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Treasury Supply and Debt Buyback Redux

In a surprising and explosive development, the US Treasury announced on October 31, 2001 that it would suspend issuance of 30-year securities, including both the nominal and inflation-adjusted securities.

The Fuss

Talk about excitement in the stolid US Treasury market! Relish these spicy details of the drama: Most players were positioned for further curve steepening in anticipation of the Fed's November meeting and many were short long bonds. The current long bond surged almost 9 points over a 2-day period. The announcement was accidentally placed on the US Treasury website about 10 minutes prior to its release. A private fixed-income consultant was included in a briefing on the announcement and contacted some of his clients before the release. The information-handling debacle and insider trading allegations have been referred to the SEC.

The Facts

What should we make of this heady turmoil? First, let us review some of the facts in the remarks of Under Secretary of the Treasury Peter Fisher.

"As a consequence of the further weakening of the economy and the increased federal outlays that have occurred since the attacks of September 11th, the management of the Treasury's marketable debt needs to anticipate the possibility of a unified budget deficit for the fiscal year and, perhaps, the following fiscal year as well. However, even if this happens, we expect the federal government will return to surpluses in the coming years."

"We are adjusting the debt buyback program as follows:
- We will continue to conduct buybacks for the remainder of this calendar year;
- We will make no buybacks in January 2002; and
- Beginning in February 2002, we will announce at our quarterly refundings the amount and timing of any buyback operations for the subsequent three-month period; …"

So, to summarize, the 30-year auctions have been eliminated indefinitely, but there may also be a reduction in buybacks in general and 30-year buybacks in specific, although that is speculation. But gross-issuance overall will increase from expectations pre-September 11th, with the supply concentrated in 2-10 years area.

What Impact?

Net Issuance

The table below shows the last four years of 30-year bond auctions. We see the biannual auction size of $15bn for the last two years, down from $20bn for the two years before that.

Source: U.S. Treasury

Issue	Total amount (Bln $)	Coupon rate	Foreign add-on (Bln $)	Non-comps (Bln $)	Bid/ cover ratio	Avg. yield	Tail (basis points)
Aug 01	5.001	reopen	chg	0.032	2.16	5.520	5.472
FEB 01	10.004	5.375		0.034	1.95	5.460	1.2
Aug 00	5.001	reopen	0.723	0.015	3.71	6.688	1.0
FEB 00	10.001	6.250	0.100	0.033	1.33	6.207	5.0
Aug 99	10.001	6.125	0.100	0.072	2.22	6.144	1.0
Feb 99	10.009	5.250	0.000	0.061	2.05	5.279	6.0
Nov 98	10.001	5.250	0.000	0.067	1.63	5.240	6.0
Aug 98	10.003	5.500	0.000	0.047	2.49	5.590	0.8

Now let us look at the amount of buybacks in recent years. More than $48bn of bonds scheduled at mature in 2015 or later have been retired. So net issuance over the last 3 years has been approximately $50bn in new issuance less $48bn in long debt buybacks, or $2bn net issuance. Over a more recent period, net issuance has actually been negative. So net issuance of the 30-year would not be greatly changed in the near term if new issuance equals zero going forward, but buybacks are reduced to zero also. Of course, part of the significance of the announcement also relates to the potential for relative supply in the intermediate curve. Most market analysts believe the bulk of issuance will be accomplished in the Treasury Bill market.

A Strategic Intent?

In his remarks, Peter Fisher explicitly addressed any strategic intent to lower yields. “The Treasury does not try to outsmart the market at any one moment or be a ‘market timer’ with respect to any particular shape of the yield curve.” The 30-year was relatively expensive issuance, and as such, desirable to eliminate. 30-year auctions could easily be reinstated if long issuance is once again required. But there is no question that a flattening of the curve and a lowering of key rates that might result in further household-level financial stimulus would be an attractive and timely additional benefit. If we look to history for a guide on active curve reshaping, we are reminded of “Operation Twist” conducted in the 1961-62 period, when the Fed switched its open market operations to the buying of only longer issues. Intended to be conducted in coordination with the Treasury, the operation ended up being largely the Fed’s alone. The result was poor execution irrespective of the concept, and interest rates in the long end went up despite these actions.

