

# INSIDE DEBT

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Tuesday, February 9, 2010

## CHART OF THE DAY

### Euro hit by euro zone fiscal worries



The premium investors demand to hold Greek government bonds over euro zone benchmark German Bunds fell to its lowest since Jan. 27, indicating some easing of Greek-related tensions.

## TODAY'S TOP NEWS

- European governments agree to help Greece
- Fed's Dudley: Financial reform needs global scope
- Greece doubts cloud \$40 bln U.S. 3-year debt sale
- BofA, Citigroup rating outlooks negative-S&P
- Sovereign woes see funds seeking swaps cash-flows
- U.S. wholesale inventories unexpectedly fall in Dec
- Global default rate falls in January-Moody's
- EU parliament backs creation of bank crisis fund
- BIS head sees tougher bank capital, liquidity rules
- UK trade deficit widens to 11-month high in Dec

## ECON WATCH

FOR WEDNESDAY FEBRUARY 10

ET	Indicators	Unit	Reuters	Prior
02:45	FR Industrial output mm	%	0.5	1.1
04:00	IT Industrial output mm sa	%	0.1	0.2
04:00	IT Industrial output yy wda	%	-4.6	-7.9
04:30	GB Industrial output mm	%	0.2	0.4
04:30	GB Industrial output yy	%	-4.1	-6.0
04:30	GB Manuf output mm	%	0.3	0.0
04:30	GB Manufacturing output yy	%	-3.0	-5.4
05:30	GB BoE inflation report	-	-	-
07:00	US Mortgage index	ind	-	620.7
07:00	US Mortgage refinance ind	ind	-	2854.8
08:30	US International trade	bln	-36.0	-36.4
08:30	CA Trade balance C\$	bln	-0.10	-0.34
08:30	CA Exports C\$	bln	32.00	31.58
08:30	CA Imports C\$	bln	32.20	31.93

## MARKETS TODAY

**TODAY'S TOP STORY:** European governments have agreed in principle to help heavily indebted Greece, a senior German coalition source said, in what would be the first rescue of a euro zone member in the currency's 11-year history. **For more please click here**

**TREASURIES:** U.S. Treasuries broadened losses after the government saw only average demand for its \$40 billion three-year auction.

- 30-yr bond prices fell more than a point to yield 4.58 pct, up from 4.49 pct on Monday.
- 3-yr Treasury prices fell 7/32 to yield 1.33 pct. The yield was up 1.38 pct from 1.36 pct before the auction.
- 10-yr Treasury prices fell 21/32 yielding 3.64 pct.
- 2-yr notes fell 4/32 to yield 0.83 pct.

**FOREX:** The euro rose against the U.S. dollar, on track for its best one-day gain since November, after reports of a possible European bailout for debt-strapped Greece.

- Euro rose 0.97 pct to \$1.3783. The euro has fallen 9 pct from a 15-month high of \$1.5145 reached in late November.
- The euro rose against the yen, with gains of 1.32 pct at 123.5 yen.
- Dollar jumped 0.34 pct at 89.59 yen.
- Sterling was up 0.83 pct to \$1.5708.
- Dollar index fell 0.63 pct to 79.799.

**CORPORATES:** U.S. corporate bonds spreads tightened helped by reports that euro zone countries will help debt-laden Greece.

- The CDX.IG-13 index tightened by about 4 bps to 102 bps.
- S&P revised both Citi's and BofA's outlooks to negative from stable.
- 5-yr Greece's CDS tightened to 369 bps from 426 bps on Monday.
- GMAC Financial Services launched \$2.0 bln of five-yr notes.

**STOCKS:** U.S. stocks advanced, with the Dow on track for its largest daily percentage gain since November, boosted by reports about an aid plan for heavily indebted Greece.

- Dow rose 1.52 pct to 10,058.56, S&P gained 1.3 pct to 1,070.51 and Nasdaq was up 1.17 pct to 2,150.87.
- Shares of Chevron gained 1.68 pct to \$71.31.
- Caterpillar Inc was up 5.42 pct to \$53.53.
- S&P financial index gained 1.10 pct, S&P energy index was up 1.99 pct, S&P material index rose 2.50 pct.

