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So Long to 30-year Treasuries: How Suspension Of The Long Bond Could Impact Markets

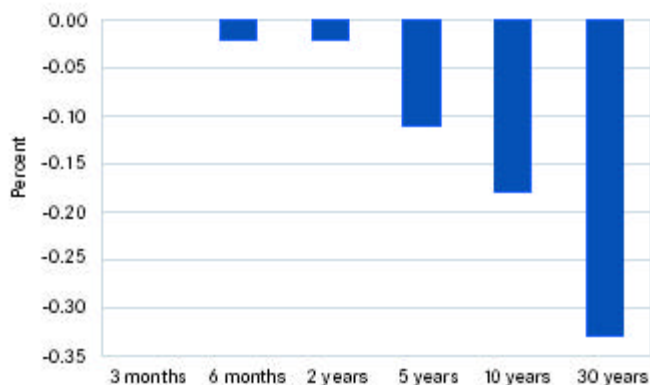
Editor's Note: The following article appeared in the October 2001 issue of the Barclays Global Investors newsletter. It is reprinted with permission

Just as the Federal Reserve has been aggressively cutting short-term rates, the U.S. Treasury has found a very effective way to cut long-term rates. Suspension of 30-year Treasury auctions will have minimal impact on bond market structure in the near term, but over the mid- to long-term, consequences could be profound. One thing is certain: markets will adapt, proving once again that necessity is the mother of invention. And of course this action may not be permanent. The Treasury could start issuing 30-year bonds again if economic or market conditions merit another shift.

The Announcement and Its Motivation

The U.S. Treasury surprised the bond market on October 31 by announcing it would suspend issuance of 30-year bonds. Investors rushed to buy the soon-to-be-scarce long bond, causing it to rally sharply. As the rally gained momentum, it snowballed into a classic "short squeeze." Investors who were short the long bond—they expected the yield curve to continue steepening in reaction to further Fed easing—forced to cover their short positions, driving prices yet higher. By day's end, the 30-year benchmark had rallied over 5.25 points, its best one-day performance since the stock market crash of 1987. The surge in the bond's price reduced its yield by over 30 basis points (Chart 1).

CHART 1
Change in Yields of Benchmark Treasury Securities, from 10/30/01 to 10/31/01



Source: Bloomberg, as of 10/31/01

This announcement was all the more surprising because the U.S. federal government will probably need to issue more Treasury securities over the next couple of years to finance a fiscal stimulus package designed to help revive the economy from September 11's terrorist attacks. While the Treasury acknowledges a deterioration in this year's budget outlook, it will concentrate increased borrowing needs on shorter-term instruments.

In addition to the long bond, the Treasury also announced plans to suspend auctions of 30-year inflation-adjusted bonds, causing these securities to rally strongly as well. As for the bond buyback program, which was initiated in March 2000, the Treasury left itself maximum flexibility for future purchases. Starting next February, the decision to conduct a buyback will depend on projections of the federal government's fiscal balance, quarterly cash needs, and analysis of how best to minimize borrowing costs.

In effect, the Treasury succeeded in doing to long-term rates what the Federal Reserve has been doing to short-term rates since the beginning of the year—that is, reducing them. While the Fed has cut short-term rates by about 4% this year, yields of 30-year Treasuries had not declined materially prior to October, drifting from 5.46% to 5.42% as of third quarter. The Treasury undoubtedly anticipated that its announcement would reduce long-term rates, and that this would likely have the desirable effect of stimulating the economy by enabling corporations to borrow more cheaply (increasing investment), and individuals to refinance home mortgages (increasing consumption).

Impact On The Treasury Sector

In the near-term, the Treasury's decision will not have a significant impact on the availability of long-term bonds because the size and frequency of 30-year auctions has been decreasing for several years (Chart 2). For example, in 1991 there were four auctions of 30-year bonds; more than \$53 billion of those bonds remain outstanding today (adjusted for buybacks), though they are now 20-year bonds. In contrast, there have been only two auctions of 30-year bonds this year, with a total par amount of \$15 billion. Clearly, this latest decision is the ultimate step in a trend toward smaller issues of 30-year bonds.

