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ASSET MANAGEMENT

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The Market Impact
of the
Proposed U.S. Treasury Debt Buyback

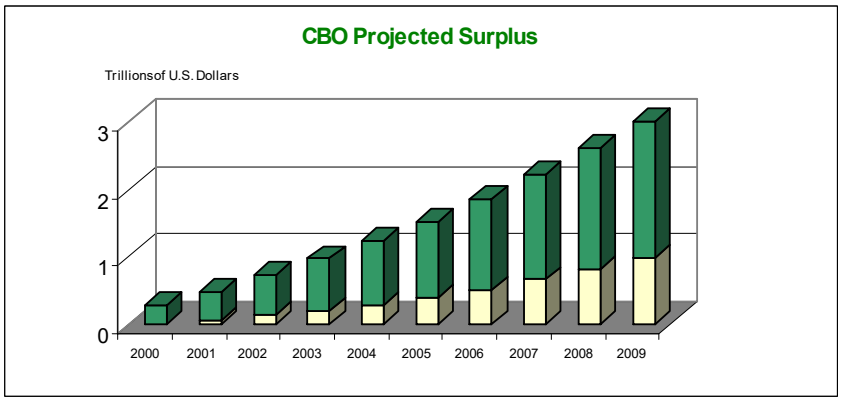
Much has been written lately about the government's announced plans to repurchase debt and reduce or eliminate the federal deficit by the second decade of the 21st century. Naturally, this has raised some concerns about the ultimate impact of this initiative on fixed income markets.

Our analysis of this situation, one based on many years of experience in all fixed income markets, leads us to conclude that:

- The treasury market will shrink in coming years
- Off-the-run treasuries will trade much closer to on-the-run treasuries
- The yield curve will flatten
- Real rates should decline
- Credit spreads should not be materially impacted
- New pricing benchmarks will be created

The Treasury Market Will Shrink in Coming Years

The U.S. is clearly moving away from large and recurring budget deficits to moderate, but sustainable, budget surpluses. The Congressional Budget Office ("CBO") estimates that the surplus will exceed $160 billion during this fiscal year and continue to rise, reaching approximately $413 billion by the close of 2009. If the government devoted all of this surplus to its debt repayments, our national debt could be eliminated by the middle of the second decade of this century.



Forecasting longer-term surpluses is difficult at best, for even a small departure from baseline forecasts in growth, inflation, unemployment, earnings and interest rates can result in major swings in budget numbers. This was the case in 1997 and 1998, for example, when initial forecasts and actual results varied by about $125 billion and $140 billion, respectively.

Let's review the assumptions on which the current CBO forecast is based to see whether it is a true forecast, or the product of an overly excitable imagination:

- Real GDP Growth 2.3%-2.5%
- CPI 2.5%
- Federal Budget Revenue Growth 4.1%
- Federal Budget Outlays Growth 3.1%

The assumptions concerning real GDP growth rate and CPI appear to be reasonable. The assumed growth rate is about 0.5% *below* the average of the past decade and, indeed, for each decade since 1951. The 10-year CPI is projected to be near that of the past ten years, although below the average levels of 1960-1990.

Varying the assumptions on real GDP growth or the CPI doesn't affect surplus projections by very much, relatively speaking. For instance, if the assumed rate of inflation turned out to be greater than that forecast, it would have the effect of increasing, not decreasing, federal surpluses! Consider. Not all federal outlays are indexed to inflation, but virtually all revenues are. Also, the infamous "bracket creep", as more and more Americans are "upgraded" to higher tax status, would only serve to increase federal revenues. On the other hand, a reduction in the GDP growth rate by, say, 0.5% reduces the surplus by approximately $800 billion, but the surplus still remains at a sizeable $2.2 trillion.

Unlike its economic assumptions, the CBO's revenue and outlay projections are, to be kind, Pollyannaish in the extreme. Imagine a large group of politicians faced with a surplus of the magnitude projected, some $3 trillion over the next decade. Could they resist the allure of pork, or that ever present temptation of tax relief? Will they instead fight the good fight and pay off our debts to make the government and the economy stronger? You decide, but we warn that history stacks the odds against a beneficent outcome in this regard.