**C & E:** Commodities rose broadly for the first time in four sessions as the dollar finally broke from its rally, making raw materials priced in the currency attractive again to users of monies like the euro. Crude oil, copper, gold, wheat and sugar prices closed up about 1 to 2 percent each in New York and Chicago trading.

- U.S. crude prices rose 2.85 pct to \$73.94 per barrel. It had fallen to \$69.50 on Friday, the lowest since Dec. 15.
- Gold rose 1.24 pct to \$1,075.95 an ounce. Last week it fell to a three-month low at \$1,043.75.
- Reuters-Jefferies index was up 1.38 pct at 265.12.

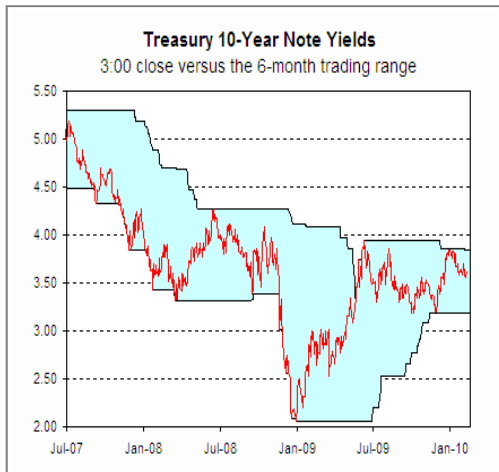
• For MARKET SNAPSHOT click here

• For NEXT UP click here

• For DEEP DIVE click here



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.040	0.005	0.041	-0.004
3-Mo Bill	0.105	0.095	0.106	0.002
6-Mo Bill	0.175	0.165	0.178	0.004
1-Year	0.300	0.290	0.305	0.022
2-Year	100.078	100.109	0.836	-0.125
3-Year	100.109	100.141	1.337	-0.230
5-Year	99.688	99.734	2.317	-0.398
7-Year	100.266	100.313	3.082	-0.477
10-Year	97.797	97.844	3.645	-0.656
30-Year	96.719	96.781	4.578	-1.227

EQUITIES

	INDEX	CHANGE
DJIA	10068.31	159.01
NASDAQ	2150.25	24.21
S&P 500	1070.30	13.50

OIL

	PRICE	CHANGE
NYMEX	73.7	1.8
BRENT	71.2	1.1

EURODOLLAR FUTURES

	CLOSE	CHANGE
Feb-10	99.745	0.003
Mar-10	99.705	0.005
Jun-10	99.575	0.005
Sep-10	99.340	-0.010

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.180	O/N	0.200
2-Week	0.180	2-Week	0.200
1-Month	0.200	1-Month	0.200
3-Month	0.220	3-Month	0.240
AGENCY REPOS		i-REPO <sup>SM</sup> INDEX	
O/N	0.180	10:00 AM	0.120
2-Week	0.200	3:00 PM	0.119
1-Month	0.210		
3-Month	0.230		

IR SWAPS <19901>

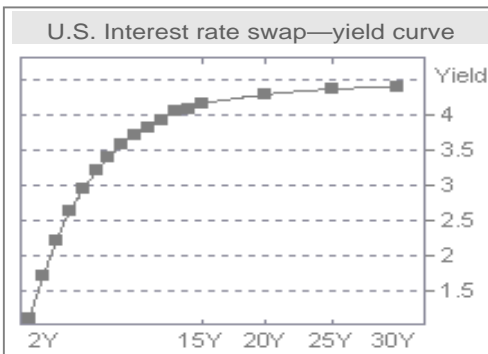
	SPREAD		RATE	
2-Year	27.75	31.75	1.11	1.13
3-Year	37.25	41.25	1.70	1.72
5-Year	31.75	35.75	2.63	2.63
7-Year	14.00	18.00	3.22	3.21
10-Year	8.00	12.00	3.72	3.71
30-Year	-16.25	-12.25	4.41	4.39

FUTURES

	PRICE	CHANGE
CBOT 5 yr	116.70	-0.17
CBOT 10 yr	118.39	-0.09
CBOT 30 yr	118.72	-0.22

