Deficit Cost Drop Gives Obama Stimulus Clinton Missed (Update2) 2010-08-30 12:27:33.0 GMT

(Updates prices in 14th paragraph and adds results from National Association for Business Economics beginning in paragraph nine.)

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The bond market is giving President Barack Obama the green light to spend more money to boost the faltering economy.

While the government has increased the amount of marketable Treasuries by 70 percent to $8.18 trillion the past two years, rising demand has driven yields so low that interest to service the debt has fallen 17 percent so far in fiscal 2010 ending Sept. 30 from all of 2008.

Instead of punishing the Obama administration for running up a budget deficit the Congressional Budget Office said will total $1.34 trillion this year, bond investors are pouring money into fixed-income assets as inflation slows and equity markets stumble. That's a turnaround from 16 years ago, when Bill Clinton was forced to abandon stimulus plans after his advisers said the bond market would punish him with higher borrowing costs if it sensed swelling deficits.

"The deficit concerns are on the back burner," said Andy Richman, who oversees $10 billion as a strategist in Palm Beach, Florida for SunTrust Bank's private wealth management division.
"The bigger concerns are on the deflationary mode and seeing growth slowing in the second half of the year."

Obama has the bond market on his side as he heads into midterm congressional elections saddled with a 44 percent approval rating as measured by the latest Gallup poll. Two-year note yields are at all-time lows, allowing companies from International Business Machines Corp. to Johnson & Johnson to borrow at rates never seen before.

Bonds Rally

Treasuries have returned 7.9 percent in 2010 after losing

3.7 percent last year, according to Bank of America Merrill Lynch indexes. The MSCI World Index of shares has lost 4.6 percent, including reinvested dividends.

Through the first 10 months of fiscal 2010, $375.2 billion of taxpayer money was spent on interest, compared with $383.4 billion for all of fiscal 2009 and $451.2 billion in 2008, according to the Treasury. As a percent of gross domestic product, it was 3.2 percent in 2009, down from 4.1 percent in 2001, the last time the budget showed a surplus.

Bond vigilantes, the debt markets' self-commissioned advocates of fiscal discipline, have been placated as the rate of inflation falls to a four-decade low of 0.9 percent. These traders drove up long-term interest rates and persuaded Clinton to place deficit-reduction above fulfilling his spending promises after he took office in 1993.

Support of Growth Measures

Policy makers should focus on promoting economic growth and job creation rather than deficit reduction, a majority of respondents said in a survey by the National Association for Business Economics released today.

Three-quarters of respondents said President Obama's administration should do more to support job creation, with the leading prescription being clarity on future tax policy and regulation, the group said in a statement. A majority of respondents said none of the 2003 tax cuts should be allowed to expire at the end of the year, the survey showed.

Seven out of every 10 survey respondents said promoting economic growth should be the policy priority at the federal level, while 29 percent said cutting the deficit should take precedence.

'Deflationary Vice'

With inflation so low, "fiscal-policy restraint is not a virtue, but a deflationary vice," Paul McCulley, a managing director at Pacific Investment Management Co., which runs the world's biggest bond fund, wrote in a report posted on the Newport Beach, California-based firm's website on Aug. 13.

The yield on the two-year Treasury fell a record 0.4542 percent on Aug. 24, the day the U.S. sold $37 billion of the securities. In 1994, two-year yields exceeded 7 percent. Yields on 10-year notes dropped to an 18-month low of 2.4158 percent on Aug. 25, from more than 8 percent 16 years ago.

The 10-year noted yielded 2.60 percent as of 8:15 a.m. in New York, according to BGCantor Market Data. The 2.625 percent security maturing in August 2020 was up 14/32 at 100 8/32.

While the dominant concern for the markets now is that the economy will fall back into recession, investors shouldn't become complacent about the deficit, said former Federal Reserve Vice Chairman Alice Rivlin. She was named by Obama in February to serve on a commission on cutting the budget shortfall.

'Looming Problem'

"We need to take serious steps on the long-run deficit right now, but they don't have to be steps that affect the economy in the near-term.," Rivlin said in a Bloomberg Television interview Aug. 17. "We have a looming problem."

Continued borrowing to service the gap may eventually cause competition among the government, companies and consumers for funds when the economy rebounds, raising borrowing costs on everything from corporate bonds to mortgages.

"Obama and Congress are strained by the large deficits," said Mark Fovinci, who manages $2.8 billion for Ferguson Wellman in Portland, Oregon. "If they came up with a large stimulus plan, there would be doubt in a lot of bond buyers' minds about the longer-term stability of the deficit. We don't want to end up like Greece."

The U.S. Congressional Budget Office predicted on Aug. 19 that the budget deficit for fiscal year 2011 will be $1.066 trillion, revised up from an estimate of $996 billion in March.