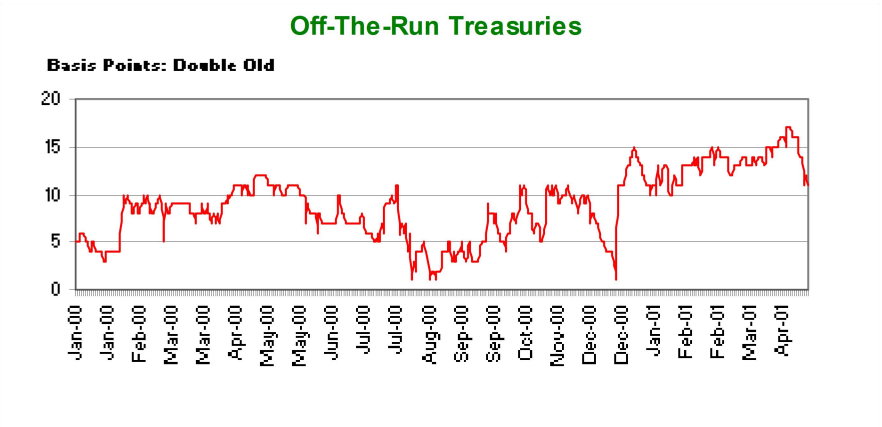
This being said, and giving the politicos their bone to chew, saving Social Security has become such a dominant rallying cry that it may even come to pass. As we write, Social Security is expected to account for about two-thirds of the accumulated surplus through 2009, or slightly less than $2 trillion. So, even assuming some politically inspired skimming and no surplus is generated by on-budget items, marketable treasury debt will still contract by a substantial amount over the next 10 years.

Off-the-run Treasuries Will Trade Much Closer to On-the-run Treasuries

The federal government is engaged in a debt buyback program. At the same time, the Treasury continues to offer the four active on-the-run issues on a regular schedule, albeit at a reduced volume.

The impact of these moves on the yield curve could be significant. Spreads between "on-the-run" benchmark issues and "off-the-run" issues are presently near all time highs. The curve is currently "humped" at approximately the 20-year maturity. Any buyback program will focus on the cheapest issues and will create a narrowing in spreads between various issues along the curve.

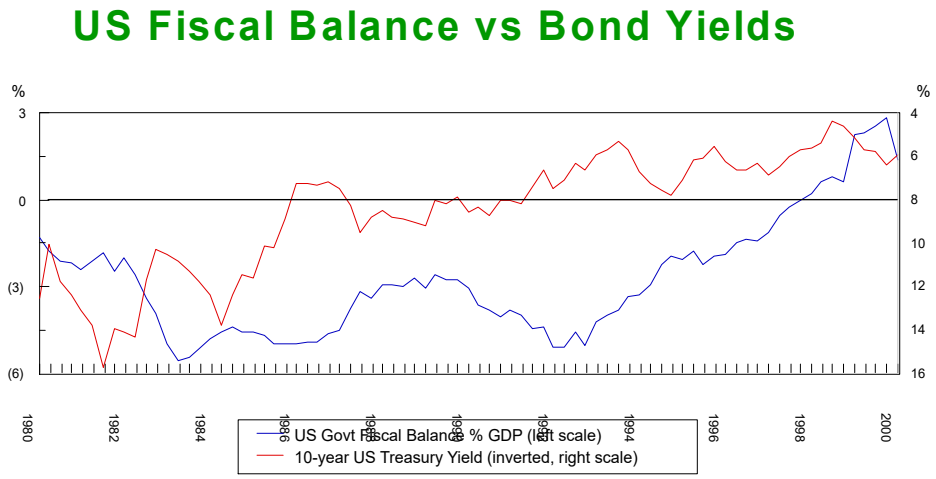
Since the 15-24 year maturities are the "cheapest", these will be emphasized, and yields in this area will be driven back towards fair value. The "hump", then, should disappear.



The combination of reduced 30-year new issuance and open market purchases of longer-term issues should serve to permanently flatten the yield curve. It will also serve to increase the appeal of high quality, longer-term corporate bonds and agencies as pension funds and insurance companies seek alternatives to treasuries in their efforts to match long term liabilities with long term assets.

Interest Rate Levels Will Not Be Impacted

Intuitively, one might expect that a large drop in US Treasury supply should cause a fall in long-term interest rates. In fact, the link between the supply of Treasury debt and Treasury interest rates is extremely tenuous. The following graph shows that the relationship of government fiscal balance to 10-year Treasury bond yields is extremely weak.



