

Topics: Are there signs from the bond and swap spread markets that government debt risks will derail the expansion?

“**Tremors**”. A good way to describe the psyche of some investors right now is to imagine being a resident of San Francisco or Los Angeles. Everyone is extremely jittery about any sign of a tremor coming from the big fault lines; but as long as nothing happens, life goes on and things improve at a normal pace. In the case of the U.S., **there are noticeable improvements which may be self-reinforcing**: production, consumption (retail sales, vehicles), profits, inventories, delinquencies, confidence and possibly even employment¹. Even California tax collections appear to have bottomed. Equity and credit markets reflect these improvements, with YTD gains on target for our 2010 forecasts.

But these improvements all lie close to the San Andreas fault lines of U.S. Treasury funding needs, Chinese demand for Treasuries, the end of Federal Reserve purchases, crowding out of private sector demand, rumors of a Moody’s downgrade of the United States, etc, etc. Rates generally rise at the end of a recession, so there’s nothing new in that. But there’s a point at which very high long term rates could derail the expansion. Let’s examine where the greatest concerns are coming from.

Just how big is the U.S. budget deficit?

- Largest peacetime deficit and debt/GDP ratio
- Deficits harder to reduce today given much larger component of mandatory spending (vs. discretionary or defense spending²)
- Unlike the Office of Management and Budget, the independent Congressional Budget Office does not project a stable long-term debt/GDP
- Consider the following options for reducing the U.S. budget deficit to 3% by 2015:
 - All taxes raised by 15%, or
 - Individual taxes raised by 30%, or
 - Raise top to brackets to 70%, or
 - VAT tax of 7.7%

These large budget deficits are inextricably linked to many of the improvements. The only way to sustain the biggest collapse in private sources of income in 60 years and keep consumer spending going is through massive government transfers. That’s why disposable income has not changed much during the recession.

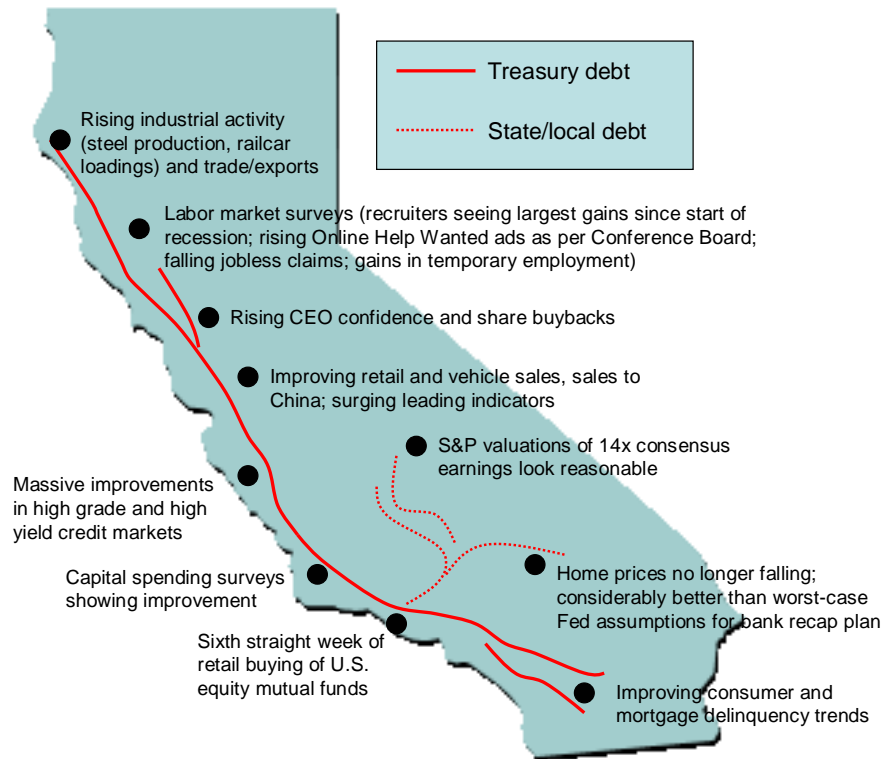
Who owns the \$8.2 trillion in publicly tradable U.S. Federal debt?

Central banks and other non-U.S. public/private entities, mostly. They own half the Treasuries outstanding, with China and Japan representing the largest amounts (\$890 bn and \$765 bn, respectively). A variety of US-domiciled entities own the rest, including households, state & local governments and the Federal Reserve (all ranging from 7-10%). Money market funds are 5%, with pension funds, banks, broker-dealers and life insurance companies each owning even less (2-3%).

