How safe are US Treasuries?

Rajiv Setia, US Fixed Income Strategy

Amrut Nashikkar, US Fixed Income Strategy

Anshul Pradhan, US Fixed Income Strategy

PLEASE SEE ANALYST CERTIFICATIONS AND IMPORTANT DISCLOSURES STARTING AFTER SLIDE 25

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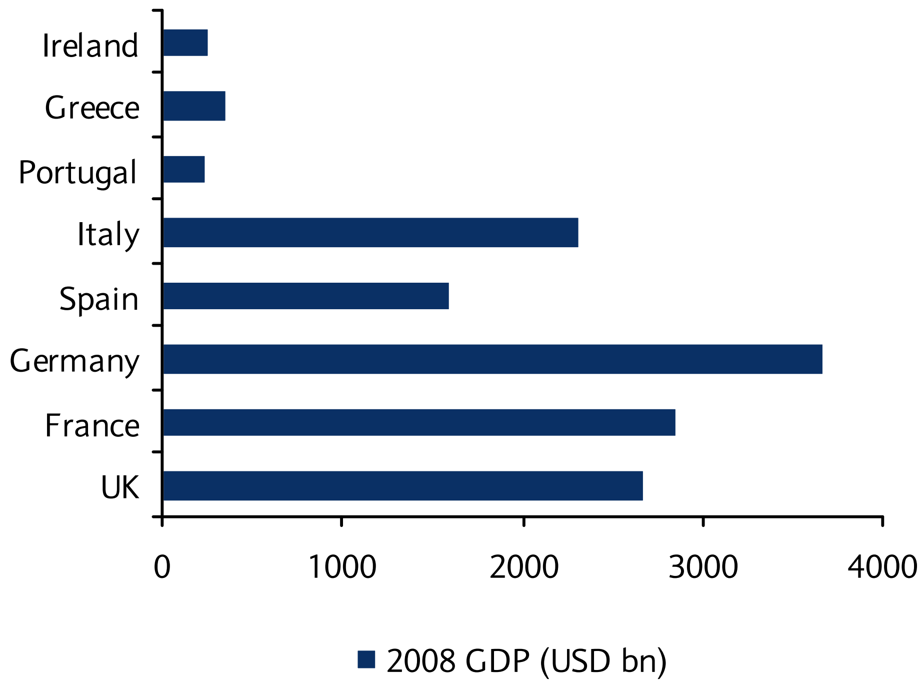
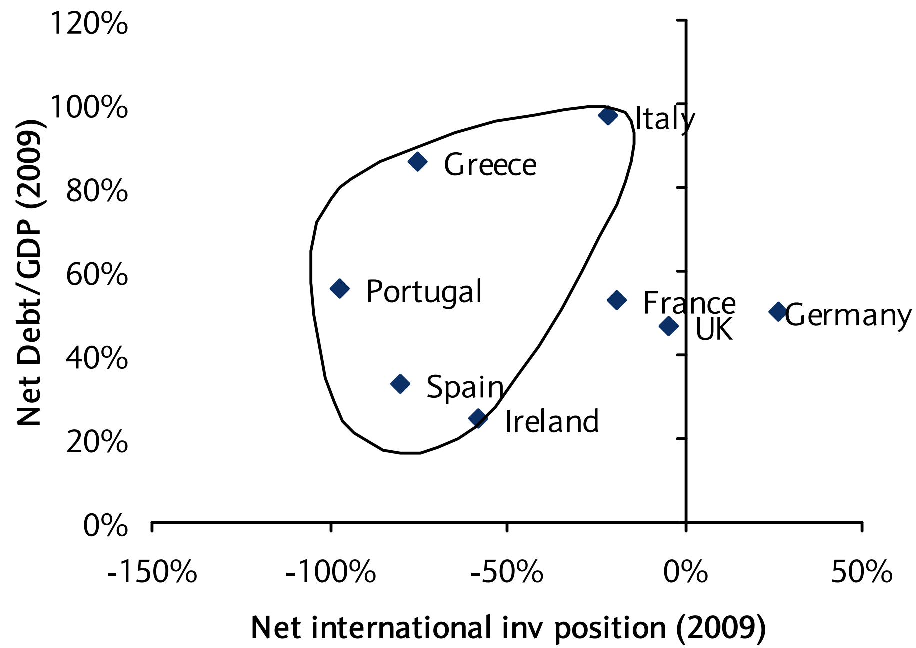
Greece has focused investor attention on sovereign risk

Greece is a small player in the Eurozone



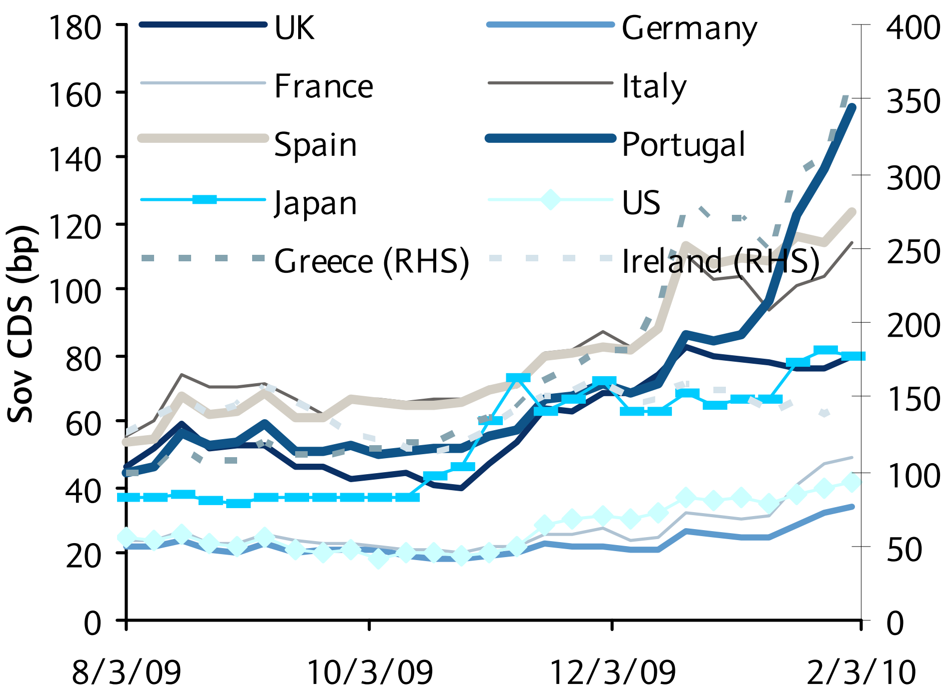
But resolution has major implications for the peripherals



