

U.S.

# Fed Watch

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## Economic Analysis

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## Large Scale Asset Purchases

The Fed's scheme for easing and the Treasury's borrowing

- The Fed's expected purchases and moderate foreign demand will constitute serious heft in the outstanding stock of 1 to 10 year Treasuries
- The Treasury is issuing relatively more bills recently, which will help add to this heft

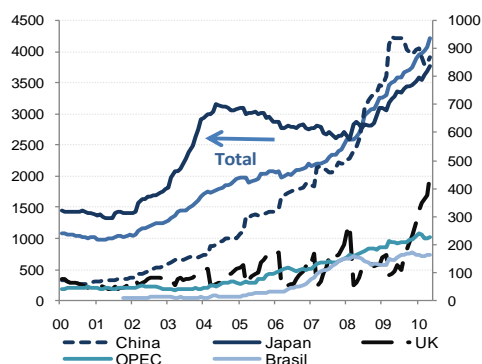
### An Overview of the Fed's Purchases and the Outstanding Stock of Government Debt

On 3 November, the Federal Reserve announced a second round of quantitative easing that aims to ensure its dual mandate of price stability and economic growth. The Federal Reserve instructed its Open Market Operations desk to conduct \$600bn in purchases of Treasuries until the end of 2Q11. This is in addition to an expected \$250 to \$300bn over the same period under an existing program to reinvest principal from maturing mortgage-backed securities (MBS), for a total of \$850-\$900bn in purchases. In order to gauge the effect of these purchases on the market, we must relate the Fed's plan to the contours of the existing Treasuries market. According to the Treasury, net issuance for 4Q10 and 1Q11 will be \$362 and \$431bn, respectively. Over the past eight quarters, the Treasury averaged \$408.7bn in net marketable borrowing. This equates to roughly \$1.2tr in net issuance of marketable government debt, assuming the same pace continues into next year. Alongside the Fed's purchases of Treasuries, foreign governments are quite active as well. Since January, foreigners increased their holdings of Treasuries by \$500bn. In the prior two years, foreigners increased their holdings of Treasuries by roughly \$650bn each year. An additional issue is that in nominal terms with deflation over part of the time period, the real increase in holdings is slightly larger. If we assume slightly less demand for 2011 of around \$300bn, then the Fed's purchases and foreign demand will account for the \$1.2tr in our back-of-the-envelope calculation for the next marketable issuance until the end of 2Q11.

These purchases mostly occur through the secondary market, as the Fed is not a major influence on the direct auction of Treasury securities. Data on the Fed's involvement in Treasury auctions show that the central bank accounts for only a small percentage of the accepted bids. With regard to net issuance, the Treasury during the crisis issued relatively more bonds than bills. Recent data illustrates that the Treasury is moving away from this trend and back towards bills.

Graph 1

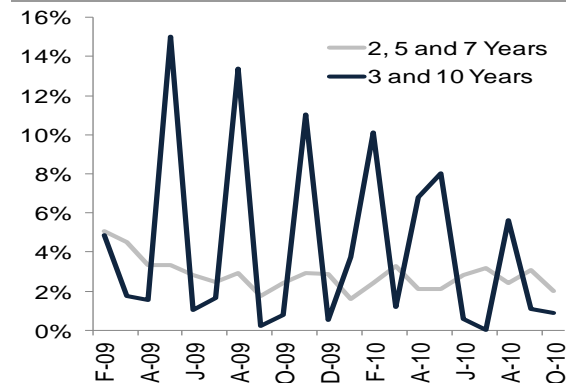
### International Demand for Treasuries (\$bn)



