Fixed Income Report
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First Trust BondWave

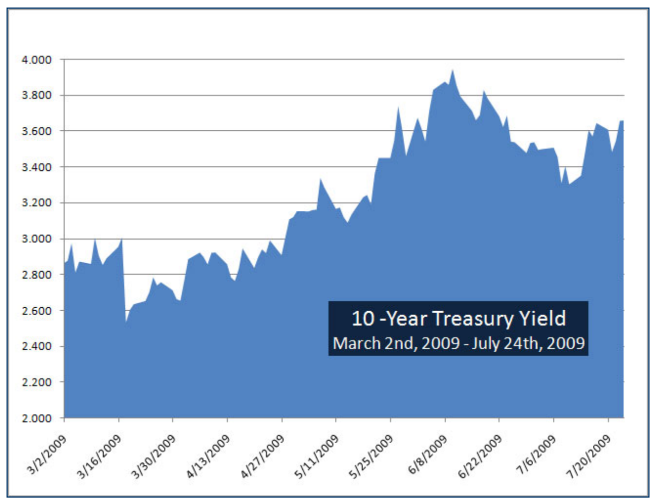
What $3 Billion Gets You

On Thursday, July 23, 2009 the U.S. Federal Reserve spent $3 billion buying long-end U.S. Treasury bonds as part of their quantitative easing program to keep borrowing costs down and help bolster the economy. What did spending $3 billion get them? The benchmark 30-Year Treasury bond ended the day sharply lower in price (down more than 1-20/32) and 10.3 basis points higher in yield (from 4.448% to 4.551%). So the short answer to what adding $3 billion to the Fed balance sheet gets you seems to be: "Not much".

To be fair, the Dow was up 188 points on July 23 (to a new 2009 high) – so a sharp selloff in bonds should not have been entirely surprising. Still, if that's what $3 billion of Fed buying does on a day like that, imagine what $3 billion of Fed selling might look like! Asking such a question is not an idle exercise, but is instead the first step in ascertaining whether there is any value in longer-dated U.S. Treasuries. One has to get arms around the supply and demand situation. In this report we will consider this question from the perspective of how the activities of the Federal Reserve, foreign central banks, and the U.S. Treasury are likely to impact U.S. Treasury levels going forward.

On March 18, 2009, the Fed announced that it would buy $300 billion in U.S. Treasuries as a further step in its efforts to facilitate the unfreezing of credit markets through bringing borrowing rates down. Concurrent with this, the Fed also announced an expansion of its previously initiated agency (Fannie Mae and Freddie Mac) debentures and agency mortgage-backed securities (MBS) purchase programs. These latter programs have by and large succeeded, because since that time, mortgage rates – which many market participants suspect were the true target of the Fed's actions – have come down – as mortgage spreads have narrowed dramatically.

The Fed's U.S. Treasury program, on the other hand, has been somewhat of a losing battle. Despite the fact that the Fed has purchased $219.72 billion of its $300 billion target, longer-dated government borrowing rates have moved up since the program commenced.[1] As shown in the graph below, the 10-year Treasury, for example, has risen from its low yield of 2.46% reached shortly after the Fed announced its program on March 18 of this year, to the close of 3.66% on July 24.



Yield of the U.S. Treasury 10-Year Note: March 2 - July 24, 2009
Source: Bloomberg

In assessing value at current levels, one needs to consider where rates would be absent the Fed's purchases, what the impact will be of the Fed stepping back once the $300 billion target is reached, and longer-term, what the effect will be of the Fed unwinding the program (unless the Fed announces a plan to mature its Treasury holdings).

1 Source: Bloomberg

As such, it is first necessary to appreciate the scale of the Fed's program. So let's put it in some context.