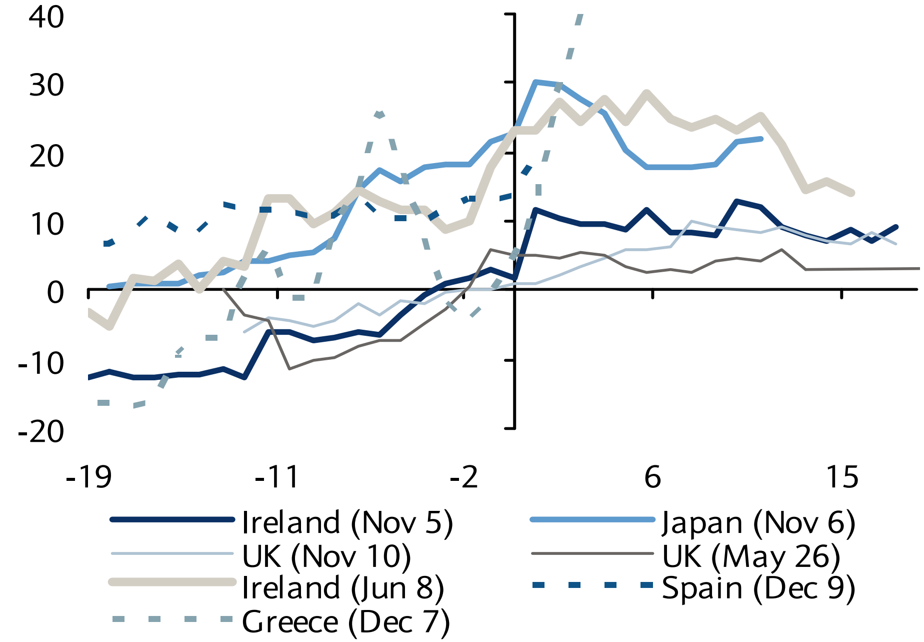
Source: Barclays Capital, Haver, OECD

CDS market is a useful leading indicator

Risk concerns have been apparent in the sovereign CDS market



Widening in CDS precedes negative ratings news



Source: Barclays Capital

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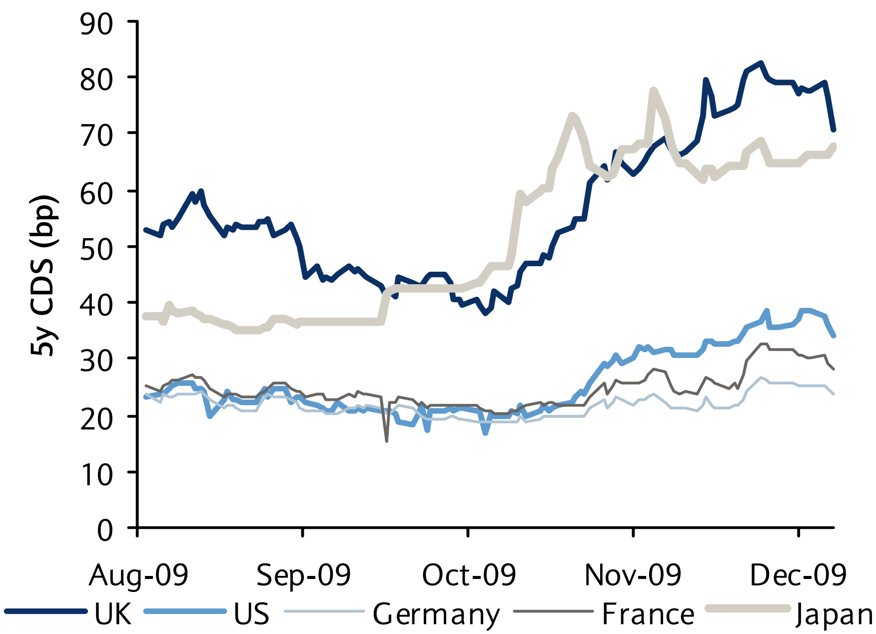
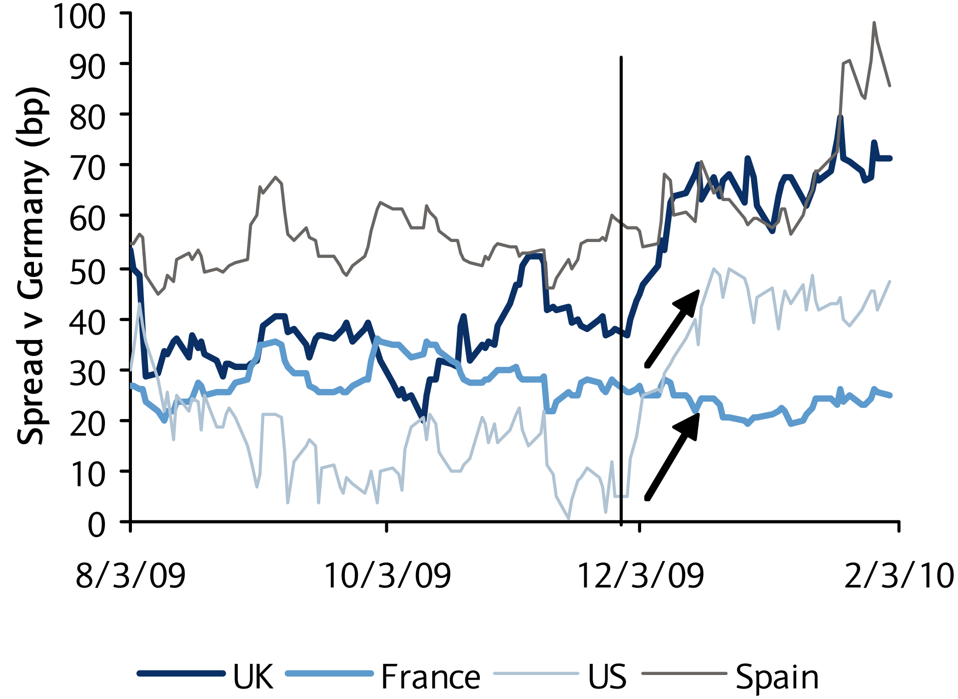
Sovereign risk is spreading to developed economies

Recent widening of sovereign CDS for developed economies



Cash markets tell the same story



Source: Barclays Capital

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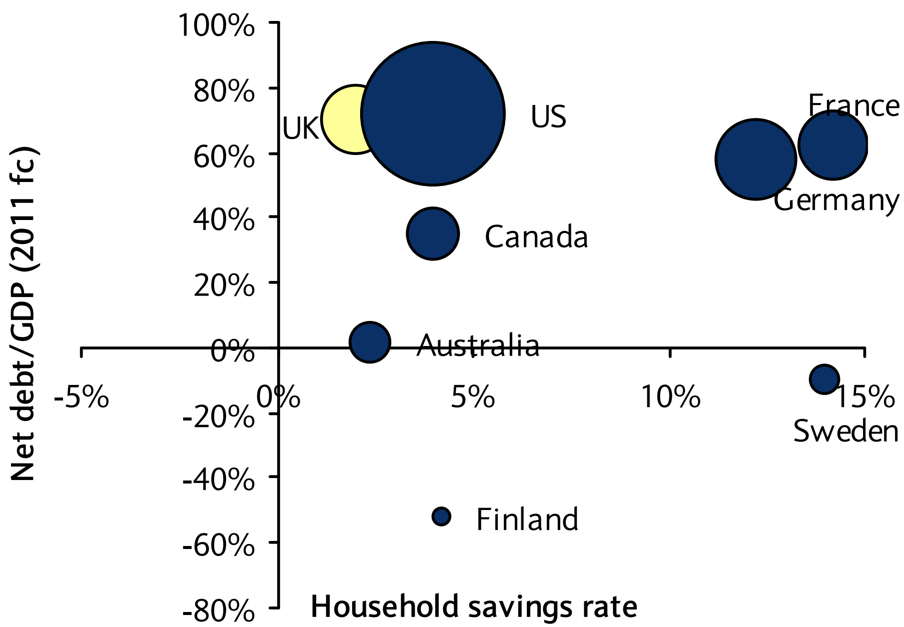
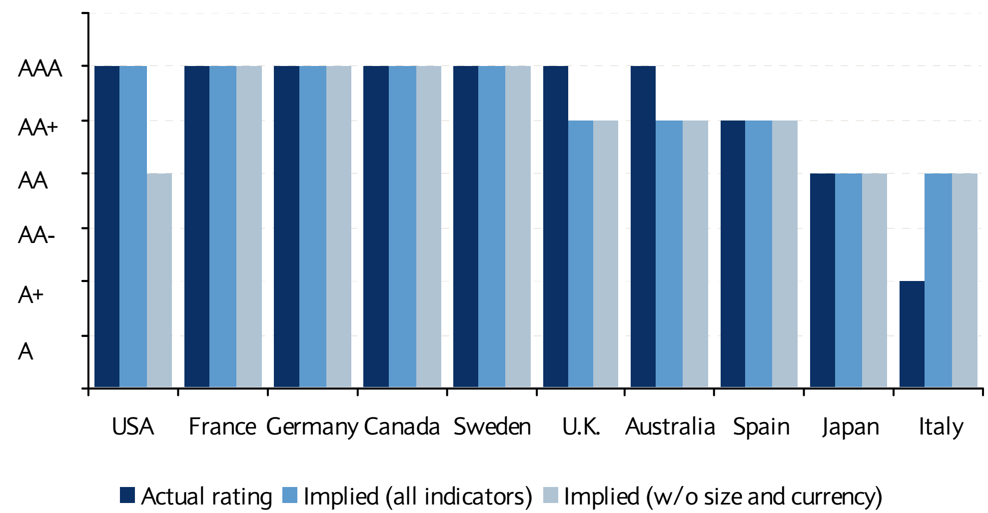
Why is the UK's AAA rating under threat while the US is seemingly immune?