Any change to non-U.S. demand for Treasuries? Not yet....

The elephant in the room being non-U.S. demand, is it changing? Not yet. The most recent data show that demand for Treasury bonds has been stable after a dip in late 2008 when Lehman failed (see charts on following page). There are many reasons for this, most having to do with Treasury purchases **being in the mercantile self-interest of the countries buying them**. Asia is still fighting a ferocious battle to prevent their currencies from appreciating, with Treasury purchases being a by-product of this strategy. But this symbiotic approach is contingent on inflation and political considerations in these countries, which are opaque and subject to change. **This factor remains the largest macroeconomic imbalance of our times.** The analogy to a geological fault line is apt, since if it broke, damage could be substantial³.

The Recovery and its Fault Lines, Reimagined



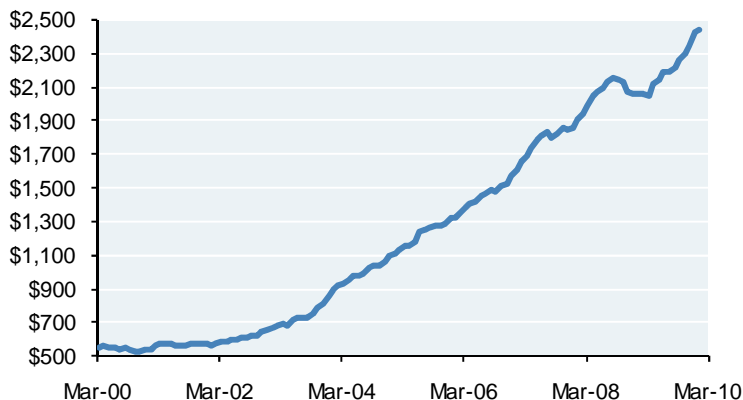
¹ Labor markets are improving in Brazil, Mexico, Finland, Germany, Sweden, Australia, Canada, Turkey, the Philippines, Taiwan, Singapore and even Japan (where January employment growth was the largest in 30 yrs).

² After WWII, defense spending made up 90% of government expenditures. In 2015, entitlements and interest payments will make up 71% of government expenditures. **There are not enough levers to pull to materially cut spending without changing entitlements.**

³ I am baffled by the logic of pushing China to revalue while the U.S. is running enormous deficits, as it would almost certainly reduce their demand for Treasuries substantially. China is buying way more than Germany or Japan did during their interventionist periods.

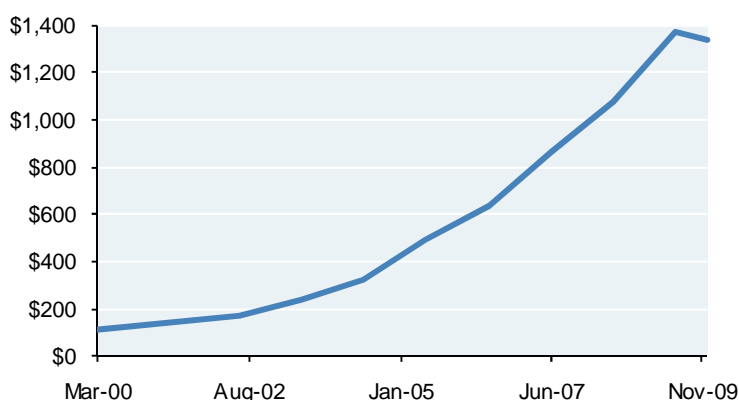
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Non-U.S. demand for Treasuries as per Fed custody holdings
Billions, includes Agency securities



Source: J.P. Morgan Securities Inc, Federal Reserve.

Chinese Treasury/Agency purchases as per TIC data
Billions



Source: U.S. Treasury.