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.140	0.160	-	-
1-Month	0.180	0.280	0.130	0.140
3-Month	0.220	0.400	0.148	0.158
6-Month	0.250	0.450	0.178	0.188
12-Month	0.650	1.000	0.329	0.339



CURRENCIES

	BID	ASK
Euro	1.3779	1.3782
Sterling	1.5688	1.5694
JP Yen	89.66	89.68
Swiss Franc	1.0647	1.0650
Can Dollar	1.0684	1.0688
Mexico	13.0518	13.0654

FED FUNDS NYFR<sup>SM</sup> - 10AM

Open	0.1400	1m	0.2150
High	0.2800	3m	0.2463
Low	0.1000		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	0.875	12/01/2012	15 0	0.99
3-Year	1.375	09/01/2013	24 22.5	1.57
5-Year	2.875	09/02/2015	34 33	2.67
7-Year	5.125	18/10/2016	24 22.5	3.32
10-Year	-	-	- -	-
30-Year	6.625	15/11/2030	36.75 36	4.95

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	1.125	15/12/2011	11.5 11	0.95
3-Year	1.75	22/02/2013	29 28	1.63
5-Year	2.625	20/11/2014	20.5 0	2.53
7-Year	5.25	15/09/2016	20.25 19.5	3.28
10-Year	3.75	27/03/2019	27 26	3.9
30-Year	6.25	15/07/2032	45.5 45	5.03

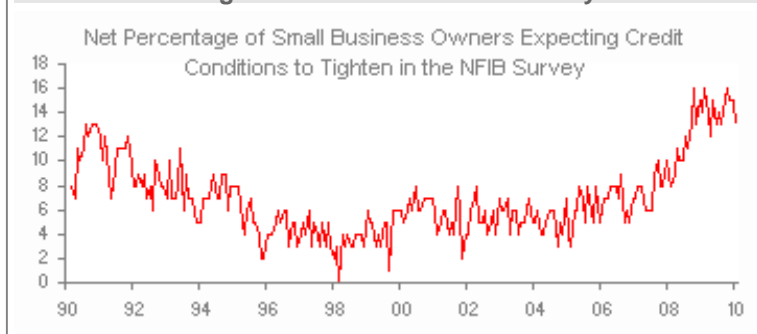
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	105.2300	105.2500	2.504
FHLMC	5.0	105.2400	105.2600	2.491

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	106.0700	106.0900	2.686
FHLMC	5.5	106.0800	106.1000	2.612
GNMA	5.5	106.0470	106.0670	3.412

Wrightson ICAP<sup>SM</sup> Chart of the Day



## TODAY'S TOP NEWS

**European governments agree to help Greece-source**

European governments have agreed in principle to help heavily indebted Greece, a senior German coalition source said, in what would be the first rescue of a euro zone member in the currency's 11-year history.

Various options were under consideration and no final decision had been taken but the most likely possibility was to offer "bilateral help", the source said.

German government spokesman Ulrich Wilhelm called reports that a decision had already in effect been taken "unfounded", but the daily Financial Times Deutschland also said Germany was preparing an aid package for Greece.

The disclosure came two days before a European Union summit expected to discuss the Greek debt crisis. Outgoing EU Monetary Affairs Commissioner Joaquin Almunia fuelled speculation of a rescue by urging European leaders at their meeting on Thursday to help Athens in exchange for drastic fiscal reforms.

The Greek troubles are expected to dominate the informal summit of EU leaders on Thursday, in the presence of ECB President Jean-Claude Trichet, that was originally intended to focus on a long-term growth strategy for the bloc.

The government has vowed to cut the budget deficit, which spiraled to 12.7 percent of GDP last year, below the EU's 3 percent ceiling by 2012.

**Greece doubts cloud \$40 bln U.S. 3-year debt sale**

The U.S. government sold \$40 billion worth of three-year debt in an auction that posted soft results due to financial market uncertainties over Greece's fiscal mess.

The auction came amid conflicting reports over whether the euro zone nations were going to craft a deal to help Greece, clouding the outlook for safe-haven assets such as Treasuries.

The three-year offering, part of this week's \$81 billion in bond sales, attracted bids worth 2.83 times the amount on offer, which was above the average of 2.78 times in the 12 auctions over the last year.

