

JVB FINANCIAL

Weekly Commentary by Bill Sullivan, JVB Chief Economist



ABOUT BILL SULLIVAN

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

Mr. Sullivan received his Bachelor of Arts Degree in Economics from Fairfield University.

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The Underwriters of U.S. Treasury Debt

The U.S. Treasury continues to attract a broad array of buyers for its debt. The ability to place its offerings with a variety of investors has helped to contain overall interest rate pressures despite the record pace of deficit financing. The latest ownership trends were evident in the Federal Reserve's Flow-of-Funds report for the second quarter which was released earlier this month.

CHANGES IN U.S. TREASURY SECURITY OWNERSHIP			
	IVQ08	IQ09	11Q09
Total Issuance	\$2,154.2	\$1,442.8	\$1,896.4
Households	19.7	1,074.5	342.9
Foreign	1,041.8	688.1	403.0
Federal Reserve (-14.0)		88.9	647.4
Brokers/Dealers 773.9		(-354.7)	403.6
Other	332.8	(- 54.0)	99.5

Source: Federal Reserve Board Flow-of-Funds. Data in billions, seasonally adjusted annual rates.

During the April-June, 2009 period, the Treasury actually increased the amount of new cash it raised as compared to the first quarter. According to Fed data, the nation's debt managers borrowed nearly \$1.9 trillion from the global capital markets during the second quarter, up by more than \$450.0 billion from the volume raised during the opening three months of the year. The second quarter pace, however, was still below the record of \$2.154 trillion that was established during the October-December, 2008 period. To provide some perspective, during the 2004-2007 interval, or before the meltdown in the financial markets and the

onset of recession, annualized borrowing averaged just \$273.0 billion.

The largest underwriter for the Treasury's new issue calendar during the second quarter was actually the Federal Reserve. In particular, the central bank acquired \$647.4 billion in marketable securities during the three months ending June and thus accounted for 34% of total purchases. The sharp acceleration in Fed buying reflected a decision by the policymakers that was made earlier in the year to add \$300.0 billion in direct Government debt to the System Account portfolio in an effort to push long term rates lower. The program will continue through October and upon its completion, it is quite apparent the Treasury will be losing a major buyer for its security offerings. The roll back in the Fed's involvement could in theory be viewed as a negative for the interest rate outlook. However, acknowledgement has to be given to the fact that many other considerations, such as the preference for quality, also shape the ongoing shifts in open market yields. These forces can easily override the expected reduction in Fed buying in the months ahead.

The household sector, which includes domestic hedge funds, reduced its pace of acquisition, with net purchases totaling about \$343.0 billion on an annualized basis. While down appreciably from the opening three months of 2009, the second quarter pace was still historically large and contrasts markedly with the net liquidations that characterized the household group during the 2005-2007 period. Given the maintenance of relatively

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low returns in the Treasury market, especially on shorter-dated maturities, it is clear that households continue to add to their Government holdings largely for liquidity and safety purposes. But, with yield spreads versus other debt instruments narrowing, Treasury securities in the longer end of the market are gradually becoming more attractive in relative terms for those investors that are focusing on current income. Against this backdrop, individual investors are likely to sustain their active involvement in the Treasury market for the foreseeable future.

The most consistent buyer of Treasury debt over recent years has been the foreign investor group which continued to add to their portfolios during the second quarter, albeit at a reduced pace. As indicated, the offshore buyer segment, which includes foreign central banks and private investors, boosted their holdings of marketable securities by \$403.0 billion on an annualized basis during the April-June period. The increase was less than two-fifths of the acquisitions that took place during the final three months of 2008 and was the smallest quarterly gain in one year. Some of the deceleration in net acquisitions appeared attributable to reduced buying by OPEC members as the price of oil moved lower as compared to last year. With the dollar losing substantial ground since mid-year, it seems probable that offshore buying re-strengthened during the third quarter and should remain vigorous through year-end.

The Flow-of-Funds data continue to capture amazing swings in the activity of brokers and dealers. No doubt, the tremendous volatility in the holdings of this group reflects inventory decisions by trading desks. In the

fourth quarter of 2008, the dealer community boosted its Treasury positions by almost \$775 billion on an annualized basis, an unprecedented volume of purchases. Over the January-March period this year, dealers apparently decided to lessen their exposures to Government debt and subsequently reduced their positions in Treasuries by \$354.7 billion. Returning to the buy-side during the spring months, dealers elevated their net long positions by more than \$400.0 billion in the second quarter.

Beyond the sectors that seemingly dominate the ownership trends in Treasury securities, it should be noted that many other investor groups have consistently added to their Government debt portfolios over recent quarters, but at lesser volumes. Among the institutions that have boosted their holdings in the last year or so are credit unions, commercial banks, life insurance companies, mutual funds and exchange traded funds. The acquisitions of these firms also help to distribute the Treasury's calendar of new offerings and probably represent an overlooked reservoir of buying power for future issuance. ■

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