CHART 2

Par amount outstanding (in billions) of 30-year bonds by year of maturity

2021	\$ 53.16
2022	\$ 15.40
2023	\$ 34.62
2024	\$ 8.09
2025	\$ 18.15
2026	\$ 28.51
2027	\$ 35.11
2028	\$ 19.70
2029	\$ 19.85
2030	\$ 15.15
2031	\$ 15.00
Total	\$ 262.72

Source: Lehman Brothers, as of 10/31/01.

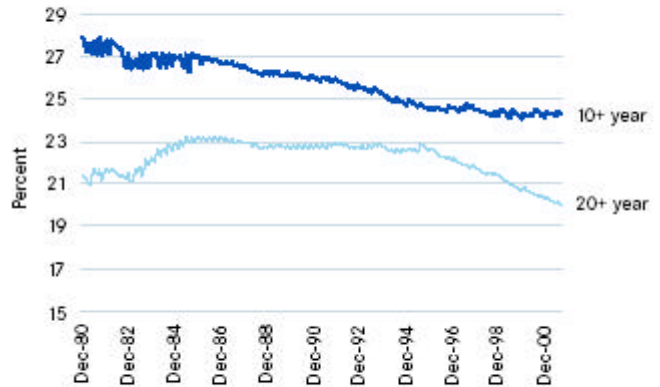
In addition, though the Treasury issued \$15 billion worth of 30-year bonds during each of the past two years, they also repurchased about \$30 billion in long-term bonds (maturing in earlier years) each year. In effect, net supply of long-term Treasuries shrank \$15 billion per year during the past two years. Given the budget outlook in the near future, the Treasury may decide to buy back fewer long-term bonds. But if the Treasury bought back \$15 billion of long bonds in 2002 with no additional issuance, the net effect would be a reduction in supply of \$15 billion of long-term Treasuries. Alternatively, if it eliminates buybacks altogether, there will no impact on net supply: zero issuance and zero buybacks.

If the suspension of 30-year bond issuance persists over the long term, however, it will fundamentally transform not only the U.S. Treasury market, but also the entire U.S. economy and, indeed, the global bond market. At the risk of stating the obvious, if no new 30-year bonds are issued, then in 10 years there will be no Treasury bonds with maturities longer than 20 years; and in 20 years, there won't be any Treasuries with maturities longer than 10 years.

What about the average maturity of Treasury bond indices, which many investors utilize as part of their investment program? Looking at the past, we can make some projections about the future. Chart 3 shows that the average maturity of long Treasury indices has been declining over the past 20 years. For example, the average maturity of the 20+-year Treasury index has declined from about 27 years in 1985 to about 24 years in 2001. During the same period, the average maturity of the 10+ year index has declined from 23 to 20 years.

CHART 3

Average Maturity of Treasury 10+ and 20+ Year Indices



Source: Lehman Brothers, as of 10/31/01.

Looking ahead 5 and 10 years, we can see the trend toward lower average maturity will continue.

CHART 4

Average maturity of index

Index	Today	In 5 years	In 10 years
10+ Treasury	20.0	16.5	14.3
10+ Treasury's	24.3	22.0	—*

*In 10 years, there will be no bonds left in the 20+ Year Treasury Index.

Note: Projections assume the relative weights of bonds remain the same as today. In 10 years, there will be no bonds left in the 20+ year Treasury index.

Source: Lehman Brothers and BGI, as of 10/31/01.

Not issuing new 30-year bonds will also have a profound impact on Treasury bond futures. To be deliverable into the bond futures contract, a Treasury bond must have a minimum maturity of 15 years. As fewer bonds become eligible for delivery, the attributes that make futures a liquid hedging and trading vehicle will diminish. Eventually the contract, as it is currently structured, could become extinct.

