.1 billion of debt on Aug. 12 at the lowest rates on record for 10- and 30-year securities, according to Citigroup Inc. data going back to 1981. The New Brunswick, New Jersey-based drugmaker sold \$550 million of 2.95 percent notes due in 2020 and the same amount of 4.5 percent bonds maturing in 2040.

Demand for high-rated securities is also spilling over into the municipal bond market as brokers look for alternatives to Treasuries, according to Matt Fabian, managing director of Municipal Market Advisors in Westport, Connecticut.

Portland, Oregon, sold about \$408 million in sewer-system revenue debt on Aug. 11, with utility bond yields at the lowest level on record. Yields on 10-year, AA rated tax-exempts backed by utility revenue stood at 3.02 percent on Aug. 10, according to Bloomberg Fair Market Value data. That's the lowest since the index was created in November 1993.

"We are in uncharted territory," Larkin said. "We are pushing and pulling levers that we don't understand the full implications."

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