Investors, however, were exceptionally aggressive in bidding to push prices lower, with yields coming in well above expectations based on trade in the when-issued market at the deadline. Such a result is known as a tail.

Demand from foreign central banks and large institutional investors was below average, based on the indirect bidder category, which accounted for 50.9 percent of the sale.

**Sovereign woes see funds seeking swaps cashflows**

Bets that euro zone interest rates will stay low for a long time and falling risk assets on worry over fiscal stability have seen pension funds seeking longer-dated fixed income cash flows, driving 30-year swap rates down.

Funds have been seeking to receive 30-year fixed rate payments in the interest rate swaps market to match their long-term liabilities.

That has compressed the spread between 10-year and 30-year swap rates since last Friday by more than 20 basis points to its tightest since mid-2009.

Credit Agricole CIB strategist David Keeble said the recent receiving flows appear to have been exacerbated by swaption traders who have short gamma -- a change in the sensitivity to the underlying asset's price -- positions, needing to receive 30-year swaps the more the rate declines. Keeble said the moves may be so extreme because of fear of what occurred in the second half of 2008, when 30-year swap liquidity dried up making it extremely difficult for dealers to execute trades.

**Fed's Dudley: Financial reform needs global scope**

A revamp of the financial system needs to be global in nature to prevent a repeat of the worst financial crisis in some 70 years, a top U.S. Federal Reserve policy maker said.

"Although the raging crisis appears to be over, our work is not close to being complete. Making sure this work keeps moving forward and is coordinated internationally is hugely important," William Dudley, president of the Federal Reserve Bank of New York said.

Briefly addressing the state of the U.S. financial system, Dudley said it was in "much better shape" than a year ago. U.S. capital markets, with the exception of some securitization markets, "are generally open for business," he said.

Smaller U.S. banks, however, are likely to remain under pressure from loan losses "for some time to come," he said.

Separately, President Barack Obama said he expects U.S. lawmakers to move quickly to deliver fresh legislation to boost U.S. jobs but acknowledged it may not contain all of the ideas his White House has proposed. Job-creating legislation that Senate Democrats hope to pass this week will not include an extension of the estate tax, U.S. Senate Majority Leader Harry Reid said.

**BofA, Citigroup rating outlooks negative-S&P**

S&P revised its rating outlooks on BofA and Citigroup to negative from stable, citing uncertainty whether the government will provide more extraordinary support that benefits debt holders.

"We previously stated our belief that the extraordinary support was temporary," S&P said in a statement. "We believe markets are beginning to stabilize, and the U.S. government is seeking ways to reduce the potential for moral hazard and systemic risk associated with large financial institutions."

"If such legislation were enacted in the form that has been proposed, it could cause us to revise the analytical basis we currently use for imputing extraordinary government support in our ratings on BofA and other highly systemically important financial institutions," S&P said.

Ratings on Citigroup and BofA are currently enhanced by three notches to reflect the potential for additional extraordinary government support, S&P said. Both banks carry S&P counterparty credit ratings of A, the sixth-highest investment grade.

S&P also raised Citigroup's hybrid capital rating by one notch to BB-minus, three steps below investment grade, from B-plus.

**U.S. wholesale inventories unexpectedly fall in Dec**

U.S. wholesale inventories unexpectedly fell 0.8 percent in December, while sales rose 0.8 percent, a government report showed.

Analysts polled by Reuters had expected inventories to rise 0.5 percent and sales to surge 1 percent. November's inventories rise was revised up to 1.6 percent from the previously reported 1.5 percent, and the increase in sales was revised up to 3.6 percent from 3.3 percent.

Separately, U.S. consumer confidence fell in February to near a level seen at the beginning of the recession, as high unemployment and some stock market weakness sapped January's optimism, a research group said. IBD/TIPP Economic Optimism Index fell to 46.8 in February from 48.8 in January.

Separate government data showed, U.S. job openings rose modestly in December, while hiring's were little changed. Job openings edged up to 2.5 million from 2.4 million in November. The job openings rate was steady at 1.9 percent. Hiring's were little changed at 4.1 million in December, leaving the rate of hiring flat at 3.1 percent.



