



Treasury Benefits From Massive Paranoia as Rates Fall (Update3)

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By Matthew Benjamin and Liz Capo McCormick

Dec. 15 (Bloomberg) -- **Bill Clinton** was forced to abandon spending initiatives to boost the economy at the start of his presidency when advisers warned him that the borrowing needed to fund the programs would push interest rates higher. President-elect **Barack Obama** may not have the same problem.

While the total amount of U.S. government debt outstanding rose to \$10.7 trillion in November from \$9.15 trillion a year earlier, the amount of interest paid in the last two months fell by \$10 billion, according to the Treasury Department.

Instead of shunning the U.S., where losses on subprime mortgages in 2007 triggered a global seizure in credit markets that led to the downfall of securities firms Bear Stearns Cos. and Lehman Brothers Holdings Inc., investors can't get enough **Treasuries**. Even as estimates of Obama's stimulus package and the budget **deficit** rise to a record \$1 trillion, demand continues to increase as investors flee risky assets around the world and put their cash into U.S. bonds paying, in some cases, nothing in yield just to ensure the return of their principal.

"You still have a massive paranoia in the marketplace and you've got that safety-at-any-cost mentality," said **Jay Mueller**, who manages about \$3 billion of bonds at Wells Fargo Capital Management in Milwaukee. "People are not buying Treasury bills because they think the yields are attractive. They are buying them because they are afraid to put money anywhere else."

Foreign Demand

Foreign central banks and other institutions are **accumulating** Treasuries at the fastest pace since 1988, boosting their holdings 12 percent since September, compared with a 7.7 percent increase last quarter, according to the Federal Reserve.

Purchases accelerated even as the yield on the benchmark two-year Treasury note tumbled to 0.76 percent last week from this year's peak of 3.11 percent on June 13. Rates on **three-month** bills turned negative on Dec. 9 for the first time. The same day, the U.S. sold \$30 billion of **four-week** bills at a zero percent rate. Yields on two-, 10- and **30-year** Treasuries last week all fell to lowest since the U.S. began regular sales of those securities.

The two-year note yielded 0.73 percent as of 2:32 p.m. in New York, according to BGCantor Market Data, after falling as low as 0.66 percent on Dec. 12.

The drop in yields drove bond prices higher, pushing returns to 12.4 percent on average this year, the best performance since they gained 13.4 percent in 2000, according to New York-based Merrill Lynch & Co.'s U.S. Treasury Master Index. The returns compare with a drop of 41 percent in the Standard & Poor's 500 Index and average losses of 15 percent in Merrill Lynch's broadest corporate bond index.

'Raw Fear'

"This is not about return and yield and value; investors are functioning out of raw fear," said **Barr Segal**, a managing director at Los Angeles-based TCW Group Inc., which oversees \$90 billion in fixed-

income assets. At the same time, "this is fabulous for the Treasury because they are borrowing at virtually nothing," he said.

Japan's bond market suggests that low yields may remain for a sustained period. In an effort to revive sagging growth in the 1990s, the world's second largest economy ran its national debt to 1.5 times of gross domestic product. Yields on Japanese bonds are near the lowest in three years, with the country's benchmark 10-year bond paying 1.40 percent, compared with 2.59 percent in the U.S. The **national debt** in the U.S. is 72 percent of GDP.

"It's good news," said **James Horney**, director of federal fiscal policy at the Center on Budget and Policy Priorities in Washington. "Even though we're borrowing larger amounts of money, the total amount we're going to pay in interest is going to be somewhat lower."

Stimulus Package

Interest was \$92.5 billion from August through November 2007 on the \$9.15 trillion in total debt outstanding, resulting in interest expense of 1.01 percent. In the same period a year later, interest was \$87.5 billion on \$10.66 trillion in total debt, dropping the expense to 0.8 percent.

While the median estimate of 49 economists and strategists is for **10-year Treasury** yields to end 2009 at 3.65 percent, that's still below the average of 6.91 percent paid on the securities since 1962. The security helps determine corporate and consumer borrowing rates.

Obama plans an economic stimulus package that may approach \$1 trillion, in addition to a middle-class tax cut and universal health care, which may add \$4 trillion or more to the national debt over 10 years, according to the Tax Policy Center in Washington and health-care economists.

Record Shortfall

The U.S. already posted a record \$401.6 billion budget **shortfall** for the first two months of fiscal 2009, which began Oct. 1, according to a Treasury report last week. The largest postwar budget deficit by the U.S. was \$412.7 billion in 2004.

"The role of the deepening economic slump in this deterioration coupled with the escalating size of the likely fiscal stimulus puts the deficit on course to exceed \$1 trillion," **Edward McKelvey**, a senior economist in New York at Goldman Sachs Group Inc., wrote in a Dec. 8 report to clients. "This implies upside risk to our \$2 trillion figure for Treasury supply."

Clinton's proposals to spur the economy early in his administration in 1993 were stymied by concern how bond investors would react, according to **James Carville**, a Clinton consultant during the 1992 presidential campaign.

Clinton Days

"Early in the Clinton days, the hallmark of policy was if you did this, how would it affect the bond market," Carville said in an interview last year. "Every time I would talk to someone they would say 'you can't do that, it will freak the bond market out.' I said 'goddamn, whoever the bond market is, these bastards are powerful.'"

The potential for massive deficits has done nothing to damp demand for government debt as the U.S. prepares to spend \$8.5 trillion to bailout financial institutions, homeowners and the economy. The biggest deficit as a percentage of the economy was 6 percent in 1983. A trillion-dollar 2009 gap would top that.

To prevent yields from rising, Fed policy makers indicated that the central bank may buy Treasuries. Fed Chairman **Ben S. Bernanke** suggested in a Dec. 1 speech that he would consider such a measure, saying one option is to buy "longer-term Treasury or agency securities on the open market in substantial quantities."

'Printing Press'

"If there is a whiff of anything getting worse, the Fed can just go downstairs and start that printing

press,” said **Kevin Gaynor**, head of economics and interest-rate strategy at Royal Bank of Scotland Group Plc in London. “They can easily stop targeting the federal funds rate and start targeting a two- or five-year Treasury yield.”

Policy makers may also cut interest rates again, which may keep bond yields low. The Federal Open Market Committee will reduce its **target rate** for overnight loans between banks by a half-percentage point, to a record 0.50 percent, when it meets Dec. 15-16, according to the majority of economists surveyed by Bloomberg News.

The U.S. economy has been in a recession for a year, the National Bureau of Economic Research declared on Dec 1. The economy will continue to contract through June, with **unemployment** rising above 8 percent the end of 2009, from 6.7 percent last month and this year’s low of 4.8 percent in February, according to Bloomberg surveys of economists. That would make the current slump the longest since the Great Depression.

‘It’s Ironic’

“In some ways it’s ironic,” said **Meg Browne**, senior currency strategist at Brown Brothers Harriman & Co. in New York. “The U.S. turned down first and the crisis appeared first in the U.S., yet people continue to flock to the U.S. government debt market because it’s the biggest and deepest market in the world and still has a low risk.”

The U.S. will eventually have to commit to balanced budgets, said **Alice Rivlin**, former Fed vice chairman and founding director of the Congressional Budget office.

“We can’t press our luck,” said Rivlin, now a scholar at the Brookings Institution in Washington. “Eventually, we’ve got to show the world that we are fiscally responsible.”

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