The Supply Situation

Further, the outstanding supply of long-end Treasury bonds is by no means insignificant and it is not rapidly disappearing. More than $420 billion bonds mature in 2015 or later, and more than $136 billion bonds mature in 2026 or later. While we grant bonds will roll out of the 25-30 year bucket over the next five years, reducing that bucket to zero, they will have to roll into the 20-25 year bucket. Remember that duration change is not as great as the maturity change, so 'buyers of duration' can still largely do so.

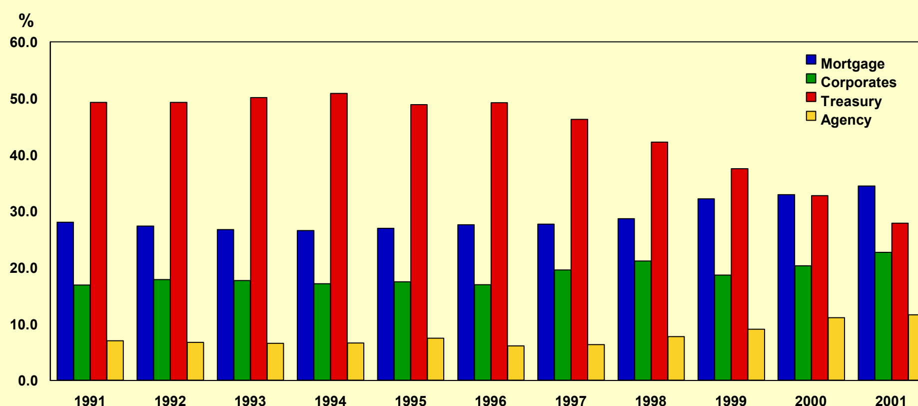
Treasury Coupon Bonds, 25-30 Year Maturity, Jan 1 of Each Year
Assuming NO BUY-BACKS in $Billions

Year	25-30 Year Outstanding
2001	136
2002	107
2003	70
2004	50
2005	30
2006	15

Source: Salomon Smith Barney

The Demand Situation

If the Treasury is correct, we will again see the secular trend of dwindling Treasury supply return to the fore. But this is no longer the dramatic situation envisioned a year ago when steadily increasing budget surpluses were predicted, and all Treasury debt was a candidate for repayment. As we see in the chart below, the trend of the last decade has prepared institutional investors for the new supply equation with growing mortgage and corporate sectors.



But true alternatives in the long-end remain scarce, and no doubt this action will serve to increase the appeal of high quality, longer-term agency and corporate bond to pension funds and insurance companies matching long term liabilities with long term assets.

Our Assessment

We see the following implications of this action. In the short term, the strong relative outperformance of the 30-year should be partially reversed. But the curve will remain flatter with broader implications. Swap spreads, which to some extent equilibrate between high quality corporate and Treasury interest rate levels, should reflect the changed supply equation. It is likely long end swap spreads, and with them Agency and Corporate bond spreads, will widen to reflect the richer valuation of Treasury bonds off which they are quoted. In the intermediate area (2-10), where the Treasury curve will see supply, swap spreads would typically tighten. For now, the current Treasury long bond will hold a liquidity premium to the old and off-the-run long bonds. Over time, the entire Treasury bond sector may warrant an illiquidity premium, and wider bid/ask spreads may result. Long-term, high quality agency and corporate bonds should benefit from a reinvigorated search for Treasury and Stripped-Treasury alternatives. Looking farther out, the secular shift of institutional investors away from the shrinking Treasury market to the burgeoning mortgage and corporate markets will continue and find reflection in broad fixed-income indices and benchmarks.

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