On many financial metrics, the US and UK look similar – high government debt, low savings rate



Using an "implied" ratings framework provides clues



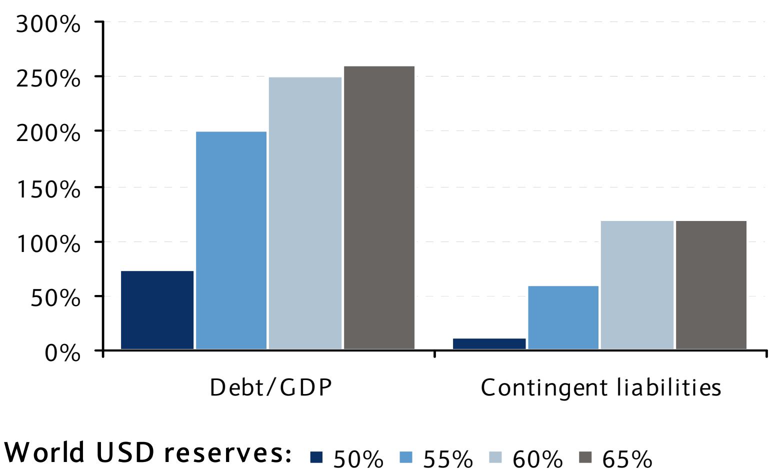
The US can finance large amounts in the international market because the US dollar is the world's reserve currency

Note: Implied ratings are based on a cluster analysis of selected economic and financial indicators

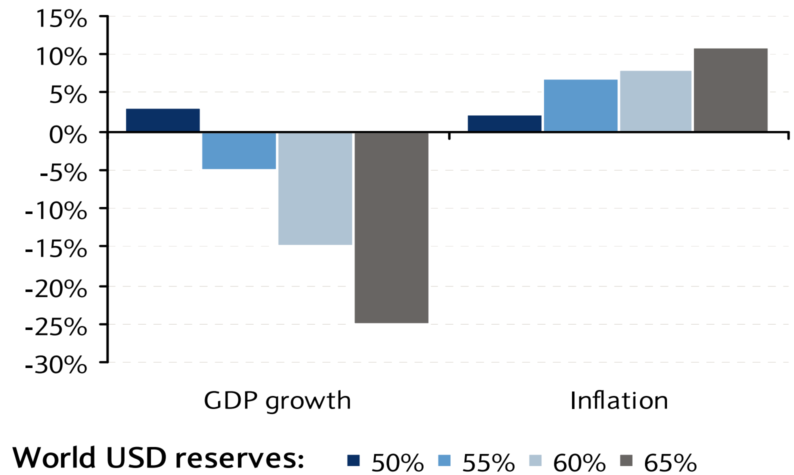
Source: Barclays Capital, OECD outlook

If the dollar's status is stable, the US can withstand significant fiscal deterioration

Trigger points for US rating downgrade to debt and contingent liabilities, ceteris paribus



Trigger points for US rating downgrade to GDP growth and inflation, ceteris paribus



Combination scenario that could trigger a US rating downgrade

World USD reserves	Debt/GDP	Contingent liabilities	GDP growth	Inflation
55%	100%	13%	0%	3%

Source: Barclays Capital

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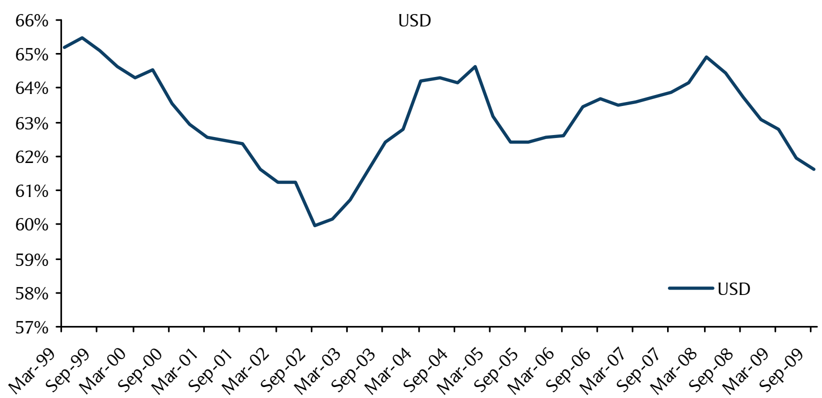
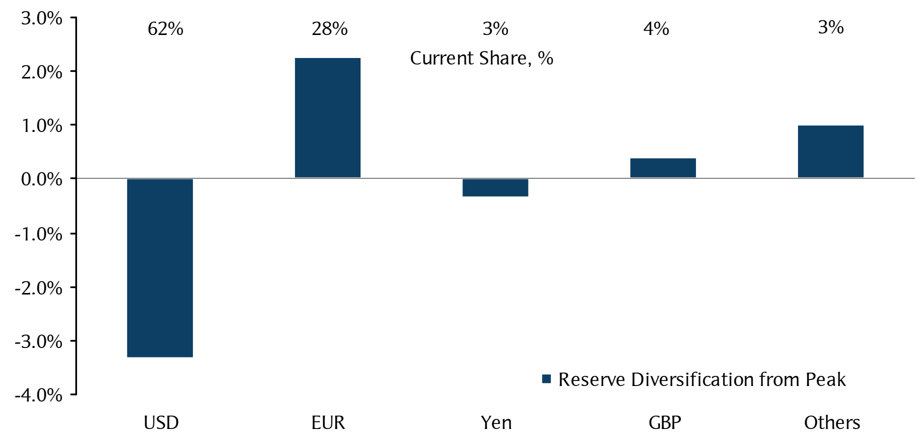
Rapid reserve diversification leads to crowding out in the US

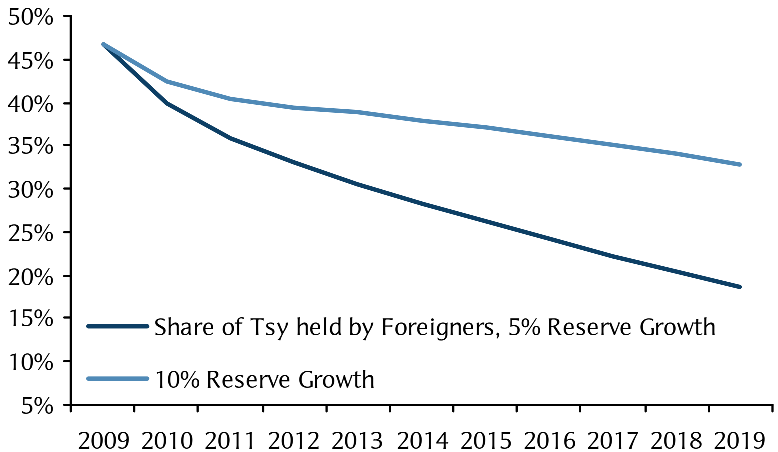
Foreign central banks diversifying away from $



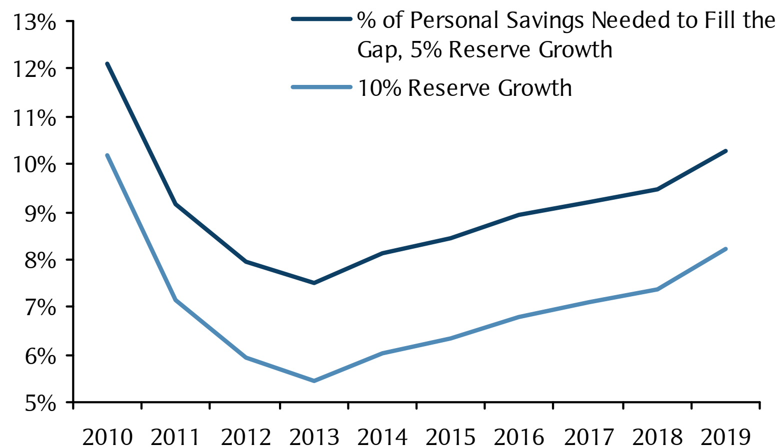
Mostly into euro



Steady diversification reduces foreign ownership of US Treasuries



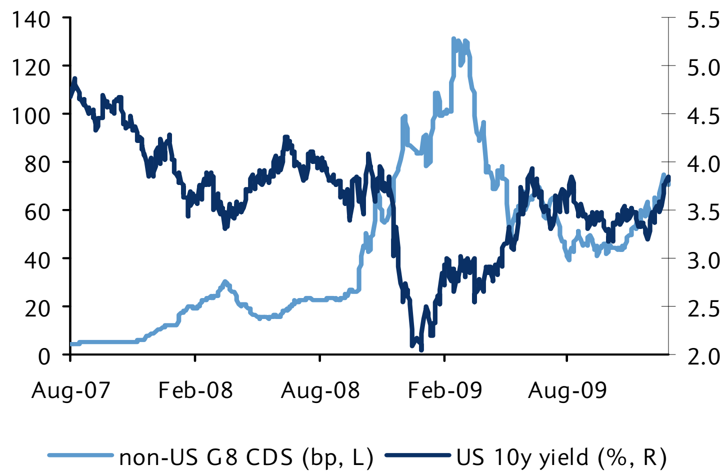
Putting a burden on domestic investors



Source: IMF, Barclays Capital

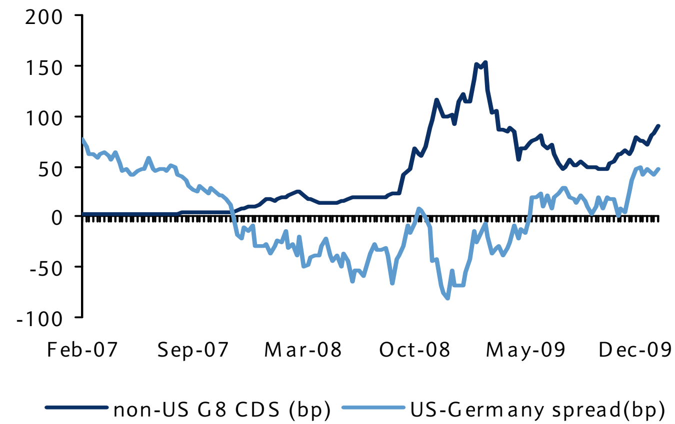
Increased Euro sovereign risk is positive for US rates