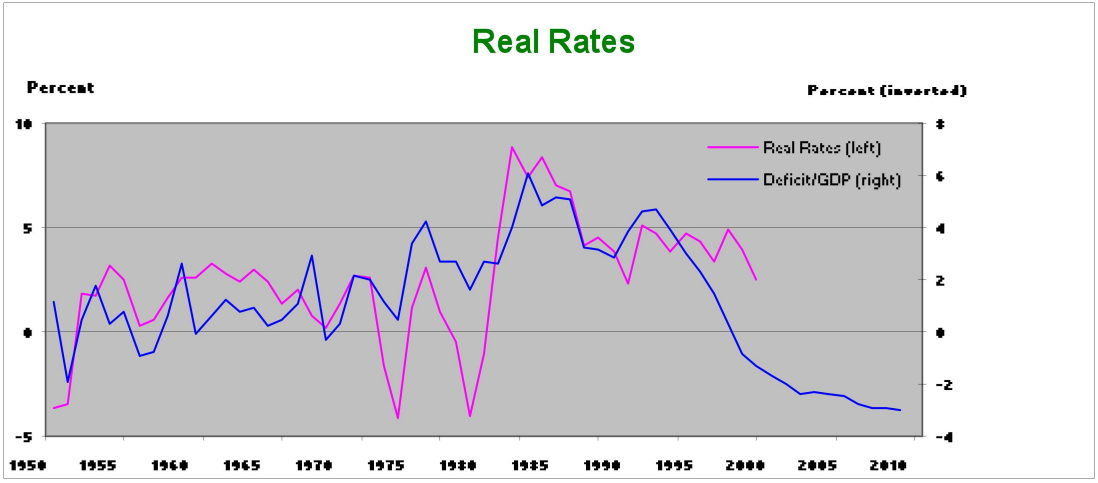
During the period from 1987 to 1993, the budget deficit deteriorated and reached a record level. 10-year US Treasury yields actually fell during this same period from approximately 9.0% to

6.0%. Likewise, bond yields have risen during the past 12 months while the government budget surplus has surged.

There are several reasons for a little relationship between the government budget balance and interest rates. One is that the budget balance is counter-cyclical, in that it improves during an expansion and worsens during an economic contraction. This is opposite to growth and inflation, which impact both Federal Reserve rate action and interest rates. Secondly, the supply of Treasury debt is unrelated to the supply of total debt. In fact, government debt often moves in the opposite direction to both household and corporate debt. For instance, during the early 1990's interest rates fell even with a surge in Treasury debt because household debt was flat and corporate debt fell dramatically. Today, Treasury debt is falling but total debt is growing rapidly. Treasury debt now comprises only 25% of total bond supply versus 45% just five years ago. The total supply of US bonds has been growing by 11% over the 18 months even though US Treasury bonds are shrinking.

Real Rates Will Decline

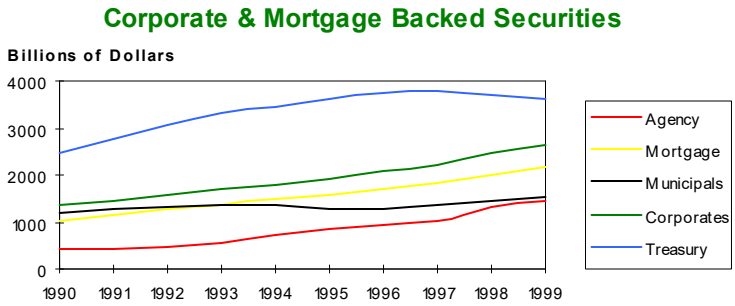
In theory, a reduction in federal borrowings would suggest a "reverse crowding out" effect in which real bond yields trend lower. For instance, during the 1950s, the last period in which the Treasury achieved consistently balanced budgets, real rates averaged only about 1.0%, far lower than the real rates of 5.7% that prevailed from 1982 through 1998.



Since 1980, the Federal Reserve's proactive policies have helped minimize the magnitude of rate changes and wild swings in the economy. In combination with a vigilant bond market, inflationary pressures have been reduced. Low and stable inflation, combined with declining public debt, should allow real rates to gradually move lower over the next several years.

Credit Spreads Should Not Be Materially Impacted by the Shrinking Treasury Market

In 1993, Treasury debt accounted for 40% of the total marketable debt within the U.S. Since that time, strong growth in corporate, mortgage, and agency debt have driven this percentage down to 32%. Even if the government does not use any of the projected surpluses for debt reduction, the treasury market is still projected to account for just 18% of the total domestic fixed income market by 2009. In order to fill this vacuum, other fixed income sectors will have to step up and assume some role as substitutes for treasury debt.



One present concern is that the coming reduction in treasury supply will lead to a material and permanent widening of credit spreads. Indeed, shifts in supply may lead to temporary mispricing. However, over time, credit spreads are determined not by the level of supply, but by a combination of expected returns, projected default rates, liquidity needs and perceived exposure to event risk. In fact, there is little historic correlation between the relative size of a market sector and the associated yield spreads versus the treasury benchmark.