Impact On Other Bond Sectors

How will investors gain exposure to long-duration instruments if there are no Treasury bonds and no Treasury bond futures? Chart 5 shows the market value of the Treasury, Agency and credit sectors divided into maturity ranges. Across the entire

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maturity range, the credit market is now larger than the Treasury market, and the Agency market is roughly half the size of the Treasury market. However, at the very long end (20+ year maturity), there are not enough Agency or highly rated corporate bonds (AA or better) for either to be a viable alternative to Treasuries. Both those markets are roughly one-fifth the size of the 20+ Treasury sector, and neither approaches the liquidity of long-term Treasuries. It is likely the long end of the Agency and corporate markets will see increased issuance in an attempt to take advantage of lower borrowing costs.

CHART 5
Market value in billions

Maturity range	Treasury \$	Agency \$	Credit \$	Credit AA+ \$
1+ years	1,585	808	1,867	480
1ñ 10 year	997	701	1,409	398
10+ years	588	108	458	82
20+ years	289	56	328	55

Source: Lehman Brothers and BGI, as of 10/31/01.

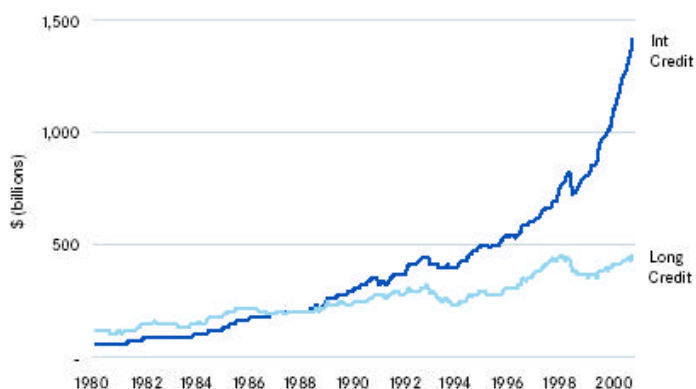
Yield Curve and Yield Spreads

As announced, the Treasury will concentrate their borrowing needs on shorter maturity instruments. All else being equal, the increase in supply of two-, five- and 10-year notes, coupled with the elimination of supply at the long end, will cause the Treasury yield curve to flatten. Furthermore, if demand for long duration instruments exceeds supply by a sufficient amount, the long end of the Treasury curve will become inverted. As has been the case in the U.K. for the past four years, the yield spread between 10- and 30-year bonds will become negative.

Because the flattening of the Treasury yield curve would be caused by demand and supply considerations, rather than fundamentals such as inflation expectations, we would not expect yield curves in other sectors to be affected commensurately. Therefore, we can expect the flattening of the Treasury yield curve to lead to wider sector spreads at the long end and narrower spreads in short-to-intermediate maturities. However, to the extent that Treasuries do not satisfy the demand for long-duration instruments, investors may turn to Agency and high-grade corporate bonds as the closest substitutes. This would mitigate the spread widening of long-term, highly rated bonds. Therefore, the spread between the highest-rated corporate bonds (rated AAA and AA) and lower-rated bonds (BBB) should widen. Furthermore, as corporations begin to issue more long-term bonds to meet this demand, the issuance pattern of the past

20 years will most likely reverse (Chart 6). And as lower Treasury yields drive prepayments higher from their already elevated levels, it is likely that mortgage-backed securities spreads will widen.

CHART 6
Market Value of Intermediate and Long-Term Credit Indices



Source: Lehman Brothers, as of 10/31/01.

A Final Thought

It's important to bear in mind that markets are comprised of people, and people adapt. Many of the structural changes discussed above will not occur for five, 10 or 15 years, and only then if current conditions remain. But the history of financial markets is one of innovation and of self-interest leading to a common good, so we can be sure that conditions will change. If there is an unmet need for long-duration instruments, these securities likely will be created. For example, if the current bond futures contract no longer remains useful for investors, it will either be modified or an entirely new instrument will be developed.

Finally, structural changes may not come to pass because the Treasury left open the possibility that the 30-year bond could be reintroduced. It's no coincidence that they used the word "suspend" to describe their decision, as the word connotes a temporary situation.

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