## TODAY'S TOP NEWS

**Global default rate falls in January-Moody's**

The global junk bond default rate fell to 12.5 percent in January from a revised 13 percent in December and will likely tumble to 3 percent within a year, Moody's Investors Service said.

Just eight Moody's-rated issuers defaulted in January, down from 24 a year earlier. Seven of last month's defaults were from North American borrowers and one from Asia.

Moody's said its default forecast assumes that a global economic recovery continues and credit spreads remain steady through 2010. If the recovery falters and credit spreads widen, the rate could end up at 7.1 percent a year from now, the rating agency said in a report.

The U.S. junk bond default rate fell to 13.6 percent in January from a revised 13.9 percent in December, while Europe's rate fell to 9.6 percent from a revised 10.3 percent, Moody's said.

Moody's is forecasting the U.S. rate will fall to 3.4 percent a year from now, while Europe's rate will likely decline to 2.5 percent.

**EU parliament backs creation of bank crisis fund**

The European Parliament is set to back a proposal that would force banks to pay into an emergency fund designed to help cope with future financial crises, a document seen by Reuters shows.

The European Parliament is set to give the idea a thumbs up, according to senior members of the assembly.

In a report outlining how Brussels should set up a new authority to police banks, lawmakers outline their desire to establish a so-called European Financial Protection Fund to protect savers, banks in difficulty and the broader market.

They propose that payments into the fund from banks replace those made to national deposit guarantee schemes.

In the report, yet to be published officially, lawmakers signal scope for a compromise with EU countries on the powers that should be given to new pan-European super-authorities to police banks as soon as next year.

It suggests a rewording of a veto that Britain and others want to be able to use to overrule the new watchdogs on local matters such as the supervision of London's financial centre.

**BIS head sees tougher bank capital, liquidity rules**

Banks face tougher capital and liquidity rules in the wake of the global financial crisis, the head of the BIS said, though he had doubts on plans to tax large institutions or to broadly limit their activities. Jaime Caruana also saw a role for monetary policy in maintaining financial stability by helping head off debt-fuelled asset bubbles. Speaking at a symposium of central bankers organized by the RBA, Caruana said the response to the global financial crisis had left things worse in some ways.

One way to remedy this was to require banks to build up more capital in good economic times for use when things turned tough. Such capital would have to be more liquid, so that banks should hold a sufficient stock of high-quality liquid assets to be able to survive a month-long loss of access to funding markets. Separately, central banks may need to become more pro-active in dealing with dangerous asset bubbles before they become destabilizing to the financial system, Australia's central bank said.

**UK trade deficit widens to 11-month high in Dec**

Britain's goods trade deficit with the rest of the world unexpectedly widened to its highest in nearly a year in December, after imports from non-EU countries shot up at their fastest rate since March 2005.

Figures from the Office for National Statistics also showed Britain's trade deficit for 2009 as a whole narrowed for the first year since 1997 after global recession caused both imports and exports to fall at their fastest rate in over 50 years.

The ONS said Britain's December goods trade gap widened to 7.278 billion pounds (\$11.34 billion) from 6.798 billion in November., its highest level since January 2009.

Economists had forecast a deficit of 6.63 billion pounds. The widening in the deficit was driven by a 7.6 percent month-on-month increase in non-EU imports, which was the biggest since March 2005.

The non-EU goods deficit widened to 3.553 billion pounds in December from 3.125 billion pounds the month before, compared to analysts' forecast of 3.15 billion pounds.

## NEXT UP

**G7 outlook upgraded but lagging emerging stars**

The world's richest economies are set to grow faster this year than forecast a month ago, although the latest Reuters economic outlook showed the upturn will be feeble in comparison to resurgent emerging market peers.

The monthly survey of around 250 economists showed upward revisions to full-year 2010 growth forecasts.

Strong annualized growth of 5.7 percent in the U.S. for the period prompted a new 2010 full-year growth forecast of 2.9 percent, up from 2.7 percent.

In Britain, disappointing 0.1 percent growth over the same period moved forecasters to downgrade their 2010 forecast to a 1.1 percent expansion from 1.2 percent last month.

Economists said the U.S. Fed wouldn't start tightening interest rates until the third quarter, with the ECB and BoE following suit in the fourth quarter. Japan will not raise rates for at least the next 18 months. Also concerning G7 central banks is the withdrawal of stimulus measures.

