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HEADLINE Credit Markets:
Treasury Studies Floating-Rate Note Proposal;
Bond Prices Recover From Previous Day's Plunge

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Staff Reporters of The Wall Street Journal

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* NEW YORK -- For years, floating-rate Treasury securities have been on the wish list of Wall Street and yesterday that wish came one step closer to reality.

* The Treasury Department said it is studying a proposal to offer a floating-rate note, which could attract new investors. Presently,
* all Treasury securities are sold at a fixed rate of interest.

According to a draft document of the proposed terms for a floating-rate note, the Treasury is considering a note with a five to seven-year maturity that would be "subject to early call or redemption." The note would be indexed to the "per annum average bond equivalent rate for 13-week Treasury bills."

The Treasury said the fact that it is studying the issue, which was proposed by its private-sector advisory committee last June, isn't necessarily an indication that it feels the notes might be a good idea. "We have no plans to change the current regular issue cycles, and we have no bias as to whether or not the floating-rate notes would be a viable option for us," said Darcy Bradbury, deputy assistant secretary for federal finance.

Issuing floating-rate debt would subject the government to the vagaries of shifting interest rates. A sharp rise in short-term interest rates, to which the floating-rate notes would be indexed, could make them more expensive for the government than fixed-rate
* notes. But Campbell Harvey, a proponent of the proposal and a
* professor of finance at the Fuqua School of Business at Duke University, thinks otherwise. Given the big gap between short-term and long-term interest rates, "short-term rates could go up and floating-rate debt would still be cheaper than fixed long-term debt," he said.

"Let's say the government sells floating-rate five-year notes," said Mr. Harvey. If the interest rate is pegged to the 13-week Treasury bill, it would be about 3.12% as of yesterday, he explained. Since fixed-rate five-year notes yielded 5.08% yesterday, the Treasury would be saving interest costs as long as the bill rates didn't rise above the five-year note rates. And even if bill rates did rise above the five-year note rates at some point, said Mr. Harvey, they would have to rise very quickly and very far for floating-rate notes to become more expensive in terms of interest costs. "Let's say bill rates rise above the five-year rate in the fourth year," he said. "The government would have saved money over those four years."

Of course, rosy predictions of interestrate savings depend on the path of interest rates in the future, which even many of the nation's top economists were unable to predict correctly last year.

In market activity, the benchmark 30-year Treasury bond yield dropped to 6.28% from 6.31% on Tuesday. The price, which moves in the opposite direction of the yield, rose 1/2 point, or $5 for a bond with a $1,000 face value, to 99 17/32.

Meanwhile, the Republic of China sold $1 billion of 10-year global notes. It was the nation's first global-note offering and will likely serve as a benchmark for future debt issues from China. Global notes are securities designed to be easily bought and sold in the world's major markets.

Ms. Bradbury of the Treasury Department said the main factor in determining whether the Treasury would opt for a floating-rate note would be whether such an item would reduce borrowing costs for the department.

Last June, the Treasury Advisory Borrowing Committee suggested the department consider floating-rate notes in order to prevent possible funding difficulties. The suggestion stemmed from the Treasury's decision last spring to cut the amount of long-term debt it sells in favor of issuing more short-term debt.

Floating-rate securities are commonplace in the corporate and municipal bond markets but they would amount to a new wrinkle for the Treasury's financing schemes. Possible buyers for such securities would include institutions looking to hedge their exposure to interest-rate swaps, in which one institution swaps floating interest rate payments for fixed ones, said Louis Crandall, chief economist at R.H. Wrightson & Associates, a firm that provides analysis of Treasury policies and activities. The interest-rate swap market is one of the fastest growing sectors in all the world's bond markets.

According to Art Zimmer, a portfolio manager at Oppenheimer Management Corp., banks may find floating-rate Treasury notes attractive as well. Banks "tend to buy short-maturity securities and floating-rate instruments . . . would eliminate a lot of interest rate risk," he said. Mr. Zimmer added that Oppenheimer has about 25% of its total assets of $7 billion in floating-rate or variable-rate securities. The "reduction of interest-rate risk could be a rather significant benefit for many investors," he said. "But the government would be taking it on instead," he pointed out.

But Mr. Crandall of Wrightson & Associates said "there is something curious about the fact that when everyone else in America is trying to lock in the longest rates they can, the Treasury has decided it likes to borrow at the short end of the curve." Though the Treasury's proposed floating-rate note could have maturities of five to seven years, they would be paying interest of short-term securities.

Even if there weren't a big gap between short and long-term rates, Mr. Harvey of Duke argues that floating-rate debt would still be a good idea. Issuance of floating-rate debt could have a direct influence on economic policy, Mr. Harvey added. Floating-rate debt "penalized an inflationary policy," he said. "If there is any idea of reinflation, short-term rates would rise and the servicing costs of the debt would go up as well," he said. "It's a policy-consistent strategy."

