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Geithner Debt Sales to Benefit From Paulson Failures (Update2)

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By Daniel Kruger and Dakin Campbell



Jan. 26 (Bloomberg) -- Former Treasury Secretary **Henry Paulson's** inability to restore confidence in the financial system is creating unprecedented demand for U.S. debt as his successor prepares to sell the most bonds in history.

Timothy Geithner, who may be confirmed as head of the Treasury today, will have the benefit of near record-low **yields** as he presides over auctions of as much as \$150 billion of notes and bonds the next three weeks. Goldman Sachs Group Inc., one of the 17 primary dealers that are required to bid at the auctions,

said last week the U.S. will likely borrow a record \$2.5 trillion this fiscal year ending Sept. 30, almost triple the \$892 billion in notes and bonds sold in fiscal 2008.

"There is just such a huge demand from the flight to quality and the flight to liquidity," that the U.S. will have little difficulty selling the debt, said **Joseph Shatz**, a senior government bond strategist in New York at Merrill Lynch & Co., another primary dealer. "You have a lot of forces keeping Treasury yields low."

While Paulson won approval last year to spend \$700 billion to stabilize the financial system, bank losses and failures are increasing, sending investors to Treasuries and driving up credit costs for everyone but the government. Four-week Treasury bill rates fell to 0.01 percent last week, while 30-year fixed-rate mortgages averaged 5.12 percent, 2.49 percentage points above 10-year U.S. notes. The **difference** averaged 1.79 percentage points since the start of the decade.

Citigroup Inc. and **Bank of America Corp.** sought additional funds after receiving infusions in October. The Standard & Poor's 500 Index, which fell the **most** since 1937 last year, is down 7.89 percent this month.

Falling Yields

Yields plunged in the past year as losses and writedowns at the biggest financial companies rose above \$1 trillion. Two-year note yields ended last week at 0.81 percent, compared with the **average** of 3.49 percent this decade, while 10-year rates are 2.62 percent, versus the **average** of 4.56 percent.

The plunge is helping Geithner, the 47-year-old head of the Federal Reserve Bank of New York since November 2003, because government interest costs are falling even as the amount of debt rises. Interest paid by the Treasury in the last three months fell \$18.3 billion as debt rose to \$10.6 trillion in December from \$9.23 trillion a year earlier, government figures show.

President **Barack Obama**, 47, and Geithner are counting on demand for Treasuries to finance a \$1 trillion **budget** deficit inherited from the administration of **George W. Bush** and Paulson, who was **chairman** of Goldman Sachs before becoming **Treasury** Secretary in July 2006.

TARP Funds

As the economy worsened last year, Paulson, 62, won approval for the \$700 billion Troubled Asset Relief Program that's injecting capital into financial firms. The \$8.5 trillion of initiatives by the Treasury and Fed, including the TARP funds, to prop up financial markets have done little to bring down borrowing costs for consumers and companies.

Even though the Fed cut its target rate for overnight loans between banks to as little as zero in December, from 4.25 percent a year earlier, companies are paying more to sell debt. It costs U.S. companies on **average** 9.5 percent to borrow in the bond market, up from 6.45 percent a year ago, representing about an extra \$30 million a year in interest on every \$1 billion of securities, according to Merrill Lynch & Co. index data.

Banks charge each other about 1.07 percentage points more than what it costs the government to borrow for three months, up from an **average** of 0.32 percentage point before the credit markets seized up in the second half of 2007.

Closing Banks

Regulators closed 25 banks last year, the most since 1993, and shut three this year. New York-based Citigroup and Bank of America in Charlotte, North Carolina, are down more than 50 percent in New York Stock Exchange trading this year after the second- and third-largest U.S. banks sought more funding through TARP. Financial companies shrank to less than 10 percent of the S&P 500 last week, the least since the savings and loan crisis of the early 1990s, and down from the peak of 22.43 percent on Oct. 3, 2006, according to data compiled by Bloomberg.

"When somebody wants to judge the Treasury Secretary you look at the broad stock indexes and the financial stocks," said **Michael Cheah**, who manages \$2 billion in bonds at **AIG SunAmerica Asset Management** in Jersey City, New Jersey.

A Paulson representative didn't return a request seeking comment.

Public Funds

U.S. financial losses may reach \$3.6 trillion, suggesting the banking system is "effectively insolvent," **New York University Professor Nouriel** Roubini, who in January 2007 predicted the economy was headed for a "hard landing," told a conference in Dubai on Jan. 20. Obama will have to use as much as \$1 trillion of public funds to bolster the capitalization of the industry, he estimates.

The government may say this week that gross domestic product contracted 5.5 percent last quarter, the most since it shrank 6.4 percent in the first three months of 1982, according to the median estimate of 66 economist surveyed by Bloomberg. Redmond, Washington-based Microsoft Corp. said last week it will cut as many 5,000 jobs, the first companywide firings in its 34-year history, because sales and **profit** will probably drop.

"We're turning up the volume on bad data," said **Maxwell Bublitz**, who oversees \$3.5 billion in bonds as chief strategist at **San Francisco**-based SCM Advisors LLC. He said 10-year yields may drop below 2 percent, after ending last week at 2.62 percent. "As we approach 2.75 on the 10-year I kind of want to buy it."

Quarterly Refunding

To help pay for the bailouts and Obama's proposed \$825 billion fiscal stimulus plan, the government will raise \$78 billion this week selling debt with maturities ranging from 2 to 20 years. Wrightson, a Jersey City, New Jersey-based research firm specializing in government finance, forecasts the U.S. will auction \$69 billion in 3-, 10-, and 30-year securities the week of Feb. 9 as part of the Treasury's quarterly refunding.

Treasury yields climbed last week from the record lows set in December as Obama revealed details of his economic stimulus plan and the government said the budget deficit soared to a record \$485.2 billion

in the first three months of the fiscal year that started Oct. 1.

Thirty-year bond yields surged 44 basis points, or 0.44 percentage point, to 3.32 percent last week, the **biggest increase** since April 1987. Yields dropped to 2.51 percent on Dec. 18, the lowest since the **Treasury** began regular sales of so-called long bonds in 1977. They were 4.5 percent a year earlier. The yield was little changed as of 2:07 p.m. today in Tokyo.

Currency Manipulator

Geithner helped push yields higher last week by saying during his Senate confirmation hearings that the Obama administration believes China is "manipulating" its currency. Paulson preferred diplomacy over confrontation with China to resolve disputes and, in semiannual reports, refrained from labeling the country a "manipulator."

The remarks on China's exchange-rate policy may mean a tougher line with the biggest foreign investor in government debt. China owned \$681.9 billion of U.S. securities as of November, Treasury data show.

"There's concern on the China front," said **Kevin Flanagan**, a Purchase, New York-based fixed-income strategist for Morgan Stanley's individual-**investor** clients. "Do they fire back and stop buying Treasuries, especially given the huge amount of supply we're going to need to underwrite over the next few years?"

Efforts Jeopardized

Higher government yields would jeopardize Fed efforts to lower consumer borrowing costs. Fed policy makers meeting tomorrow and the next day are exploring the purchase of longer-maturity Treasuries to push down yields and lower mortgage rates.

While Fed Chairman **Ben S. Bernanke** and his colleagues risk distorting the Treasury **market**, the focus on driving borrowing costs lower makes U.S. debt attractive, according to Cheah of AIG SunAmerica.

"Is this a buying opportunity for the Treasury bond market?" said Cheah. "I would say yes. Why? Because the Federal Reserve should be very concerned now with rising yields."

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