US rates rally when sovereign CDS widens

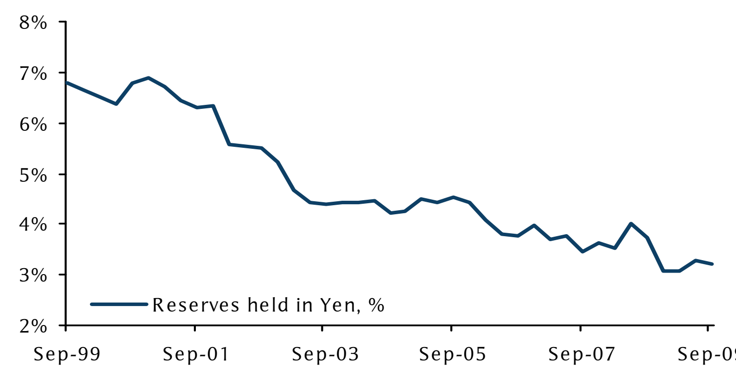


	Δ(US 10y rate, bp)	Δ(US 10y rate, bp)	Δ(US 10y rate, weekly)
Δ(Other CDS, bp)	-0.52	-0.57	-0.62
t-stat	-2.76**	-3.46**	-2.91**
Δ(US CDS, bp)	-0.10	-	-
t-stat	-0.5	-	-
Intercept	0.06	-0.10	-0.35
t-stat	0.14	-0.29	-0.29
Observations	629	629	135

Market has not fully priced in flight to quality potential for US



Reserve diversification away from Japan since it lost AAA status



Source: Barclays Capital

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Recap

- Near term, we do not think that the US AAA rating is in danger
- Negative news about PIIGS/other European countries/Japan may lead to reserve diversification *away* from these countries
  - *Does not appear priced in US rates*
- Very different story over the medium to long term if projected fiscal deficits are realized and dollar's reserve status diminishes

Implied and actual ratings for the top 30 countries

Country	GDP (USD Billion,2007)	S&P Rating	Implied rating
United States	13751	AAA	AAA
Japan	4385	AA	AA
China	3206	A+	A+
Germany	3317	AAA	AAA
U.K.	2772	AAA	AA+
France	2589	AAA	AAA
Italy	2101	A+	AA
Spain	1437	AA+	AA+
Canada	1330	AAA	AAA
Brazil	1313	BBB-	BBB+
Russia	1290	BBB	BB
India	1177	BBB-	BBB-
Korea	970	A	A+
Mexico	1022	BBB+	BBB+
Australia	821	AAA	AA+

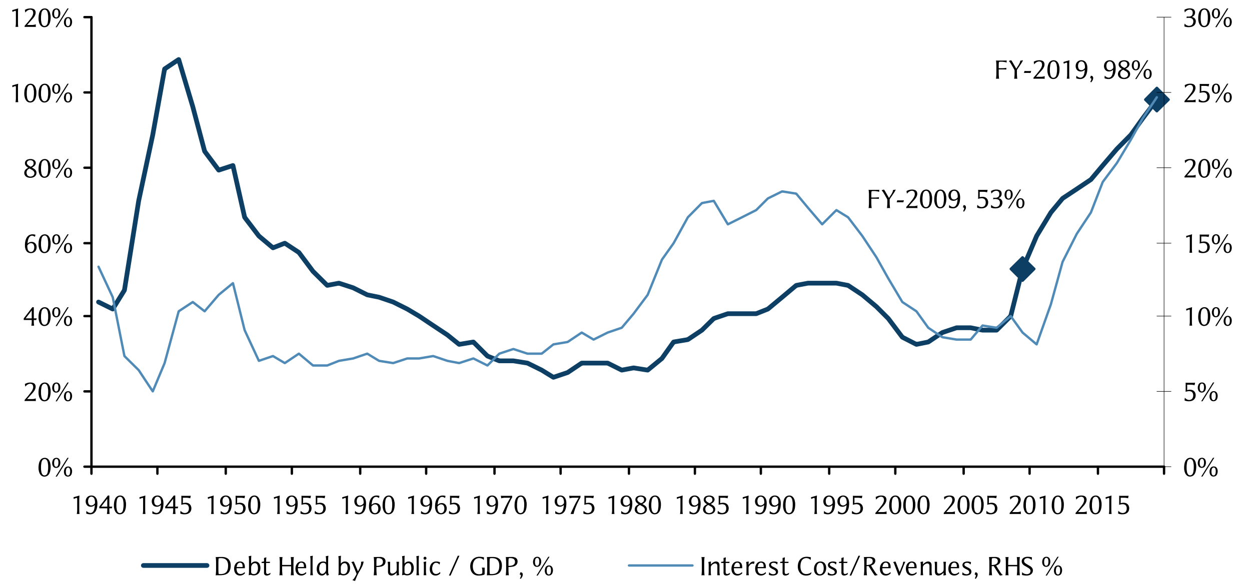
Country	GDP (USD Billion,2007)	S&P Rating	Implied rating
Turkey	656	BB-	BB-
Sweden	454	AAA	AAA
Indonesia	433	BB-	BB+
Switzerland	424	AAA	AAA
Poland	422	A-	A-
Norway	388	AAA	AAA
Taiwan	355	AA-	A
Austria	373	AAA	AAA
Greece	313	A-	A-
Denmark	312	AAA	AAA
South Africa	283	BBB+	BB+
Argentina	262	B-	B-
Ireland	259	AAA*	AA+
Thailand	245	BBB+	BB+
Finland	245	AAA	AAA

Implied rating is worse than actual

Implied rating is better than actual

US faces significant fiscal challenges

Fiscal metrics on an unsustainable path



Financeability - Ability to raise debt

Affordability? - Interest costs relative to federal revenues

<u>Reversibility?? – Political will to impose credible plan for fiscal discipline</u>

Source: CBO, Barclays Capital. CBO Baseline has been adjusted using its own estimate of the president's policies (as of June 2009) and assuming that appropriations grow @GDP instead of inflation. Interest cost has been forecast assuming that the forward path is realized and the Treasury gradually terms out debt

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Medium-term risks to US AAA status

Projecting the path of key fiscal metrics

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
CBO baseline primary deficit, Jan-2010, $bn	-1,142	-747	-370	-206	-79	-21	-2	47	82	27
a. EGTRRA/JGTRRA tax cut extension	0	-102	-185	-199	-210	-221	-230	-240	-250	-260
b. Other tax Provisions	-12	-67	-151	-151	-160	-165	-173	-183	-188	-194
c. Indexing the AMT to inflation	-7	-69	-31	-35	-39	-44	-50	-58	-66	-77
d. Interaction of a and c	0	-18	-39	-43	-46	-49	-52	-55	-57	-60
e. Appropriations grow @ nominal GDP	0	-9	-37	-82	-129	-170	-207	-244	-279	-315
Total primary deficit	-1,160	-1,012	-813	-715	-664	-669	-715	-733	-758	-879
Interest cost, (along the forward path)	-178	-267	-366	-449	-531	-620	-699	-788	-871	-967
Total deficits	-1,338	-1,279	-1,179	-1,165	-1,195	-1,289	-1,414	-1,520	-1,629	-1,846
Key fiscal metrics										
Total deficit/GDP	-9%	-9%	-7%	-7%	-7%	-7%	-7%	-8%	-8%	-9%
Debt held by public/GDP	62%	68%	72%	74%	77%	80%	85%	89%	93%	98%
Interest cost/revenue	8%	11%	14%	16%	17%	19%	20%	22%	23%	25%