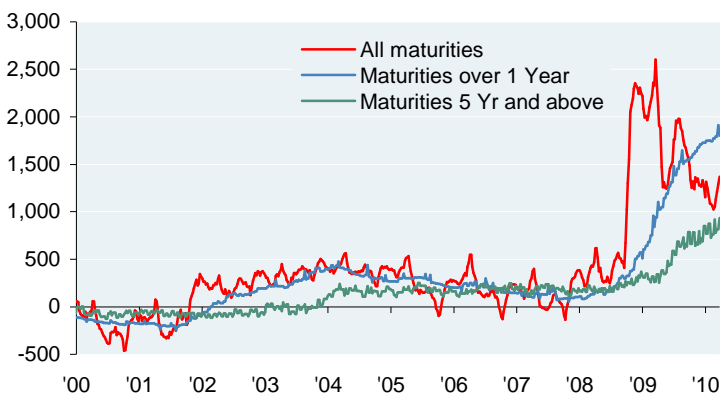
Art vs Science. Most analysts rely on Treasury International Capital (TIC) data. But TIC data is frequently revised upward after the fact. So, for real-time data, we look at more accurate Fed Custody Holdings. Their shortfall is that not every country holds Treasuries and Agencies at the Fed (roughly 80% do). **Triangulating both sources tells a consistent message: Treasury demand is still running high.** As for China, it's not totally clear what they own. A former IMF Chief Economist believes that China's State Administration of Foreign Exchange (SAFE) places orders through entities in Britain, whose Treasury holdings rose from \$130 bn in 2008 to \$300 bn in 2009. If so, China's ownership of Treasuries may approach \$1 trillion.

Avoid misreading 2009 as a sign of perpetual calm in Treasury markets: 2 tailwinds are now fading

Once the recession began, U.S. funding needs rose sharply. The surprise of 2009 was how 10 year Treasury yields did not exceed 4% despite a \$1.4 trillion deficit. But upon closer inspection, was it that much of a surprise? When funding needs rose, the Treasury initially relied almost exclusively on T-bills to finance them (first chart). **It was only recently (September 2009) when issuance of paper longer than one year caught up, and even more recently that paper longer than 5 years is being issued in bulk.** As shown in the second chart, the U.S. has among the lowest average debt maturities in the OECD. We expect the Treasury to push its average maturity profile back to 5-6 years, which will require a lot of longer-dated issuance.

Net issuance of U.S. Treasuries

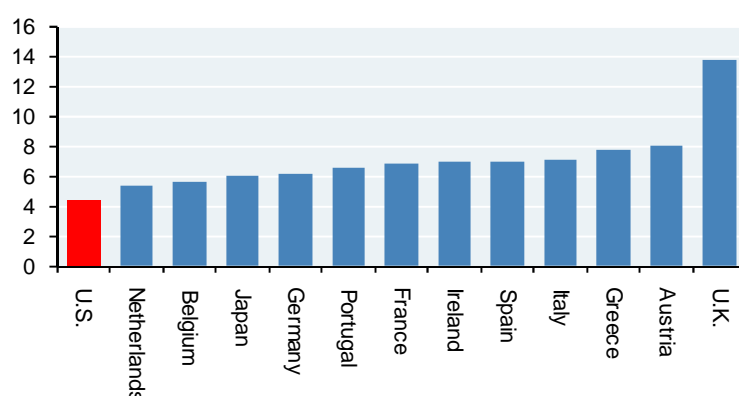
Annualized 26 week average, billions



Source: U.S. Treasury.

U.S. looking to increase average maturity of its debt

Average maturity of federal debt, years



Source: Morgan Stanley, Lombard Street Research.

Second, the impact of Fed purchases in 2009 was the dominant factor in fixed income markets. Here are the numbers:

- 2009 net *issuance* by Treasury, state, local, housing, asset-backed, high grade and high yield entities = \$1.75 trillion
- 2009 Federal Reserve *purchases* of Treasuries and Agencies = \$1.6 trillion

So, in other words, Fed demand accounted for 90% of all net US\$ fixed income issuance in 2009. This is why we do not assume that 2009 bond or credit market conditions will persist in 2010 and 2011. Corporate de-leveraging reduced supply in 2009, but **the longer tenors of upcoming Treasury issuance, and the lack of support from the Fed, suggest that the real challenges for Treasury supply absorption are just beginning.** Only a continuation of Fed purchases could change that.

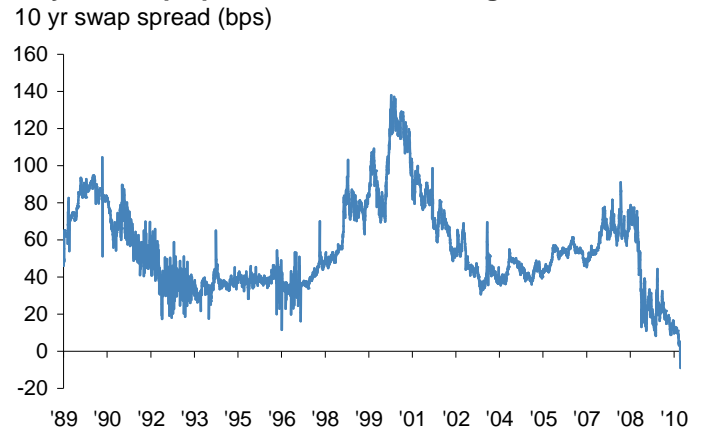
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Are collapsing interest rate swap spreads telling us anything? It depends whom you ask (and you may not want to)

