



**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.

JVB FINANCIAL

Weekly Commentary *by Bill Sullivan, JVB Chief Economist*

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A primer on interest expense

The highly accommodative approach to monetary policy that the Federal Reserve has pursued over the last year or so has had a huge positive impact on the Government's financial position. Indeed, the willingness of the credit authorities to maintain a Fed funds target close to zero percent for a lengthy period has kept Treasury borrowing costs at historically low levels. The reduced expense of issuing securities has allowed interest outlays to actually fall on a year-over-year basis, despite the explosion in outstanding debt over recent quarters. Needless to say, a heightened preference for quality and safety among global investors of late has also helped to keep interest costs in check. Clearly, when the Federal Open Market Committee does eventually decide to remove some liquidity from the system, the Treasury's interest expense could skyrocket, given the huge volume of debt that has been issued. The upturn in interest-related expenditures will of course add to the difficulty in narrowing the budget deficit in upcoming fiscal years, and from that perspective, could arguably encourage the Fed to limit the degree of tightening that is likely to take place as the economy enters a recovery phase.

When viewing the Government's fiscal position via the unified budget concept, there are two categories of interest-related expense. For issues that are held by the public, a monthly expense for debt service is provided on an accrual basis which attempts to smooth the trend in interest outlays for marketable securities. Alternatively, for those issues owned by Government Trust Funds,

the interest cost is published on a cash basis and thus can vary widely from month-to-month. During fiscal year 2008, total interest outlays on a unified budget basis registered \$451.1 billion, up approximately \$21.0 billion from the prior year's expense. Public issues accounted for \$238.3 billion of that aggregate cost while the Trust funds received \$212.8 billion in interest payments.

The influence of the Federal Reserve's low interest rate policy is strongly evident in the budget data for the first nine months of the current fiscal year which ended June 30, 2009. Over this interval, the volume of public and non-marketable debt outstanding has exploded upward by \$1.586 trillion as the Treasury has raised huge sums of new cash to support a variety of programs to prop the financial markets and to help U.S. families that have been battered by the recession. Notwithstanding the quantum leap in debt issuance, unified budget outlays for interest expense over the October, 2008-June, 2009 period tallied \$320.6 billion, or \$56.7 billion under the actual expense registered over the comparable period of fiscal year 2008. Without a doubt, the smaller total for interest outlays prevented the budget deficit from being even larger than what was reported for this nine month interval.

The biggest risk to the debt service expense outlook resides in the Treasury bill market, the maturity sector that would be the most responsive to any ongoing shifts in domestic monetary policy. At the end of June, there were \$2.0 trillion in Treasury bills outstanding, comprising about 17.4% of all

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public debt. As is widely known, the nation's debt managers issue a variety of Treasury bills, including four, thirteen and twenty-six week auctions. Recently, the cost of these offerings has averaged well under 25 basis points, mirroring the Federal Reserve's target range on overnight money. As soon as the Committee begins to tighten monetary policy, the weekly auction process will almost immediately capture the added expense to the Treasury for issuing these short-term debt instruments. Most likely, coupon bearing securities, such as two, three and five year notes, will also be heavily impacted by the rising cost of borrowing, adding further upward momentum to overall debt service expense. Although it is difficult at present to anticipate a trajectory for the Federal funds target, an increase to just 2.00% over the next few years would effectively entail an eightfold jump in the cost of issuing bills, adding hundreds of billions of dollars to the Government's outlays for interest expense. Another consideration is that the volume of public debt financing will undoubtedly be moving higher in the years to come as the Treasury continues to raise cash to fund prevailing deficits. As a result, any tightening in monetary policy and subsequent rise in borrowing costs is likely to be applied to a much larger volume of securities outstanding as compared to the current amount.

When the Federal Reserve begins to raise its interest rate target, the adjustment will obviously be in response to an improvement in the U.S. economy. Stronger growth will generate more jobs and bolster corporate profits, developments that should give a lift to tax receipts. Moreover, many Government programs, such as unemployment benefits, should begin to

experience a lower pace of spending in an improved economic setting. Nevertheless, it appears that the general cost of issuing debt, at least for several fiscal years, will more than offset these positive influences and will thus add to budget deficits during this period. In theory, the Federal Reserve's decision-making process should not be influenced by the reality that a tighter policy could initially promote a higher flow of budgetary red ink. Nonetheless, when formulating an exit strategy from the current degree of accommodation, the unprecedented volume of Government debt that is now outstanding could be a complication that the central bank did not confront in the past. ■

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