Source: CBO, Barclays Capital. CBO Baseline has been adjusted using its own estimate of the president's policies (as of June 2009) and assuming that appropriations grow @GDP instead of inflation. Interest cost has been forecast assuming that the forward path is realized and the Treasury gradually terms out debt

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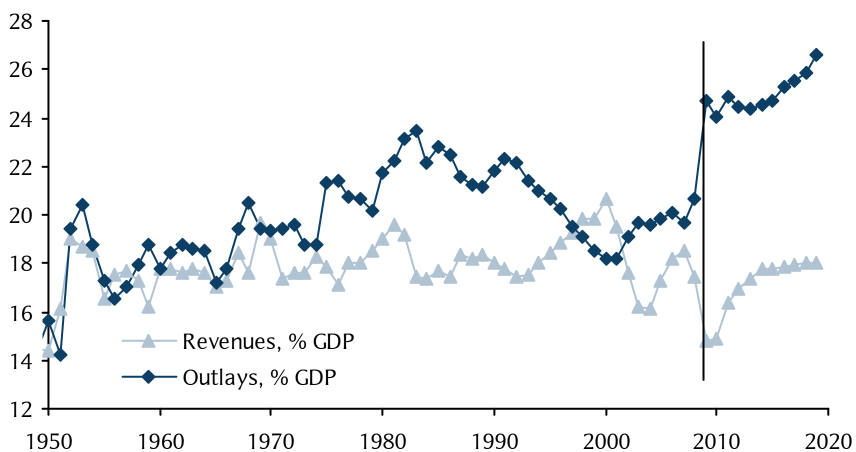
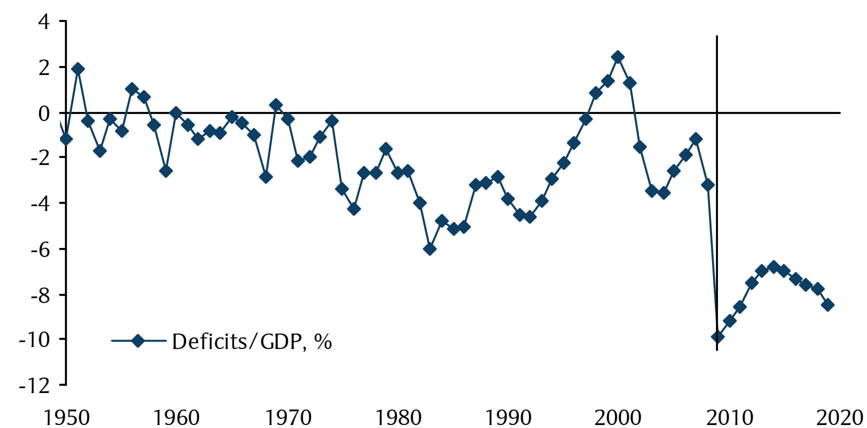
Revenues/outlays in a historical context

Revenues to improve, but outlays projected to worsen



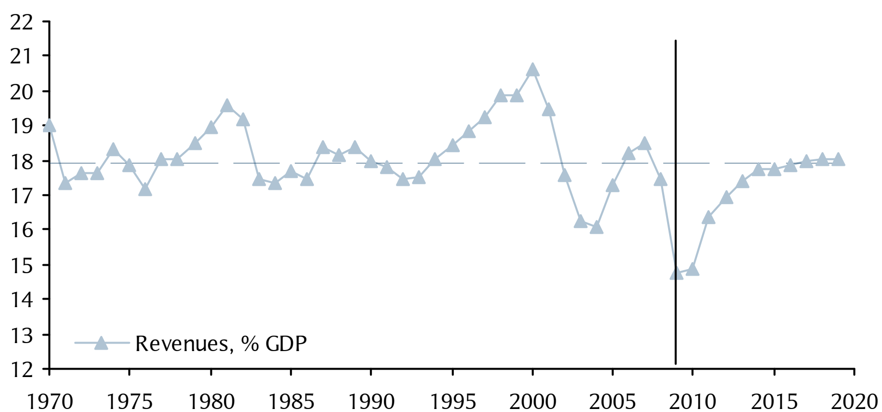
Improvement in deficits temporary



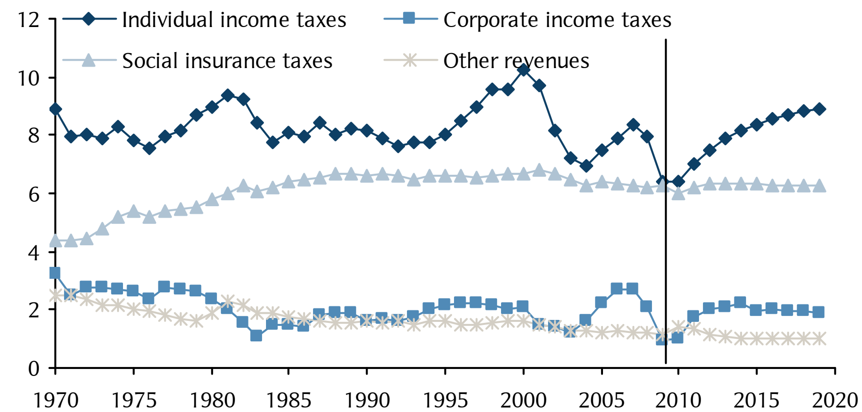
Source: CBO

Revenues projected to rise to historical average

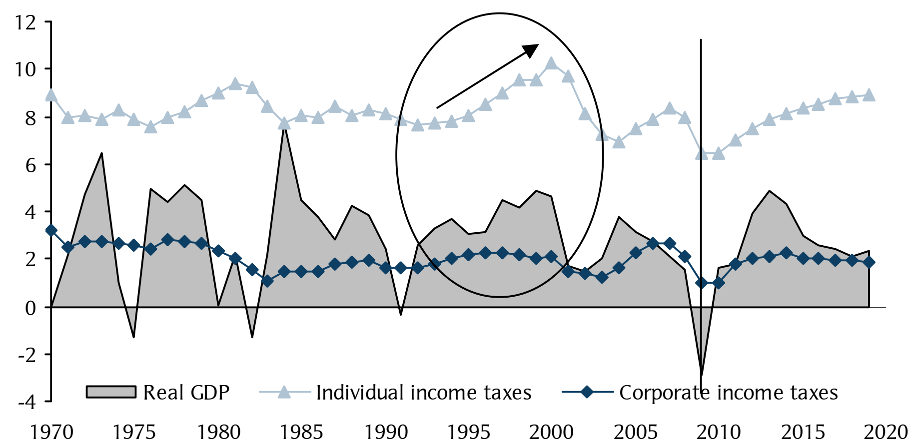
Revenues should rise



Led by individual and corporate income taxes



Sustainable strong growth a way out ?



Source: CBO

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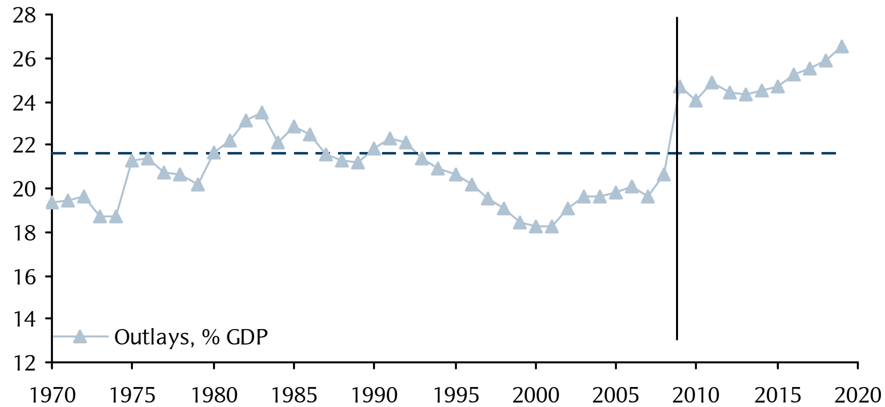
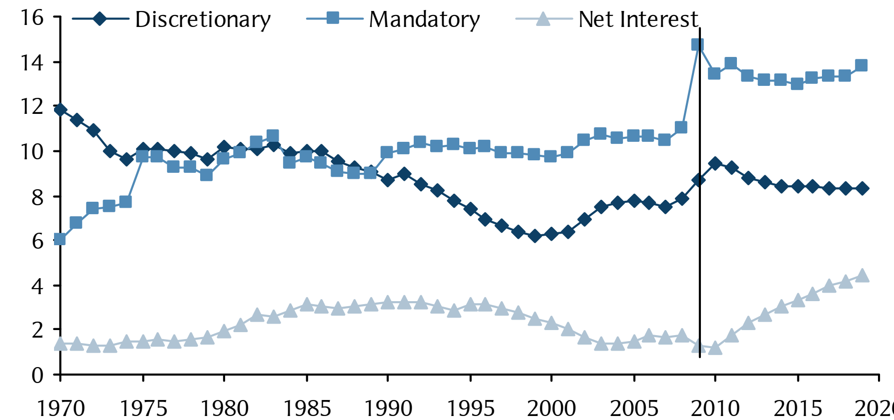
Reduction in spending: Tough choices