Much is made in the financial press of the importance of China's role in financing the U.S. government. According to the most recent U.S. Treasury Department data, at the end of May 2009, China was the largest holder of Treasuries at $801.5 billion, followed by Japan with $677.2 billion. The Fed's $300 billion program puts it at number three -- ahead of the Caribbean Banking Centers, Oil Exporters, the U.K., Brazil and Russia, which range from just under $200 billion to just over $100 billion.[2] (For a detailed chart of major foreign holders of U.S. Treasury securities, see: http://www.treas.gov/tic/mfh.txt)

Country	$ Billion
China, Mainland	801.5
Japan	677.2
Caribbean Banking Centers	194.8
Oil Exporters	192.9
United Kingdom	163.8
Brazil	127.1
Russia	124.5

Major Foreign Holders of Treasury Securities
As of May 2009
Source: U.S. Treasury Department

Another way to capture the magnitude of Fed buying is to consider that going into next week's largest ever Treasury auction, just over 23% of debt issued in 2009 by the U.S. Treasury Department has been purchased by the Federal Reserve[3]. Consider if you will, that were a private U.S. financial entity to borrow money in a similar fashion (with its corporate treasury issuing new debt while its trading desk is buying to drive prices up higher than they otherwise would be), it seems safe to say that at a minimum one would be wise to think twice about buying the new issue debt – at least until the smoke cleared. The Fed is arguably manipulating the U.S. Treasury market in a manner that is preventing investors in U.S. government debt from receiving a legitimate, market-clearing interest rate. While such a program may well be in the national interest broadly speaking, from an investor's perspective, it should give one pause.

That's not all. As significant a factor as the "demand" manufactured by the Fed is, one has to consider the supply side as well. Simply put, the amount of debt the U.S. Treasury needs to issue is staggering. As Mohammed El-Arian, the CEO and Co-Chief Investment Office of PIMCO, has succinctly framed the magnitude of Treasury issuance they expect in an article in Britain's Daily Telegraph:

> "The amounts involved are huge, whether you use absolute, relative or historical metrics. As an illustration, just look at the error term we attach to our 12-month issuance projection: +/- $500 billion (£309 billion) around a central forecast of $2 trillion. The error term is bigger than the largest 12-month issuance in history." [4]

Bear in mind also that these numbers do not take into account the possibility of a second stimulus program – a possibility which, while reduced by the recent strength in the equity market, could nonetheless regain momentum should the more pessimistic scenarios (including the Fed's) predicting that the jobless rate will spend an extended period above 10% prove accurate. Should funding a second stimulus program prove necessary, U.S. government debt issuance would increase even further.

In sum, for all but those adhering to the most bearish economic outlooks, longer-dated U.S. Treasuries appear to possess a risk/reward profile heavily skewed to the downside. The Federal Reserve is running out of ammunition in its $300 billion effort to keep yields low. The U.S. Treasury has on-going borrowing needs beyond historical precedent, and the future actions of foreign central banks – who hold more than half of outstanding U.S. Treasuries – will

2 Source: Department of the Treasury/Federal Reserve Board
3 Source: Bloomberg
4 Source: Daily Telegraph, 30 June 2009

continue to be a wildcard. Japan and Russia, for example, cut their Treasury holdings in May, while China, while adding to its holdings, nonetheless put $34 billion of its $38 billion increase into short-term Treasury bills.[5] Moreover, according to the Xinhua News Agency, China will raise the issue of the safety of China's investment in U.S. Treasuries at the first U.S.- China strategic and economic dialogue next week in Washington, where it will continue to press for "the negotiation of a bilateral agreement on investment protection."[6] It is likely that such headline risk will only continue to grow in frequency given current U.S. fiscal policy.

For these reasons, it is our belief that for the foreseeable future, both total return oriented accounts, as well as buy-and –hold investors, should stick to short-maturity U.S. government debt within the fixed-income portion of their portfolios. In our opinion, the risk of curve steepening makes owning longer-dated Treasuries an unattractive trade, and although a hold-to-maturity strategy would protect investors from an absolute loss, our expectation of increased price volatility, as well as the likelihood of a more attractive entry point, makes longer duration U.S. government debt unattractive relative to other fixed-income opportunities at this time.

- Eric Maisel, CFA

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This information does not constitute a solicitation or an offer to buy or sell any security. There are many risks associated with investing in securities, including bonds. Please consult your financial advisor before investing.

5 Source: The Wall Street Journal, 17 July 2009
6 Source: Xinhua News Agency July 23, 2009

The FIXED INCOME REPORT is produced as a cooperative effort between fixed income analysts from First Trust and BondWave.

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First Trust
Institutional Capital Markets
www.FTCapitalMarkets.com
800.872.7276

BONDWAVE®
www.BondWave.com
877.795.6288