It projected the cumulative gap for the next decade will be $6.27 trillion, up from its March estimate of $5.99 trillion.

Rising Demand

For now, the deficit isn't the main concern. Demand for Treasuries has been spurred in part by banks piling into U.S. government debt, preferring their safety and security rather than lending to consumers and small businesses. Commercial banks' holdings of Treasuries and agency debt reached $1.59 trillion this month, a 43 percent increase from $1.1 trillion in January 2008, according to Fed data.

Demand at the Treasury's debt auctions rose 18 percent this year through July to a record, with bidders offering $2.95 for every dollar of debt sold, compared with $2.50 last year, Treasury data compiled by Bloomberg show.

Worsening Projections

"The bond market is looking through the current deficit and of likely worsening in near-term projections of deficits because economic growth is so slow," said Christopher Sullivan, who oversees $1.6 billion as chief investment officer at United Nations Federal Credit Union in New York.

Obama's stimulus package may have created or saved as many as 3.3 million jobs last quarter and lowered the unemployment rate by as much as 1.8 percentage points, the CBO said last week. The $814 billion program, known as the American Recovery and Reinvestment Act, probably added between 1.7 percent and 4.5 percent to gross domestic product, the nonpartisan agency said.

When Congress returns from its August recess, lawmakers plan to debate extending tax cuts enacted in 2001 and 2003 under President George W. Bush. Those cuts include lower rates on income, capital gains and dividends, a $1,000 child credit and relief from the so-called marriage penalty.

Obama argues that the nation can't afford to extend the tax cuts for individuals making more than $200,000 or households with annual incomes over $250,000. The cost for the most prosperous Americans would be about $700 billion over a decade, according to Treasury Secretary Timothy Geithner.

'Good Stimulus'

"A statement that taxes will not increase on Jan. 1 would be a good stimulus," John B. Taylor, a Stanford University economics professor and a former Treasury undersecretary in the Bush administration, said Aug. 27 in an interview on Bloomberg Television's "In the Loop" program.

Obama's approval rating at this point in his second year of office is below that for former President George H.W. Bush at 75 percent and George W. Bush at 65 percent, according to Gallup.

U.S. House Minority Leader John Boehner said in an Aug. 24 speech that Obama's stimulus policies are "failing" to create jobs and that he should fire Geithner.

"The government is in a bind, because with the outstanding stock of debt so high, if interest rates go up, it just makes the deficit worse again," Jeffrey Gundlach, the founder of Los Angeles-based DoubleLine Capital LLC, whose flagship Total Return Bond Fund returned 12.5 percent from its April 6 inception through Aug. 20.

Biggest Beneficiary

Besides the government, the biggest beneficiary of the drop in borrowing costs may be companies.

Johnson & Johnson sold $1.1 billion of bonds at the lowest interest rates on record for 10- and 30-year corporate securities on Aug. 12, according to Citigroup Inc. data going back to 1981. The New Brunswick, New Jersey-based drugmaker issued $550 million of 2.95 percent notes due 2020 and the same amount of 4.5 percent bonds maturing 2040, data compiled by Bloomberg show.

International Business Machines Corp., the world's biggest computer-services company, raised $1.5 billion in the bond market on Aug. 2. The 1 percent rate for the three-year notes paid by the Armonk, New York-based company was the lowest of the more than 3,400 securities in the Barclays Capital U.S. Corporate Index of investment-grade company debt.

Individuals haven't benefited like companies. Consumer borrowing rates offered by banks via a standard variable-rate credit card have increased, averaging 13.4 percent on Aug. 8, up from 13 percent three months ago and 11.5 percent at the beginning of the year, according to Bankrate.com in North Palm Beach, Florida.

Mortgage Rates

Mortgage rates at record lows have provided scant relief to the housing industry as unemployment hovers at about 10 percent, foreclosures hold near record-highs and the economy cools. Sales of new homes fell 12 percent in July to a record low pace of 276,000, and those of previously owned dwellings tumbled 27.2 percent to a 3.83 million annual rate, reports showed last week.

As the economy struggles, the Treasury has reacted by lengthening the average maturity of its debt to lock in low rates. The average due date of the Treasury's outstanding debt had dropped to a 26-year low of 49 months at the end of 2008 after the U.S. sold $1.9 trillion of short-term securities to help unfreeze global credit markets.

"The bond market may side with Obama with the current low level" of long-term debt yields because investors expect the rate of inflation will stay low, said Anthony Valeri, a San Diego, California-based market strategist at LPL Financial Corp., which oversees about $277 billion. "Those problems about rising debt and the deficit will be addressed, but for now, the bond market is concerned about economic growth."