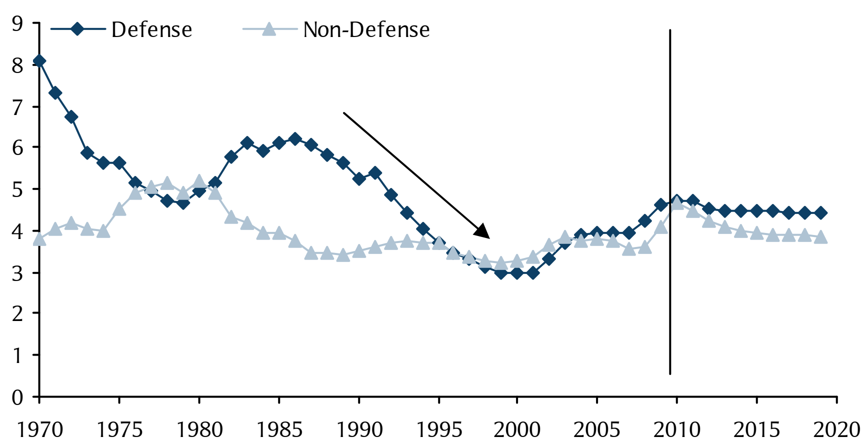
Outlays projected to remain a high % of GDP



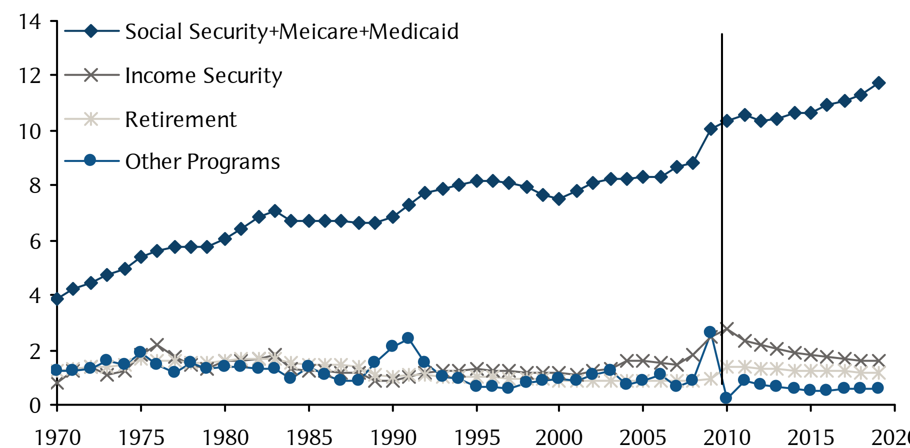
Rising interest cost outweighs reductions



Reduction in discretionary spending a way out



Limited room to manoeuvre in mandatory spending



Source: CBO

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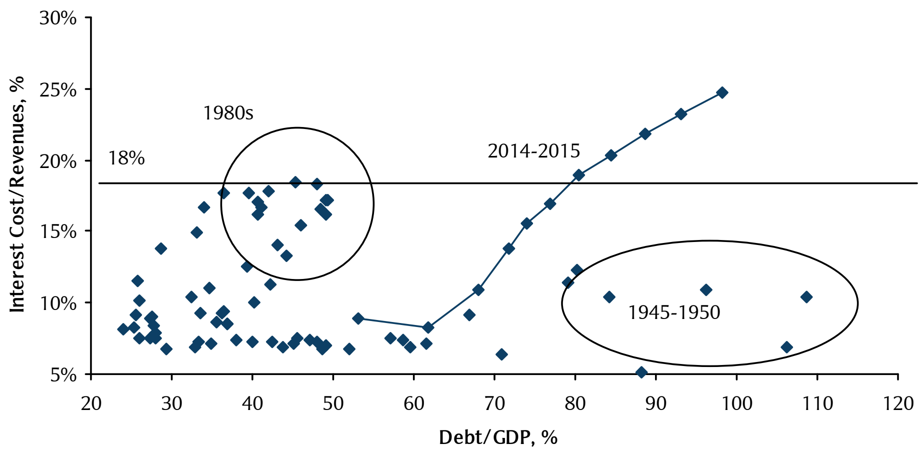
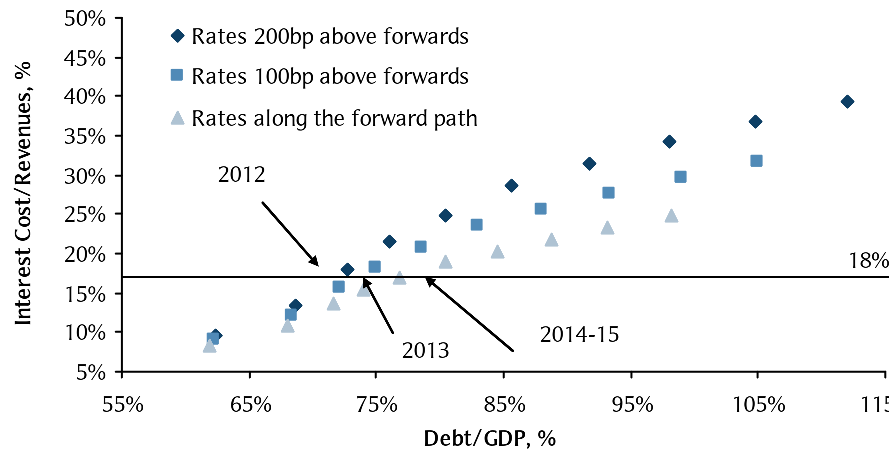
Rising interest rates a major risk

Key fiscal metrics	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total deficit/GDP	-9%	-9%	-7%	-7%	-7%	-7%	-7%	-8%	-8%	-9%
Debt held by public/GDP, %	62%	68%	72%	74%	77%	80%	85%	89%	93%	98%
Interest cost/revenue	8%	11%	14%	16%	17%	19%	20%	22%	23%	25%

Interest coverage ratio to breach historical highs by 2015



Even sooner if rates rise



Source: CBO, Barclays Capital. CBO Baseline has been adjusted using its own estimate of the president's policies (as of June 2009) and assuming that appropriations grow @GDP instead of inflation. Interest cost has been forecast assuming that the forward path is realized and the Treasury gradually terms out debt

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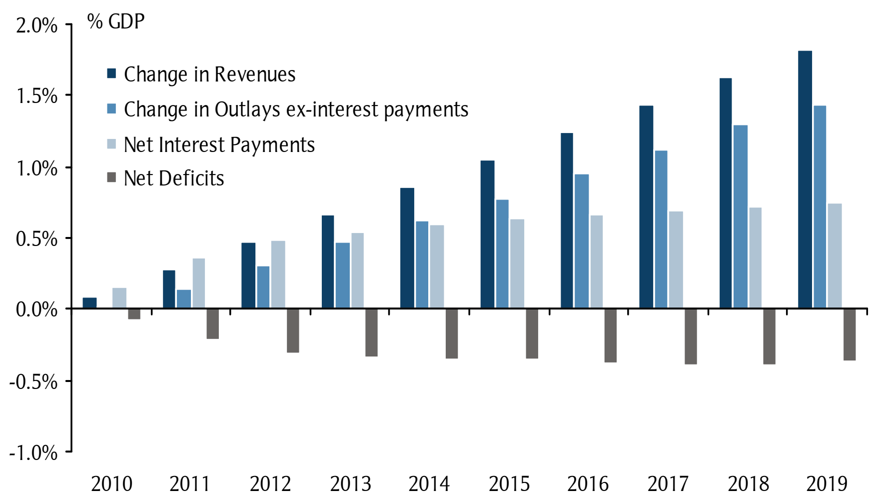
Neither inflation nor devaluation is an option

Higher inflation worsens the deficit problem



Highly dependent on foreign investors

Source: CBO, Federal Reserve

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GSEs: No hints in the president's FY11 budget

Higher cumulative draw from Treasury, but lower dividend payments and no change in draws from 2012 on

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Totals 2011-2015	Totals 2011-2020
Transactions between Treasury and Fannie Mae/Freddie Mac:															
Senior Preferred Liquidity Payments to Fannie Mae/Freddie Mac	......	96	69	23	......	......	......	......	......	......	......	......	......	23	23
Senior Preferred Dividend Payments from Fannie Mae/Freddie Mac	......	–4	–12	–18	–7	–7	–7	–7	–7	–7	–7	–7	–7	–44	–78
Net Payments	......	91	57	5	–7	–7	–7	–7	–7	–7	–7	–7	–7	–21	–55

- Released February 1, the president's FY11 budget raises more questions than it answers
- Peak cumulative draw amount is $188bn, up from the year-ago estimate of $173bn
  - Assumes no paydowns of this amount in 2012 and beyond – conservatorship lasts indefinitely
  - Dividend payments reduce from $18bn/yr in 2011 (or about 10%) to $7bn/yr thereafter
  - Implies a cut in the coupon to below 4%
- We believe further losses are in store for FNM/FRE; our base case is for $230bn combined

"The Administration continues to monitor the situation of the GSEs closely and will continue to provide updates on considerations for longer term reform of Fannie Mae and Freddie Mac as appropriate."