Poll respondents gave a one-in-four chance of Greece needing a financial bailout from the EU or IMF, and speculation about debt levels in Spain, Portugal and Italy have rattled markets in the last week.

**Treasury investors cautious before refunding**

Investors turned cautious on U.S. government securities in advance of \$81 billion in supply this week, according to a poll released.

The share of investors who said on Monday they were "neutral," or owning Treasuries equal to their portfolio benchmarks, jumped to 63 percent from last week's 51 percent, J.P. Morgan Securities said. Analysts say some investors reckoned that Treasuries turned expensive after last week's gains, when they were buoyed by fears of government fiscal problems in Europe.

On Monday, the share of investors who said they were "long," or owning more Treasuries than their portfolio benchmarks, fell to 10 percent from 18 percent a week earlier. Investors who said they had a "short" stance, or holding less Treasuries than their portfolio benchmarks, slipped to 27 percent from 31 percent a week ago.

Net "longs" or the difference between the shares of investors who said they were long and those who said they were short, was the smallest since March 26, 2007.

These clients who said were short Treasuries rose to 5 percent from last week's 4 percent, while those who said they were neutral edged up to 6 percent from 5 percent.



## DEEP DIVE Commentary and Analysis

**Watch banks for clues on Greece**

By James Saft

As odd as it sounds, concerns about the effects of a euro zone sovereign crisis on Europe's still poorly capitalized banks may prove to be the tipping point that leads to a swifter bailout of Greece.

While discussion of contagion may seem very 2008, the problems with Greece, which faces a huge fiscal deficit, are becoming tougher for euro zone authorities to leave uninsured.

That's not just because worries about Greece spread markedly in the past week to Portugal, Ireland, and Spain, all of which saw their financing costs rise.

While Greece is, in the scheme of things, pretty small beer, though crucial as test of the euro project, the combined size of all four countries is large enough to pose a substantial threat to banks across Europe.

According to Bank for International Settlements data compiled by BNP Paribas, foreign bank exposure to Greece is just about 300 billion euros - a big, ugly number surely, but not the end of the world.

Lump in Portugal and Spain and you quickly get up to 1.75 trillion euros. That figure may not include all of the 400 billion euros of Spanish structured financings, most of which are tied to the ailing real estate sector.

It seems likely that the sharp jump in the cost to insure weaker euro zone countries against default has been driven by hedging by banks in the opaque credit default swap market.

Shares in European banks did poorly in the past week, but there are no real signs of serious distress yet. If true contagion spread though it would force the hands of euro zone authorities.

That Greece will receive some sort of assistance to allow it to deal with its monumental fiscal deficit is pretty certain, but what isn't clear are the terms of the deal.

Euro zone authorities want to appear as indifferent as possible to Greece's situation so as to extract the maximum amount of cooperation from Greek authorities and its electorate.

**BAILOUTS ARE JUDO MATCHES, NOT BOXING**

As we saw in the U.S., with the bailout of banks and AIG, negotiations with firms or countries in difficulties are not one sided.

Rather than a boxing match, in which the stronger party pummels the weaker, it's like a judo match; the idea is to use your opponents' weight against them. To the extent that financial markets are getting exercised about Greece, its negotiating position improves. If Greece becomes an issue that can be conflated with the health of the financial system, the fear of moral hazard - encouraging bad behavior by insuring its consequences - will fade.

It is not so much that the case for contagion across the European banking system is solid, but rather that the risks are both potentially high and difficult to fathom.

We do know that banks in Europe were less aggressive in writing down bad debts and remain highly leveraged relative to their global peers. They remain dependent on generous liquidity provisions from the European Central Bank.

We also have no idea who is holding the baby. Exposure by banks to weaker euro zone nations is difficult to track. The existence of a credit default swaps market which is traded off exchanges means that there is no way to know who will bear whatever losses might come in the event of a default.

Officials at the Group of Seven finance ministers meeting over the weekend in northern Canada were, at least to some eyes, surprisingly and distressingly sanguine about Greece.