Going forward, several factors should minimize the extent of spread widening, including:

- 27% of fixed income investors are benchmarked against a market index. As the composition of the index changes, these investors will naturally shift their allocations into those sectors with the greatest growth potential.
- Commercial banks have the latitude to shift between treasury, agency, and mortgage debt sectors. If spreads widen for non-treasuries, one would expect these institutions to shift their allocation into more profitable spread products.
- Under pressure to increase the yield on reserve assets, Central Banks are already shifting their holdings away from treasuries and into the full spectrum of debt issuers. Spread product is an obvious and demanding option in pursuit of this goal. (*Note: The International Monetary Fund estimates that non-government assets account for less than 5% of total reserve assets at this time. Some predictions call for 20-25% of these assets being re-deployed into non-government debt, which would create some $400 billion of demand for non-treasury securities.)*

New Pricing Benchmarks Will Be Created to Replace the Traditional Treasury Benchmark

Almost all fixed income securities, both new issues and secondary bonds, are priced off the treasury curve. When trading a corporate or mortgage bond, the bid/offer is quoted as a spread over the comparable treasury, not as a price. A decline in the supply of treasuries will make this more difficult as gaps along the yield curve appear, and structural problems created by a shortage of long treasuries create pricing anomalies.

Some alternative benchmarks, notably agency issues, have already appeared. In addition, the swap market is starting to play a bigger role in pricing corporate and mortgage-backed securities.

The ultimate outcome of the acceptance of new benchmarks is that the securities tracked by them will benefit, with tighter relative spreads than can be had with similar securities that are not part of the benchmarks.

To be an effective alternative to treasury tracking, a new benchmark will have the following characteristics, at the least:

- High Credit Quality
- Stable Credit Quality
- Liquid Issues
- Adequate Size
- Limited Exposure to Event Risk.

Recent growth in deal size has demonstrated investor appetite for large, liquid, global transactions. In 1996, these transactions made up just 2% of total corporate issuance. In the first ten months of 1999, this number had grown to 19% of new issues. It is well to take note that these transactions have traded at tighter spreads than equivalent credit quality corporate bonds of issuers of smaller, less liquid issues. The extent of this advantage can be seen in the Treasury market in which on-the-run Treasuries have traded at yields 10 to 15 basis points below comparable maturity off-the-run issues, largely because of their status as benchmarks.

Conclusion

For the above mentioned and other reasons, the domestic and global fixed income marketplace may be in the beginning stages of the most extensive period of change in its long and fabled history. It will not be without turmoil…or the potential for profit.

As U.S. treasuries decline in prominence as *the* standard bearer of global capital markets, they will be replaced to some degree by the offerings of companies and agencies that have demonstrated remarkable credit quality and the ability to effectively manage risk in a truly global marketplace. Old fixed income performance benchmarks will have to be replaced to accommodate this new reality.

Please call on us if you have questions about how you might approach this changing marketplace and take advantage of its vast potential in the years to come.

Vanderbilt Research Team

Emad A. Zikry

Chief Executive Officer
Vanderbilt Avenue Asset Management

Emad is the Managing Partner and Chief Executive Officer of Vanderbilt Avenue Asset Management LLC. Vanderbilt's client base includes Multi-national Corporations, Public Funds, Foundations/Endowments, and Taft Hartley accounts.

Previously, Emad was Chairman of Institutional Business at Pioneer Investments. Pioneer investments has more than $300 Billion in assets under management. The parent of Pioneer, UniCredit S.p.A., is the largest bank in Italy and the second largest bank in Europe. Pioneer had purchased Vanderbilt Capital Advisors, of which Emad was the founder and Chief Executive Officer.

Emad has had numerous articles published in professional and academic journals such as The Journal of Forecasting, The American Economist and The Journal of Fixed Income. He is a Board member of The National Investment Company. Emad was a member of the Board of Advisors of the Pacific Institute, The Advisory Committee of Fulcrum Global Partners, The Chief Executive Officers Club and formerly a board member of The Foreign Policy Association. He also served on the Board of Directors of the University of Albany Foundation, NextGen Healthcare Inc., The Park Avenue Bank, AA Bank and The New Providence Fund and Associates LP.

Emad is an FINRA Arbitrator. He is also a member of the National Association for Business Economists and The Economic Club of New York. Emad served as an adjunct professor at the University of Kansas and St. John's University.

Emad holds a Bachelor of Science from the University of Albany, and a M.A. and Ph.D. in Economics from the University of Kansas.