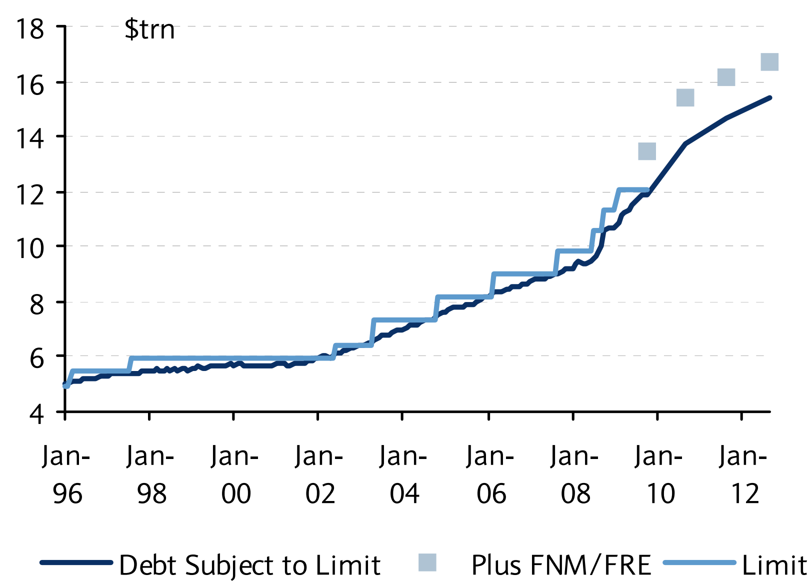
- From p.352, Credit and Insurance, Analytical Perspectives, Budget of the US Government for FY 2011

Source: White House Office of Management and Budget, Barclays Capital

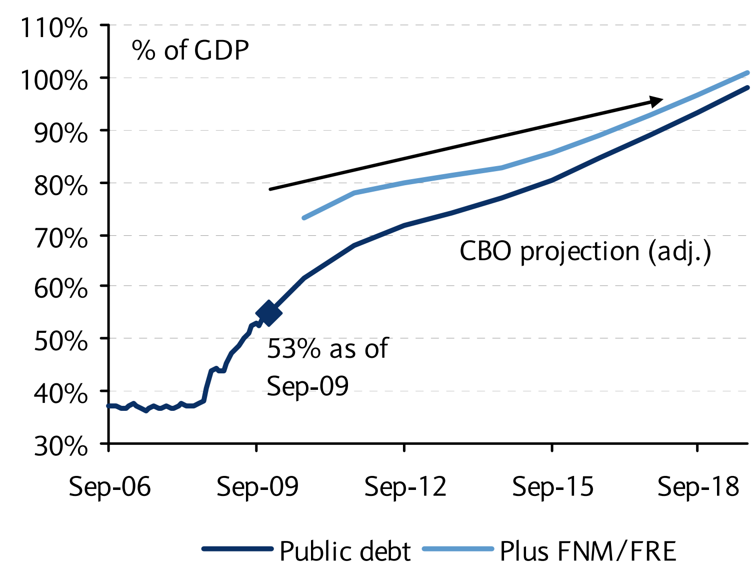
Insurmountable losses, but receivership is not an option *yet*

- Full government ownership would place the GSEs on the government balance sheet
  - if explicitly guaranteed, debt will be subject to the borrowing limit, which could be politically infeasible
  - Projected deficits in 2010-15 will already require a politically risky increase in the borrowing limit

Debt ceiling becomes a limiting factor



Worsening debt/GDP ratio threatens AAA rating status of US



Source: Barclays Capital, CBO

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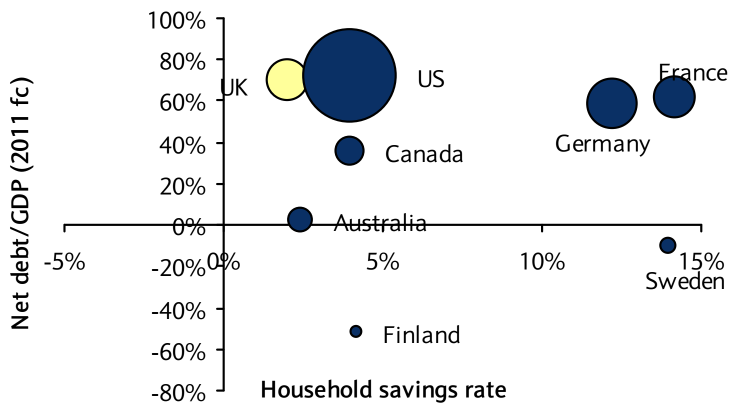
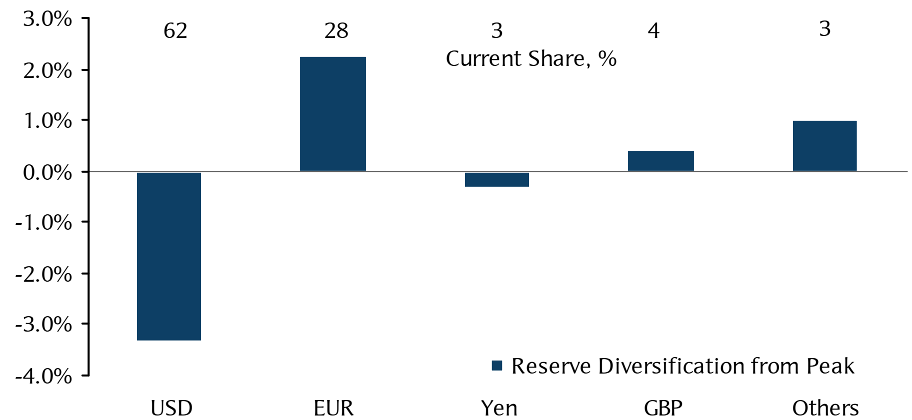
Market implications

A steeper Treasury curve:
Sovereign risk and supply demand imbalance

Underweight countries with higher sovereign risk



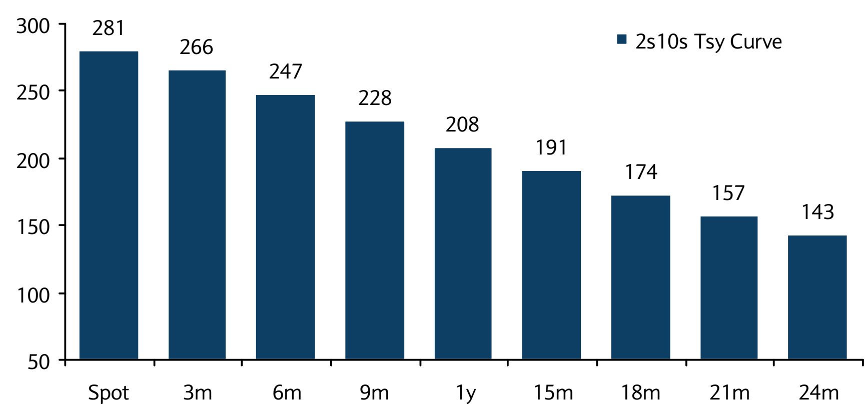
Reverse diversification favors US curve steepeners



Supply-demand imbalance also favors steepeners

Ex-Ante Demand	Total
Overseas	+600
Banks	+300
Households	+600
Pension allocation	+100
Total ex-ante demand	1,600
Total net term FI supply	2,640
Imbalance	-1,040