Ten-year swap spreads vs Treasuries are negative for the first time⁴. Market interpretations differ sharply on why (“just technical noise, please move along” vs “a scary leading indicator for bond yields”). The arguments may seem esoteric, and they are. But interest rate swaps are a **\$14 trillion market** (that’s market value; notional values are 25x higher), so it’s important to understand what negative swap spreads might mean:

- *Just noise.* Companies are desperate to improve net income by whatever means possible, resulting in a crush of companies looking to swap interest rate exposure from fixed to floating, thus reducing their interest expenses.
- *Just noise.* Pension funds and endowments went into the crisis underweight fixed income⁵, owning equities and alternatives instead. When the crisis hit, they added duration through the interest rate swap market since it required much less cash than outright Treasury purchases would have; this suited cash-strapped endowments well. [Some governments did the same, and reportedly borrowed against the fixed leg of the swap. Loose disclosure rules may have allowed them to include the proceeds as tax revenue or other organically earned income].
- *Just noise.* The natural payer of fixed rate swaps in a rising rate environment had always been mortgage owners. But now that mortgages have lost their convexity (don’t ask), there’s less of a need to hedge interest rate sensitivity, leading to an excess of fixed rate swap receivers vs. payers.
- *Just noise.* Hedge funds have been looking for a cheap way to position for higher interest rates. The problem with conventional rate and option strategies to execute this view is “negative carry”, since the yield curve is so steep. Given the historical coincidence of rising interest rates and rising swap spreads, hedge funds shorted trillions of swap spreads instead, which has positive carry. But the strategy isn’t working, and they are being forced to cover their short positions.
- *A sign of the apocalypse.* The Treasury supply is monstrous and this is a sign that it will not be absorbed well. P&G, J&J and Lowe’s corporate bonds have traded tighter than Treasuries in recent weeks, indicating that supply concerns about the U.S. government are not confined to swap markets.

10 year swap spreads have turned negative



There’s a lot of conjecture here, none of it conclusive. **I’m inclined to see this as more technical than fundamental.** On being short swap spreads, this is far from a clear-cut trade, given all the changes in the factors affecting them. If needed, our fixed income guru Brian Carlin and I could do a conference call for all the masochists who want to go into greater detail.

Bottom line: we are preparing for higher long-term U.S. interest rates

Some humility is called for here, since Japan’s rising debt burden was accompanied by a *decline* in long-term interest rates. But it’s not clear that the Japanese experience is a universal one. Rising long term rates do not have to be an insurmountable problem for risk markets (credit, equities, real estate), when rising rates are a by-product of normalizing market conditions. Signs of a self-reinforcing recovery are rising, and **we all knew higher Treasury yields came with the territory as risk aversion fades. However, given massive U.S. budget deficits, a changing demand/supply equation, and the bilateral marriage of contempt and convenience between the U.S. and China, 10-year Treasury rates that rise much higher than 5% could be a big problem.** Our fixed income durations are short, and we hold ammunition in reserve for what may lay ahead.

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If you missed it (investment themes we are currently working on, with EoTM date)

- Middle market private lending strategy [February 1, 2010]
- Bank roll-up strategies, including FDIC dispositions [February 22, 2010]
- Local-currency emerging markets bonds [March 15, 2010; March 23, 2010]
- Profiting from increased merger arbitrage activity [March 15, 2010]
- Natural gas stocks [March 23, 2010]
- Normal weighting to U.S. equities [March 23, 2010]
- Investing in companies targeting the Asian consumer [pending]

⁴ There’s no room here for a thorough review of the history of interest rate swaps. Here’s a synopsis. Before interest rates swap markets, suppose a company that had issued fixed rate debt wanted floating rate exposure instead. They could borrow at Libor, and buy a Treasury bond. Their net exposure would be floating. But this did not convey to the company the “lending” value Treasuries have in repo markets. So, the interest rate swap market was born, with swap spreads representing **the lending value of Treasuries, the credit risk of the fixed-rate swap payer, and expectations for future Libor levels.**

⁵ One indicative example: the \$16.3 bn Yale Endowment has \$4 bn in private equity, and another \$7.6 bn in uncalled commitments.

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