Source: U.S. Treasury

Graph 2

### Fed % of Treasury Auction Accepted Bids



Source: BBVA Research &amp; U.S. Treasury

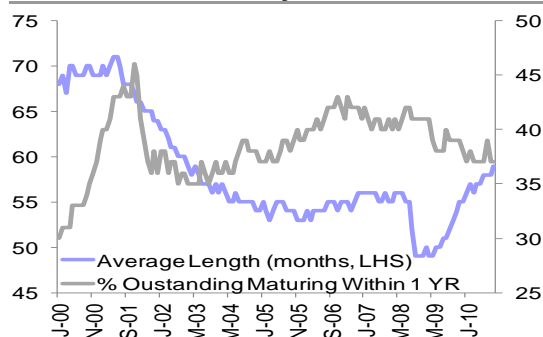
The Federal Reserve, however, is focused on bonds and expects purchases to reach an average duration of 5 to 6 years. This may suggest that the Fed will have considerable influence over the middle of the yield curve. For example, the Treasury reports roughly \$5tr in outstanding securities with maturity of 1 to 10 years. The Federal Reserve, as of 12 November, holds roughly \$600bn in securities within this maturity range and expects 91% of its purchases to occur within this same range, or roughly \$775-820bn. This amount plus \$300bn in foreign demand for Treasury securities is around 22% of the existing stock of Treasury securities with 1 to 10 years maturity. Combined with the existing \$600bn on the Fed's balance sheet, this level reaches 34.4%, given our very conservative estimate of foreign demand. This analysis assumes that the total outstanding \$5tr in this maturity range stays at the same level and that all foreign demand is directed to this maturity range.

The structure of the government's outstanding debt is changing since the crisis. Immediately during the crisis, high levels of bills issuance caused the average maturity of US government debt to decline to 49 months, the lowest since 2000. After several months, the Treasury shifted away from bills and toward bonds and in September the average maturity reached 59, the highest since May 2003. This is probably why the percentage of outstanding debt maturing with one year is at 30%, the lowest since 2000. It follows that the rollover risk of the U.S. has declined over the past months, when it reached a high of 45% in November.

This outline of the outstanding government debt and the Fed's purchase schedule imply that the Fed will constrain the major private actors within the 2 to 10 year maturity distribution and will push investors to purchase longer-dated bonds and switch their portfolio allocation away from Treasuries. It is also possible that investors may increase their holdings of bills, but extremely low yields may not compensate them as much as they would desire.

Graph 3

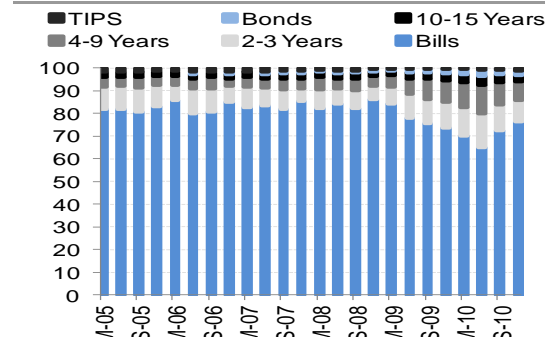
### US Gov't Ave. Maturity and Rollover Risk



Source: BBVA Research &amp; Federal Reserve

Graph 4

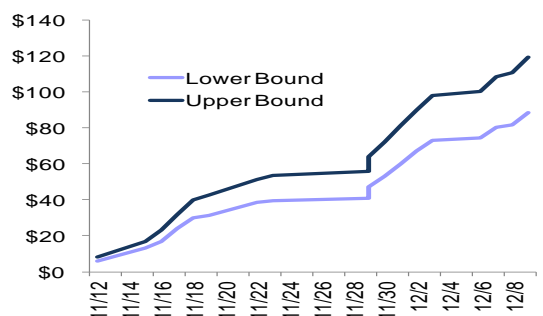
### Breakdown of Net Marketable Issuance



Source: BBVA Research &amp; Federal Reserve

Graph 5

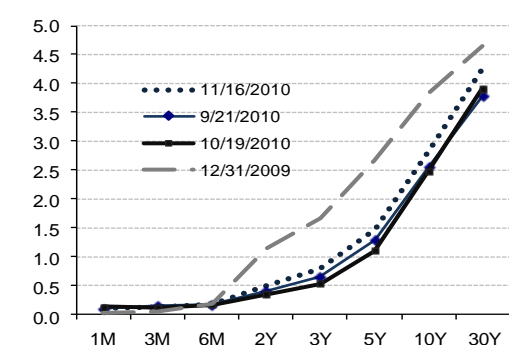
### Projected Fed Purchase Schedule, In \$bn



Source: BBVA Research &amp; Federal Reserve

Graph 6

### Yield Curve



Source: BBVA Research &amp; Federal Reserve

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