Market is priced for a flatter curve



Source: Barclays Capital, IMF

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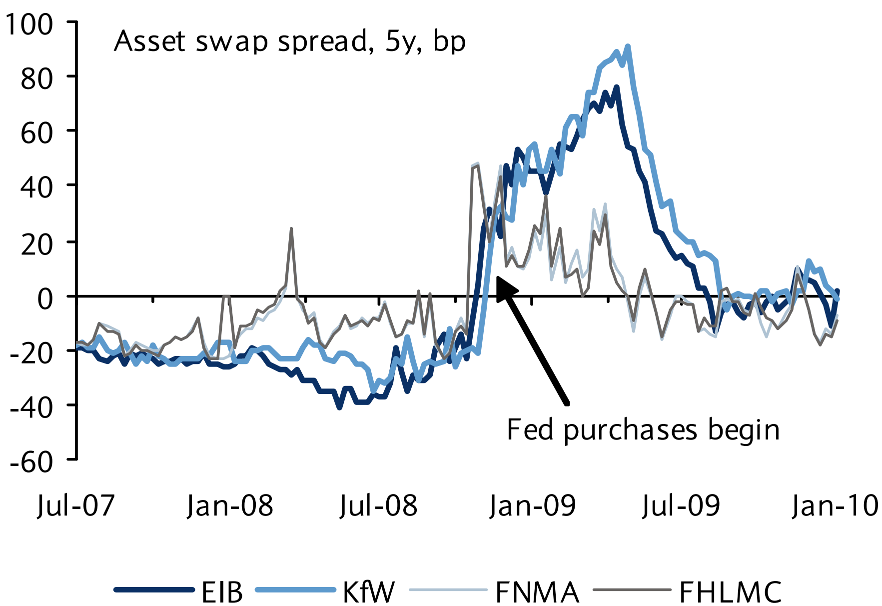
Greener pastures across the pond

- Fundamentally, EIB/KfW should trade through FNM/FRE; US sovereign risk is being underpriced

EIB/KfW versus FNM/FRE



Foreign GGB versus TLGP

	GGB ASW	Sovereign CDS	
bp	3y	3y	5y
US	-10 (FRE) 0 (TLGP)	41	43
UK	37	65	82
France	7	42	50
Germany	-3 (KfW)	29	35
Netherlands	25	26	34
Sweden	24	35	49
Australia	21	46	54

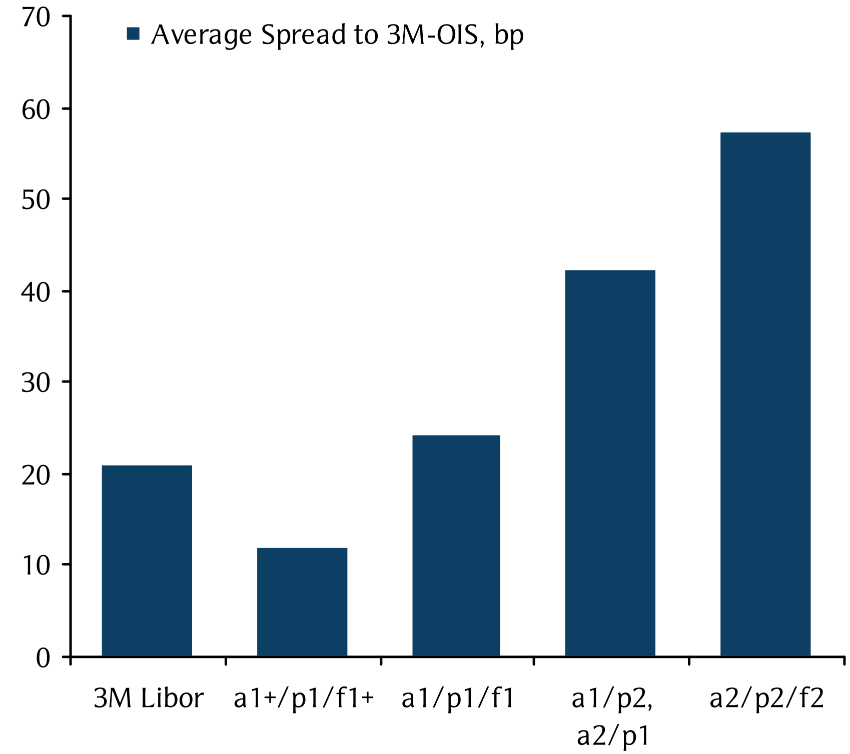
Source: Barclays Capital

Front-end swap spreads: Widening in the Libor-OIS basis

Banking ratings are supported by expectations of sovereign support

S&P		
Entity	Rating (ICR)	Standalone (SACP)
Credit Suisse	A+	A+
JP Morgan	A+	A+
BNP Paribas	AA	AA
Deutsche Bank	A+	A+
Goldman Sachs	A	BBB+
Societe Generale	A+	A+
Morgan Stanley	A	BBB
UBS	A+	A-
Citigroup	A	BBB-
Bank of America	A	BBB
Nomura	BBB+	BBB+
Wells Fargo	AA-	AA-
HSBC	AA-	AA-
Lloyds	A	BBB-
RBS	A	BBB-

Potential widening in Libor-OIS basis in the absence of government support



Source: Barclays Capital, CBO

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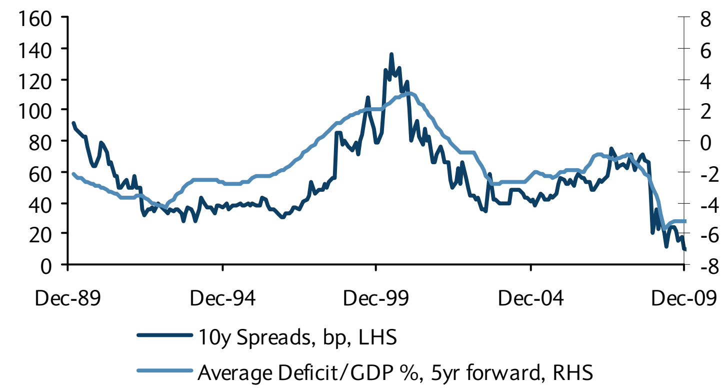
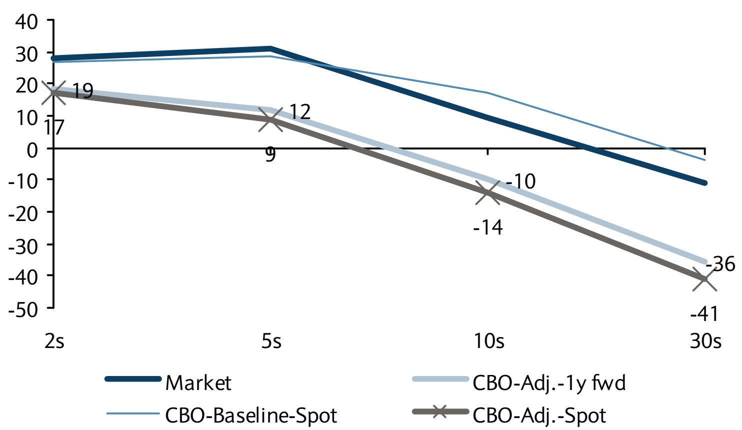
Long-end swap spreads should drift tighter: Treasury supply and related sovereign risk

- Long end spreads could drift further into negative territory as supply of government paper remains high.
- Sovereign risk also argues for tighter long-end spreads as investors question the creditworthiness of long-dated government paper
- Negative long end spreads would force Libor issuers in the front end of the curve.

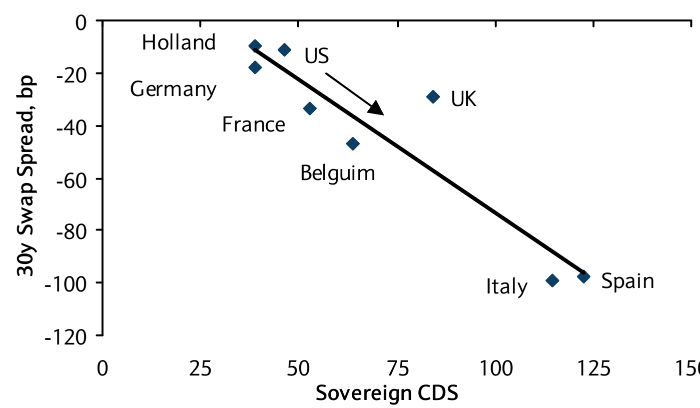
Embedded Treasury supply expectations



Treasury supply modestly priced



Long-end spreads and sovereign CDS



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Source: Barclays Capital, CBO

Reg AC and Important Disclosures

Analyst Certification(s)

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