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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Weekly Commentary

by Bill Sullivan, JVB Chief Economist

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Households Big Buyers of Treasuries During Third Quarter

The U.S. Treasury continued to attract a broad array of investors for its securities during the third quarter. Indeed, despite the need to raise nearly $1.5 trillion in fresh funds on annualized basis during the July/ September, 2009 period, the nation's debt managers were still able to accomplish their financing task in a declining rate atmosphere. The downturn in open market yields in face of this huge calendar once again underscored the point that supply is typically a residual or secondary influence on the overall direction of interest rates.

CHANGES IN U.S. TREASURY SECURITY OWNERSHIP

	1Q09	11Q09	111Q09
Total Issuance	$1,442.8	$1,896.4	$1,481.2
Households	1,066.5	330.3	742.9
Federal Reserve	88.9	647.4	446.3
Foreign	688.1	403.0	401.9
Comm'l Banks	66.0	26.0	241.8
Money Funds	(-253.6)	(-64.4)	(-260.4)
Brokers/Dealers	(-354.7)	393.8	(-323.9)
Other	141.6	160.3	232.6

Source: Federal Reserve Board. Data in billions.

According to the Fed's Flow-of-Funds statistics, the largest buyer of Treasury debt during the period under review was the household sector. Official data indicate that individual investors boosted their portfolio holdings of direct Treasuries at a $742.9 billion annual rate, accounting for half of the total debt placements by the Federal Government during the third quarter. The pace of acquisition was more than double the volume that transpired during the April/June interval,but fell short of the purchases that were effectuated during the opening quarter of the calendar year. Notwithstanding the large purchases throughout 2009, Treasury securities continue to represent a small share of household financial assets. In particular, at the end of September, Treasuries comprised only 1.8% of total financial assets as compared to 13.5% for bank deposits, an equally low yielding investment. Clearly, the household group is in a position to add significantly to their holdings of Government debt, a situation that could help to ease the Treasury's financing burden in the quarters ahead.

The offshore segment maintained strong buy-side interest in the Treasury's offering slate during the third quarter. This sector, which includes central banks, private investors and some hedge funds, added $401.9 billion on an annualized basis in U.S. Treasury securities to their portfolios, sustaining a pattern of aggressive acquisition that began several years ago. The Federal Reserve was also a huge buyer during the period, reflecting its commitment to add to its system account holdings of Treasury debt. As detailed in the table, the Fed was actually the second largest buyer of Treasury securities during the third quarter, adding nearly $450.0 billion to its portfolio. While off from the acquisitions during the second quarter, the volume was the second largest quarterly total on record and contrasted markedly with the outright liquidations that dominated the 2007-2008 period. With the Committee bringing its program of Treasury purchases to an end, the pace of buying will obviously be much lower during the current quarter and throughout the New Year.

One surprise in the third quarter report was the dramatic step-up in the pace of buying by the commercial banking sector.

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This investment group had revealed little interest in adding to their Treasury portfolios over recent years. To provide perspective, over the 2005-2008 interval, Federal Reserve data capture a net liquidation of about $15.0 billion in Treasury debt positions by commercial banks. In that context, the $241.8 billion annualized pace of addition over the July/September quarter was virtually unprecedented by this group of financial institutions. Most likely, the acquisitions were an effort to offset the loss of income that was being driven by a sharp reduction in the volume of outstanding business and consumer loans on bank balance sheets. With the Federal funds target holding steady in the zero to 25 basis point range, banks can take advantage of the huge positive carry that exists between the cost of short-term borrowing and the return available on Treasury coupon issues. As long as lending activity continues to shrink, banks will have a clear incentive to add to their investment holdings of Treasury debt, a development that could help offset the anticipated reduction in Federal Reserve purchases.

Against the backdrop of strong demand, the Treasury raised another sizeable block of new cash at progressively lower yields throughout the third quarter. The two year note yield, for instance, fell by 17 basis points during these three months, finishing September at 94 basis points. The ten year note and thirty year bond dropped by 21 basis points and 27 basis points, respectively, allowing the yield curve to flatten modestly during the quarter. The downward pattern in open market yields is consistent with the notion that interest rate projections based solely on supply factors have little validity. In particular, the volume of new issue placements, whether large or small, must always be measured against investor preferences for liquidity and safety. At times, those preferences can be so overwhelming that the Federal Government can raise record sums of fresh funds in a setting of declining costs. Moreover, it appears another factor has entered the marketplace for Treasury debt; namely, the pressure for banks and other firms to add income producing assets to their balance sheets to offset declining loan demand. ■

William V. Sullivan, Jr.
Chief Economist
JVB Financial Group
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JVB Financial Group, LLC, member FINRA, SIPC
2700 N. Military Trail, Suite 200 / Boca Raton, FL 33431
(561) 416-5876 • www.jvbfinancial.com