

INVESTMENT UPDATE

In a dramatic change of policy, the Treasury abandoned its support of a long maturity benchmark with the October 30th announcement that it would no longer issue 30-year maturity Treasury bonds. “Long bonds”, as 30-year Treasuries are known, have been the undisputed global benchmark for the long end of the maturity spectrum since they were first issued in 1974. Up until now, even with the recent budget surpluses and a reduced Treasury auction schedule, long Treasuries have been considered to be essential to the smooth functioning of the financial markets. With long-term interest rates at historically low levels, and with post-September 11 borrowing likely to rise in the next few quarters, one has to ask the question: Why end 30-year auctions now?

The answer of course has everything to do with politics and (unfortunately) little to do with sound fiscal management. It’s hard to imagine a company in the private sector choosing to limit its own borrowing flexibility in this manner. When it comes to the Federal Government, the normal rules of logic don’t always apply. In the current case, the goal is not long-term financial management; the Treasury’s objective is political: bring down borrowing costs and bring them down quickly.

In the passenger’s seat of this operation is the Federal Reserve, who has expressed frustration that long rates have remained stubbornly high despite their best efforts to bring them down. The Fed can manipulate short rates practically down to the last basis point, but has no way to *directly* control long-term interest rates. Yields on long Treasuries are

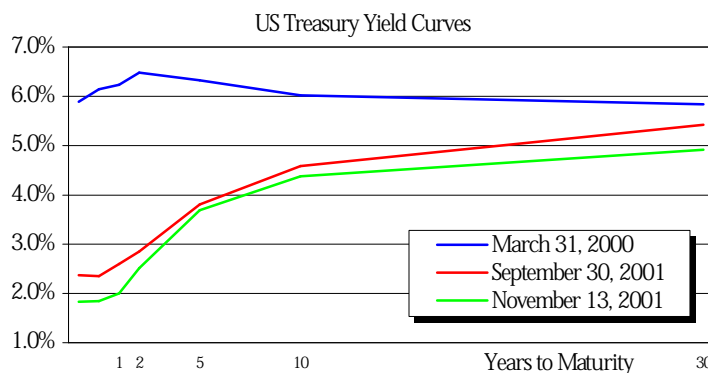
controlled by two factors that are outside the immediate control of the Fed: inflation expectations and the supply/demand balance. Ironically, the Fed’s most aggressive-ever easing program this year (the Fed funds target has been lowered by 4.5% in 10 separate moves) has actually *raised* expectations of future inflation, keeping long rates higher than the weak economy alone would have dictated.

While the Fed can’t do much to lower long rates, the Treasury can drive them down simply by reducing the supply of long bonds. The Bush administration has been equally frustrated by the recent stickiness of long rates—constituents are demanding cheaper funds, and recovery depends on lower long-

term borrowing rates for both businesses and consumers. Thus we see the signs of a coordinated effort between the (normally apolitical) Fed and the (highly political) Treasury.

In their announcement, the Treasury emphasized the savings they hope to

realize by increasing the issuance of shorter maturities, due to the very steep slope of today’s yield curve. The accompanying chart shows just how much lower short rates are than long rates. Yet history tells us that today’s ultra-steep yield curve is anomalous, and sure to flatten once the Fed’s easing program is over. The savings from emphasizing shorter maturities will prove to be short-lived if the curve reverts to a more normal shape. In addition, long rates, while higher than short rates, are near the lowest levels in a generation. The Treasury may be kicking itself for not locking in cheap long-term funds now if the economy turns around and rates rise.



The Treasury has also seemingly abandoned its previous goal of reducing the duration of its debt. You will recall that this was the reason given when the Treasury announced scheduled buybacks of long Treasuries in the first quarter of 2000. Investors, sensing a shortage, bid up the price of long Treasuries in a frenzy that rivaled the tech stock bubble. As the previous chart shows, the speculative buying led to a rare “inversion” in the long end of the curve that lasted throughout most of last year, with yields of 30-year Treasuries well below those of most shorter maturities.

The Treasury portfolio’s long average maturity is a problem that will not go away without an aggressive buyback program of long bonds. The next chart shows the dollar value of Treasury maturities over the next 30 years. As it stands now, the Treasury is planning on boosting issuance of three- and six-month bills and two-year notes, which will do little to reduce the average maturity of their portfolio (and where there is already a glut of supply). With the elimination of the 30-year, the Treasury will now be issuing only five different maturities of public debt, compared to ten just a few years ago.

We are not criticizing the Treasury’s goal of lowering long-term rates; as investors, we simply want some continuity in the Treasury’s policies. To give credit where it’s due, the previous administration’s policy of aggressive long bond buybacks combined with regular new 30-year issuance was successful in lowering long rates while also providing the market with a liquid 30-year benchmark. Annual buybacks have been running at approximately \$36 billion over the last two years while issuance has been \$15 billion each year. In contrast, the new policy calls for no new buybacks and no issuance, so *net supply of long Treasuries will actually increase by approximately \$21 billion annually compared to the old plan.*

The Treasury claims that they may go back to issuing 30-year bonds if market conditions change in the future (i.e., if the yield curve flattens). They may not find the market so hospitable. Investors have been developing alternative benchmarks to long Treasury bonds over the past few years and these efforts will now be accelerated. The longer the Treasury goes without issuing new bonds, the more erratic will be the behavior of outstanding 30-year Treasuries. The long end of the Treasury market is likely to eventually de-link with the rest of the Treasury curve and lose its remaining usefulness as a benchmark and a hedging vehicle. The Treasury has never gone back to issuing a maturity that has been eliminated for just these reasons.

As we manage our clients’ portfolios, these changes mean that we will need to continue to use alternative benchmarks when determining the value of longer-maturity bonds. As we have mentioned before, we converted our internal valuation systems to use swap spreads as an alternative

to Treasuries when examining corporate, mortgage and Agency securities. It is our belief that Treasury bonds, especially long maturities, will continue to suffer from distortions as long as fiscal and budgetary conditions remain unsettled. Hopefully, once the war on terrorism winds down, a more stable fiscal policy will develop and the Treasury can put in place a more sensible and permanent plan to finance the country’s spending needs.

US Treasury Maturities by Year