"Europe has become a huge game of chicken, whereby the Greeks are waiting for help from the outside and donors are

waiting for Greece to take a step forward," Mohamed El-Erian, chief executive of bond fund manager Pimco, said on Monday. Financial markets are part of that game and are pushing at the reluctant donors' backs. It is possible that political considerations, especially in Germany, stiffen the donors' resolve, but, if this plays out like the rest of the crisis, look for financial market alarm to spread to bank. That, ultimately, may force emergency measures to benefit Greece and, possibly, other weaker euro zone nations.

(At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

**Angry U.S. bankers seek curbs on direct bidders**

By Emily Flitter

Two minutes after the U.S. Treasury Department closed a multi-billion dollar debt auction last month, one banker was angrily punching in numbers of a hotline he'd found on the Treasury's Web site.

Primary dealers, including his bank, had just been blindsided by a large order from a group of so-called direct bidding firms whose presence is growing.

Financial firms acting as direct bidders are sapping profits for the big banks that have long seen themselves as the main intermediaries in the sale of government debt.

Primary dealers say direct bidders need tighter control given risks they could make auctions more volatile and expensive for the U.S. government at a time when it is borrowing record amounts to fund its programs.

The U.S. Treasury, however, says it supports broader access to auctions on grounds it raises competition and cuts costs.

The banker, who did not want to be named for this story, said he called Treasury to find out more about the firms in this group: He wanted to know how many had bid that day and what the standards were for allowing them to participate.

Primary dealers say a large direct bid in an auction makes it harder for them to properly price their own bids for Treasuries ahead of time. If primary dealers guess direct bidders will turn out in force for an auction, they could choose to pull back from a portion of their bids. They say Treasury auctions could begin to show less stable results. This would likely raise borrowing costs for the U.S. government.

"Because of the direct bid, determining the accurate price in the auction becomes more problematic. If it becomes more problematic fewer people will be willing to put capital at risk for size in the auctions," said Ian Lyngen, senior government bond strategist at CRT Capital Group in Stamford Connecticut.

Some primary dealers are asking the Treasury for limits on the percentage of direct bids that can be placed in a given auction. This, they say, would cut down on the level of uncertainty that has taken hold ahead of auctions recently.

**WHY SO ANGRY?**

On the day the angry banker made his phone call, direct bidders took down more than 17 percent of a \$21 billion auction of 10-year notes, a far higher portion than normal. Direct bidders took 8.9 percent of the December 10-year note auction, and in November their bids made up 4.5 percent of the total. Similarly, January's three-year note auction saw direct bidders take 23 percent, while they accounted for only 2.9 percent of the December three-year auction.

"More and more buy-side accounts are so starved for yield that they're trying to go around the dealers," said Chris Whalen, co-founder of Institutional Risk Analytics. "Why should PIMCO go



## DEEP DIVE Commentary and Analysis

through a primary dealer?"

But despite the constant communication between these big banks and the government, they can't hope for much change.

"We support broad access to the auction process and we think that this is a good thing from the standpoint that it breeds competition and helps us achieve our goal of financing the government at the lowest cost over time," said Matthew Rutherford, the deputy assistant Treasury secretary for federal finance, speaking to reporters at last week's quarterly refunding announcement.

The direct bidder issue is one on which the primary dealers have little leverage in persuading Treasury. Despite the record size of recent Treasury issuance, investors are still snapping up U.S. government debt, creating healthy demand that has led to smoothly executed auctions.

This means the Treasury Department has little incentive to do more than listen to primary dealers' complaints about direct bidders.

"I think they like having a larger number of people with access to their auctions," said Rick Klingman, managing director of Treasury trading at BNP Paribas in New York. He explained that in the event of a disaster such as the 9/11 attacks, which knocked out New York firms' systems, a broader network of direct bidders could step in and make sure an auction went smoothly.

There are few details on the makeup of the group of direct bidders available to the public. Treasury does not disclose the number of firms authorized to participate as direct bidders, and there's little information available to indicate the potential size of firms that have direct bidding terminals.

Primary dealers aren't afraid to speculate on who the mystery bidders might be. Some posit they are smaller securities firms that are preparing to apply to become primary dealers, while others say those firms aren't well-capitalized enough to make much of a dent in a single auction.

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(Compiled by Anil Kumar and Pronita Naidu in Bangalore)

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