Separately, the Treasury said it plans to sell $40 billion of notes and bonds in its mid-quarter refunding next week to raise about $16 billion in new cash.

The refunding will consist of $17 billion in three-year notes due Feb. 15, 1997, to be sold Tuesday in minimum denominations of $5,000; $12 billion in 10-year notes due Feb. 15, 2004, to be auctioned Wednesday in minimum denominations of $1,000; and $11 billion in 30-year bonds due Aug. 15, 2023, to be sold next Thursday in minimum denominations of $1,000.

Some of the proceeds of the sale will be used to refund $24 billion in maturing debt.

The Cusip numbers are 912827N73 for the three-year notes, 912827N81 for the 10-year notes and 912810EQ7 for the 30-year bonds.

Noncompetitive tenders for the notes and bonds must be received by noon EDT on the day of the auction at Federal Reserve banks or branches.

The auction sizes were mostly as expected, although some in the market had been looking for a smaller 30-year bond offering. In when-issued trading late yesterday, the three-year note yielded 4.55%, the 10-year note yielded 5.67% and the bond yielded 6.29%.

Prices of most U.S. Treasury notes and bonds ended higher yesterday, after a late-afternoon rally reversed a portion of Tuesday's declines.

The best performing issues were longer-term maturities, with short-term Treasury securities still under pressure from concerns that the Federal Reserve is closer to raising interest rates than had been recently thought.

The 10-year note rose nearly 1/4 point to 100 8/32 to yield 5.79%, compared with 5.73% on Tuesday. The two-year note ended unchanged at 99 20/32 to yield 4.18%.

Corporate & Junk Bonds

The promise of continued growth in the People's Republic of China lured U.S. and Asian investors to the country's debut $1 billion global note offering yesterday.

China's 6.5% coupon 10-year global notes were sold at 99.406 to yield 6.582% through lead manager Merrill Lynch. The company sold the notes only hours after it was launched and a day earlier than expected. Merrill Lynch officials declined to comment on the global-note offering.

However, not everyone lined up to buy the paper.

One investor who didn't buy said he was skeptical about China's economic prospects. He added that he doesn't believe the bonds offered enough yield to compensate for the risks involved.

The investor suggested that the deal's pricing may have been speeded up because of a Clinton administration report Tuesday to Congress spotlighting Beijing's reported human-rights violations. He said the report raises concerns that the human-rights issue could endanger China's most-favored nation status with the U.S.

Syndicate officials countered that the bond market has already factored into the pricing the repeated reports of China's human-rights abuses and possible trade consequences.

"The desire for yield is clouding out and crowding out all other issues," said James Swanson, senior vice president at Massachusetts Financial Services, adding that investment-grade buyers are scrambling to boost returns.

European investors seemed to shun the offering. One syndicate official involved with the offering said the debt was priced at a yield spread that was 0.05 to 0.10 percentage point too narrow to lure European investors, who aren't as upbeat on China as their Asian and U.S. counterparts.

China's global notes, which are rated single-A3 by Moody's Investors Service and triple-B by Standard & Poor's, were priced 0.85 percentage point over the 10-year Treasury note.

The success or failure of the deal will ultimately be determined in the secondary market. "The real, telling story is how it will sell in 24 hours," one official involved with China's offering said.

Municipal Bonds

Municipal bonds finished yesterday's slow trading unchanged to 1/4 point higher, having maintained a strong tone despite two more unexpectedly strong U.S. economic reports.

Salem County, New Jersey's 5.45% bonds due 2032 closed 1/8 higher at 99 5/8, yielding 5.47%.

Sales of new single-family homes jumped 11.4% in December to an 862,000 annual rate. That month, the index of leading indicators rose 0.7% -- registering the fifth-consecutive rise and capping the strongest string of increases in a decade, the Commerce Department said.

Although munis have had a generally strong tone for the last week or so, some market participants note that purchases haven't been very aggressive.

But Smith Barney Shearson portfolio strategist George Friedlander said that munis should get a boost in the months ahead from a widely anticipated issuance slowdown. Pricings of refunding bonds -- which exceeded $185 billion in 1993 and set a record -- are expected to ebb this year.

Moody's Investors Service said its outlook for municipal credit quality in 1994 is "cautiously optimistic" and predicted that the year will be characterized by four broad, positive trends.

Those trends are the national economic recovery, lower debt-service costs because of refundings, lower oil prices, and the end of the deterioration in state-credit quality, Moody's said.

Lucinda Harper in Washington contributed to this article.

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DOCUMENT= 2 OF 2 PAGE = 1 OF 3

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HEADLINE Treasury Studies Floating-Rate Note Proposal

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