

Go Long If Fed Shortens Debt Financing

By Bernice Napach
In New York

Bondholders should be on the lookout for a change in financing by this country's largest debtor, the U.S. government.

Speculation has been building that the U.S. Treasury will reduce the size of the 30-year benchmark bond in order to save financing costs and spark a more vigorous economic recovery. The talk already has helped boost prices of the long bond.

Chief economist designate Laura D'Andrea-Tyson said yesterday that Clinton will look at cutting long-term borrowing as a means of reducing total federal interest payments.

"The government definitely will do something with its debt management strategy," said Robert Giordano, director of economic research at Goldman, Sachs & Co. "It's probably too early to

do it in the next quarterly refunding (in February). But more realistically, we could see something in the early spring (May refunding)."

Individuals can take advantage of the speculation by buying 10- or 30-year bonds, whose prices should rise if the supply declines. Ten-year bonds could benefit from increasing demand siphoned from the 30-year issue.

During the week the Clinton administration assumed office, neither the Treasury Department nor a spokesman for incoming Treasury Secretary Lloyd Bentsen would comment on a proposal to change the structure of the federal debt.

But the speculation is not unfounded. Clinton, in "Putting People First," the book he wrote with Vice President Al Gore, proposed cutting \$6 billion in debt financing from 1994 through 1996.

His economic adviser Robert Reich, the new labor secretary, has said that the administration would study several

options to improve the economy, including reducing long-term debt and increasing short-term issues.

Just last week, the Democratic Study Group, a congressional advisory service, released a report endorsing that option. The study proposed shifting new debt with maturities of two to 30 years into three-month bills, arguing that at least \$5 billion could be saved the first year because of lower interest rates in the front end of the yield curve

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and far more could be saved in subsequent years.

"Reversing the current Treasury debt management policy of relying on high levels of long-term debt issues when that form of financing is relatively far more expensive should produce two very desirable results," the report stated.

"It should provide both immediate and long-term budget savings in the areas of interest payments on the federal debt, the fastest-growing portion of the budget. It should also push down long-term rates and provide a significant portion of the stimulus needed to put the U.S. economy back on track."

About \$2.8 trillion of the total U.S. debt is in marketable securities. Of that, about 16% is in long-term bonds, 56% is in two- to 10-year notes, and the rest in bills, with maturities of one year or less. The average maturity of the debt is around six years.

Short-term debt, however, comprises the bulk of new issues, while the 10-year

and 30-year bonds account for about one-third of new debt.

The proposal to reduce long-term debt in favor of the short-end is meeting with mixed reviews.

One Wall Street economist, who spoke on condition of anonymity, called such a plan a "free, good . . . painless deficit reduction that would result in lower long-term rates."

Philip Braverman, chief economist at DKB Securities Corp., said it was "true deficit management" that makes "economic sense" by freeing up investment capital and cutting long-term rates that are historically high after adjusting for the current low rate of inflation.

Cut Would Boost Growth

According to Campbell Harvey, professor at the Fuqua School of Business at Duke University, a 1% reduction in long-term rates could add 0.8% to economic growth, after adjustments for inflation.

More specifically, according to Hani Findakly, president of Potomac Capital

Inc., an investment management firm, the reduction in long-term rates would open up that part of the market to more corporate and municipal borrowers, providing a "net savings for the economy." Currently demand for the long bond is about half the \$40 billion in new annual supplies, Findakly said.

Robert Brusca, chief economist at Nikko Securities Co., likes the idea of reducing the issuance of the long bond, but cautions that the change should occur slowly and the substitute debt should be spread out along the yield curve and not just in three-month bills, which are up for renewal every three months.

Despite these assertions, there are many people on Wall street who oppose any substantive change in the structure of the federal debt.

They argue that the proposed change won't work and point to the early 1960s when a similar strategy was tried — Operation Twist, which had little effect on bringing down long-term rates.

A less ambitious plan by the Treasury last year cut the size of the 30-year bond by \$2 billion and the 10-year by \$1 billion in each quarterly refunding. It, too, had little effect on long-term rates.

The critics say that if the Street doesn't get the regularity and predictability it likes, it will make the government pay by raising rates in the debt markets, not lowering them.

"The market will adjust for that additional uncertainty, but it will charge the government," said Suresh Krishnan, vice president at the debt market research department at Merrill Lynch Capital Markets. "The long-term solution to getting interest rates down is to get the budget deficit down."

'Short-Term Solution'

Thomas Sowanick, chief fixed-income strategist at Merrill, said the proposed changes constitute a "short-term solution to a long-term problem," that would create other problems.

Among them is rising short-term rates following the increase of short-term debt. That could end up costing the government more money as it rolls over the short-term debt more quickly than it would have rolled over the long-term financing.

By switching some of its borrowing to the short end from the long end, and possibly back again if long rates fall, the government essentially would be involved in market timing — a dangerous endeavor for anyone — and long rates could eventually end up higher than they would have if there had been no change.

As for the economic implications, lower long-term rates do not necessarily mean more economic activity if the demand for borrowing is as shallow as it appears to be, Sowanick said.

"Is there an appetite to borrow?" asked Sowanick. "The answer is no."

Wall Street Watching

Mortgage and corporate borrowing rates, moreover, are tied more closely to the seven- and 10-year notes, not the 30-year bond.

The 30-year bond, however, is an important part of the debt market for Wall Street. Among its uses are the huge Treasury strip market, under which Wall Street firms buy up the 30-year Treasury, strip it into its principal payment and interest-bearing parts and sell these issues to investors. The 30-year bond is also used for derivative products such as futures and options.

The 30-year bond is an "important piece of the U.S. securities market," said Scott Pardee, chairman of Yamaichi International (America) Inc. "To cut it back because of the short-term interest to reduce long-term rates is shortsighted."

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