Bailout Banks Buying Treasuries Help Keep Rates Low (Update2)

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By Liz Capo McCormick

Aug. 3 (Bloomberg) -- U.S. lenders bailed out by the government are returning the favor by stepping up purchases of Treasuries, helping to temper a rise in borrowing costs.

Bank holdings of U.S. government securities are up 15.6 percent from a year ago, almost double the average annual growth rate of about 8 percent since the Federal Reserve began tracking the data in 1973, according to the Greenwich, Connecticut-based trading and research firm MKM Partners LP. Purchases may accelerate as lenders look for places to park rising deposits as sales of federal agency debt of companies such as Fannie Mae and corporate bonds slow.

“We expect demand to shift to Treasuries, given low net supply in corporates,” Srini Ramaswamy, a fixed-income strategist at New York-based JPMorgan Chase & Co., the second- biggest U.S. bank, wrote in a report July 24. The firm’s models “suggest that bank purchases of corporates and mortgage-backed securities will be small relative to the growth in deposits net of loans, which have been growing at a rate of roughly $29 billion per month.”

Increased demand for U.S. debt by lenders may help keep a lid on yields as the government sells what Barclays Plc estimates will be a record $2.1 trillion in securities this year and the Fed comes to the end of its Treasury purchase program.

Ten-year Treasury yields, a benchmark for everything from mortgages to company debt, may end the year at 3.67 percent, according to the median estimate of 65 economists and strategists surveyed by Bloomberg.

Record Sales

The U.S. raised $1.02 trillion from debt sales this year to help finance spending plans designed to pull the economy out of the deepest recession since the 1930s, government data show. Barclays estimates $1 trillion more will be sold in the second half of the year. The budget deficit will reach $1.85 trillion in 2009, according to the Congressional Budget Office.

Concern that the government will have trouble selling the debt contributed to a loss of 4.08 percent for Treasuries this year through July, according to Merrill Lynch & Co. index data. The yield on the benchmark 10-year note today was 3.64 percent, up from this year's low of 2.14 percent on Jan. 15 as the price of the security fell, according to BGCantor Market Data. The 3.125 percent note due in May 2019 was at 95 26/32.

Bond bulls are taking comfort that at the same time Treasury supply is increasing, gross issuance of corporate debt is falling. Company bond sales will decline to $300 billion from $615 billion in the first six months of the year, according to JPMorgan. Net new issuance of bonds after redemptions should fall to almost zero from $271 billion, according to the firm.

Yield Forecasts

Outstanding unsecured debt issued by the Federal Home Loan Banks, Washington-based Fannie Mae and Freddie Mac in McLean, Virginia, the largest borrowers in the agency market, dropped 8.2 percent to $2.76 trillion through June, according to data compiled by Bloomberg. New York-based Citigroup Inc. projects more declines.

With little competition, JPMorgan expects 10-year yields will fall to 3.25 percent by the end of December, and for the yield on the two-year Treasury note to remain little changed over the next year from 1.11 percent on July 31. The median forecast of 54 economists surveyed by Bloomberg is for the two- year yield to be 1.68 percent in mid-2010.

Americans are hoarding money as job losses mount. The U.S. savings rate reached 6.9 percent in May, the highest level since 1993, as consumers curtailed spending. It was as low as zero as recently as April 2008.

Reflecting their newfound frugality, Fed data show households more than doubled their holdings of Treasuries in the first quarter, to $643.9 billion from $266.6 billion in the final three months of 2008.

Excess Reserves

Meanwhile, those savings and the $1 trillion pumped into the banking system over the past year by the Fed through bond purchases and emergency loans led banks to accumulate excess reserves of $744 billion. Excess reserves, the cash banks keep on deposit above what they are required by the central bank, averaged $1.7 billion for the five years prior to August 2007.

"Government financing needs are extraordinary right now, and this combined demand is helpful in keeping borrowing costs down," said Tony Crescenzi, a strategist and portfolio manager at Newport Beach, California-based Pacific Investment Management Co., which oversees the world's biggest bond fund. "At some point banks will shift from investing in securities toward making loans, but we haven't seen that yet."

Commercial and industrial loan growth is falling at a 4.5 percent pace, according to Fed data.

Cautious Banks

Even as signs of stabilization in the worst housing market since the 1930s emerge, lower-risk securities, such as Treasuries, are key for banks to shore up balance sheets, according to

Jeffrey Caughron, an associate partner at The Baker Group Ltd. The Oklahoma City firm advises community banks investing $20 billion of assets.

The seizure in credit markets triggered $1.52 trillion of writedowns and credit losses at the world's biggest banks and financial institutions since the start of 2007, and pushed the global economy into its first recession since World War II.

"One of the lessons banks learned in the midst of this market turmoil is the importance of having high-grade credit quality securities in their investment portfolios," Caughron said. "Liquidity is of paramount importance these days, and the most marketable highly saleable securities are U.S. Treasuries."

A slow and gradual economic recovery, with little risk of inflation or Fed rate increases, adds to banks' penchant for Treasuries, Caughron added.

Dudley on Rates

New York Federal Reserve Bank President William Dudley said July 29 that it was "premature" to discuss when to raise rates and officials should dispel any concern that their policies may spur inflation. Consumer prices fell 1.4 percent in June from a year earlier, the biggest drop since 1950, according to the Labor Department.

While the recession may be "waning," a recovery "will be considerably slower than usual," Dudley said during a speech to the Association for a Better New York, adding that "credit availability will be constrained for some time to come."

The Fed's target rate for overnight loans between banks will remain within a range of zero to 0.25 percent at least through June 2010, according to the median forecast of 51 economists surveyed by Bloomberg.

Pimco Rate View

Fed Chairman Ben S. Bernanke won't raise borrowing costs before 2011 because of the threat of deflation, according to Pacific Investment Management Co., which runs the world's largest bond fund. Deflation is a general drop in prices.

Benchmark rates will not rise "before 2011 and I'm not only forecasting that as a professional forecaster, but positioning portfolios on that proposition as well," said Paul McCulley, 52, managing director at Pimco, in an interview that was broadcast yesterday by the Australian Broadcasting Corp.

Pimco, based in Newport Beach, California, is a unit of Munich-based insurer Allianz SE.

Rising demand for government debt combined with negative loan growth is typical of recessionary periods -- dating back to the 1930s, according to Michael Darda, chief economist at MKM Partners.

Japan's Example

It’s also reminiscent of Japan, where banks increased their holdings of government bonds to record levels during the country’s so-called lost decade of economic stagnation that began in the 1990s.

By the end of 2005, government bonds made up 18.2 percent of Japanese bank portfolios, up from 7.5 percent in 1998, while loans as a percentage of holdings slid to 55 percent from 63 percent, according to Citigroup.

While Japan has the world’s largest bond market, with $6.9 trillion in government debt, compared with $6.6 trillion of marketable debt securities in the U.S., 10-year Japanese government bonds yield 1.42 percent.

The steepness of the yield curve, or the difference between short- and long-term rates, is giving banks incentive to borrow for almost nothing in the overnight lending markets and invest the proceeds in Treasuries.

The federal funds rate averaged 0.16 percent over the last month, while the two-year Treasury yield averaged 0.9929 percent in the same period. The difference of about 0.83 percentage point compares with an average of about 0.26 percentage point this decade.

Two-year notes have handed investors a return of 0.4 percent this year, compared with a 9.9 percent loss for holders of 10-year securities, Merrill Lynch indexes showed.

“The steep yield curve is good for net interest margins and will allow banks to recapitalize themselves over time as well as help the Treasury finance large increases of government spending,” said Darda of MKM.

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