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Treasury Eyes First New Debt Since TIPS With Floating Notes

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(Updates prices in ninth paragraph.)

Oct. 24 (Bloomberg) -- The U.S., seeking to attract investors who might otherwise avoid Treasuries amid a $1.3 trillion budget deficit, is considering the sale of floating- rate notes in what would be its first new security since it began offering inflation-linked debt 14 years ago.

The Treasury Department said this month it asked Wall Street's biggest bond dealers for recommendations on structuring securities with coupons that rise or fall with benchmark rates. Officials are scheduled to gather with the 22 primary dealers, who include Goldman Sachs Group Inc. and JPMorgan Chase & Co., on Oct. 28 as it decides whether to go further during their regular meeting that precedes each quarterly refunding.

While the government's interest in offering a new type of bond may signal that it doesn't expect deficits to diminish anytime soon, the securities would likely appeal to investors concerned that the Federal Reserve's pledge to keep the federal funds rate at a record low through mid-2013 and other stimulus will spark inflation.

"It's an opportunity for the Treasury to expand its base of securities, at a time when there is a need for more floating- rate notes," Ira Jersey, an interest-rate strategist in New York at Credit Suisse Group AG, said in an interview on Oct. 18. The firm is one of the primary dealers of U.S. government securities that were required to fill out the Treasury's survey.

Falling Yields

The Treasury has had little problem generating demand at its bond auctions even with the amount of marketable U.S. debt outstanding rising to $9.625 trillion from $4.339 trillion in mid-2007 and Standard & Poor's cutting the U.S.'s credit rating on Aug. 5 to AA+ from AAA. Yields on 10-year notes fell to as low as 1.67 percent last month from 5.32 percent in mid-2007.

There is still a large group of investors who are spurning Treasuries, including Leon Cooperman, the chairman of hedge fund Omega Advisors Inc., who said last week during a presentation at the Value Investing Congress in New York that he "wouldn't be caught dead owning a U.S. government bond."

There are signs that foreign demand may be diminishing. Fed data show its holdings of Treasuries on behalf of central banks and institutional investors outside America plunged $76.5 billion in the seven weeks ended Oct. 12, the steepest drop since 2007, to $2.69 trillion.

"If rates go up it could cause problems for the government because they will have to pay a higher interest rate," Campbell Harvey, a finance professor at Duke University's Fuqua School of Business in Durham, North Carolina, said in an interview on Oct. 19. He's also a researcher for the National Bureau of Economic Research, which determines when recessions begin and end.

Yield Forecast

Yields on 10-year Treasuries fell 3 basis points, or 0.03 percentage point, to 2.19 percent at 7:24 a.m. New York time, Bloomberg Bond Trader prices show. The benchmark 2.125 percent note maturing in August 2021 rose 9/32, or $2.81, to 99 14/32.

The weighted average estimate of more than 60 economists and strategists surveyed by Bloomberg is for yields to rise to 2.48 percent by June 2012 and 2.86 percent by the end of next year. A separate survey shows inflation may accelerate to 3.1 percent this year, before slowing to 2.1 percent in 2012.

The Treasury Borrowing Advisory Committee, the group of bond dealers and investors that meets quarterly with the Treasury to share insights on the debt market, suggested the idea of floating-rate notes in February. The securities would likely increase demand from banks, pension funds, insurers and individual investors, while reducing the government's dependence on foreign buyers, the Committee said at the time.

'Convenient Product'

A floating-rate note whose coupon is reset at a rate that matches that of the six-month Treasury bill twice a year "would be a 'convenient' product" for which "demand will likely increase if rates are expected to rise," TBAC wrote in its February presentation to the Treasury.

Treasury officials were intrigued enough that they asked the dealers this month how such notes might be structured, if they would affect the overall cost of borrowing, and whether there would be "robust market demand for such a product." Treasury officials didn't immediately respond to telephone and e-mail requests for comment on the possible floating-rate notes.

Buyers of such notes may see stable interest payments for several years as the Fed tries to lower unemployment, which has held at or above 9 percent every month except two since May 2009. The central bank has kept its benchmark rate in a range of zero to 0.25 percent since December 2008 and said in August it will stay low through at least mid-2013.

‘Snapped Up’

The notes “would very likely be snapped up by investors, as many now buy fixed-rate Treasuries and use the swaps market to convert them into floating-rate debt anyway, to hedge the risk exposure to changing interest rates,” Moorad Choudhry, the head of business treasury, global banking and markets at Royal Bank of Scotland Plc in London, said in an Oct. 18 interview.

Capital and liquidity requirements from the 2010 overhaul of financial regulation in the Dodd-Frank Act, and from the Basel III global rules have increased demand for short-term, high-quality debt at a time when supply has diminished. Treasury data show the amount of bills outstanding has fallen to $1.478 trillion from a peak of $2.068 trillion in August 2009.

“There is enormous demand for high-quality, short-term assets now,” Lou Crandall, the chief economist at Wrightson ICAP LLC in Jersey City, New Jersey, said in an Oct. 19 interview. “The Treasury would be very reluctant to meet that demand through traditional short-term instruments that have to be rolled over at a high frequency. Floating-rate notes bridge that gap.”

Average Maturity

The Treasury could sell $20 billion of three-year floating rate notes each month through 2014 to meet this demand, boosting the supply of liquid securities by $720 billion, Crandall estimated in an Oct. 17 report. To provide the same amount of short-term liquid securities, bill sales would have to be increased by $150 billion or more a month, causing the amount of debt rolling over each month to jump by about 30 percent.

Instead of issuing the debt, the government should continue to take advantage of low rates by extending the average maturity of its debt, which has risen to 62.5 months from 49.4 in March 2009, according to Harvey, who recommended 18 years ago that the Treasury sell the securities when 10-year yields were at 6.58 percent and the Fed’s target rate was 3 percent.

“The Treasury should be lengthening the maturity of their fixed-rate obligations even further,” Harvey said.

Government-run entities such as mortgage financiers Fannie Mae and Freddie Mac already sell the debt, as do countries from France to Australia. About $117 billion of the $813 billion investment grade corporate bonds issued in the first nine months of this year pay variable interest, according to the Securities Industry & Financial Markets Association.

TIPS Debut

The last time the government started selling a new type of bond was in 1997, when it began offering Treasury Inflation- Protected Securities, or TIPS, as a way to lower U.S. borrowing expenses and allow Americans’ retirement savings to keep pace with inflation.

Championed by then Treasury Secretary Robert Rubin, the market for TIPS has grown to about 7.3 percent of the $9.6 trillion of marketable U.S. debt outstanding. They have returned 11 percent this year, compared with 7.6 percent for Treasuries, according to Bank of America Merrill Lynch indexes.

“Floating-rate notes would add to the Treasury’s armory given the scale of their funding needs,” said Neil Mackinnon, an economist at VTB Capital in London and a former U.K. Treasury official, in an interview on Oct. 20. “With rates at such low levels it is advantageous for the Treasury.”

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