Structural Drop in Treasury Demand: Any Buyers Out There?
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As the Fed continues gradually to normalise its interest rate policy, there is increasing discussion about when it will announce plans to reduce the size of its balance sheet by trimming its holdings of Treasury bonds. Gavyn Davies considered the possible consequences in a recently released note. Here we review major long-term trends in the ownership of Treasury securities and the part these have played in the determination of bond yields.

One major trend starting in the previous decade was the significant purchases of Treasuries by foreign official buyers. But foreigners became net sellers of Treasuries in 2016 for the first time in about twenty years. Another major trend has been the open market purchases of Treasury bonds by the Federal Reserve (Fed) since 2008. As the Fed’s holdings decline, two major sources of structural demand for Treasuries will have started to reverse. All else equal, this is likely to reinforce the upturn in bond yields as the Fed continues to hike short-term rates.

Trends in Treasury Ownership

There have been three major changes in the ownership of Treasury bonds over the past several decades. First, direct ownership by households and banks has declined significantly. In the early 1950s, households and banks together accounted for about 60% of ownership. This share has declined to less than 15% today.

Second, foreign ownership of Treasury securities increased significantly during the decade after the Asian financial crisis. The latest financial accounts data show that foreigners became net sellers last year for the first time in almost twenty years.

Third, the Fed significantly increased its holdings of Treasury bonds through its programme of Large-Scale Asset Purchases or “Quantitative Easing” (QE) initiated in December 2008 in response to the financial crisis.

Foreigners Shift from Net Buyers to Net Sellers

The surge in foreign purchases of Treasury bonds took ownership by the Rest of the World from about 25% of the outstanding stock in 1996 to a peak of almost 45% in 2014. This figure by itself is not unusual. Foreign ownership of government bonds is commonly of this scale or higher in other countries. The unusual feature of this period, however, was the significant role played by foreign central banks, and the regional concentration.

In one regard, it is not surprising that foreign official holdings of US Treasury bonds should play a dominant role. After all, the dollar is the world’s preeminent reserve currency (accounting for 65% at end-2016) and the Treasury bond market is the world’s deepest and most liquid market within the universe of risk-free assets.

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But the surge in global foreign exchange reserve holdings following the Asian crisis was unprecedented. This pattern was repeated in the years following the global financial crisis.

The Asian financial crisis in the late 1990s was characterized by devaluations of several currencies by 50-70% versus the dollar. Subsequently, as the dollar fell following the US recession in 2001, Asian central banks intervened heavily to prevent appreciation of their currencies. The aims were firstly to preserve the gains in competitiveness and secondly to rebuild a “war chest” of reserves to offer some protection against any repeat of the speculative attacks against Asian currencies.

Famously, foreign purchases of Treasuries featured in discussions of what Chairman Greenspan called the bond “conundrum” when the yields of long maturity bonds fell while short rates were being increased, by 200bp, by the Fed over 2004 to 2005. The role played by Asian central bank buying was considered in numerous papers. In broad terms, the finding was that foreign purchases had reduced yields by about 80bp below where they would otherwise have been.

The latest national financial accounts show that foreigners were net sellers of Treasury securities in 2016 for the first time in almost twenty years.

This is mirrored in holdings of foreign exchange reserves. China’s reserves (about 30% of the world total reported by the IMF), for example, peaked at $4trn in 2014 and have fallen by about $1trn since then.

Fed’s Quantitative Easing (QE) Programme

The Fed’s QE purchases marked the third major structural change in holdings of Treasury securities. The programme, which started in December 2008, took various forms over subsequent years, including the outright purchase of bonds issued by Government Sponsored Enterprises (GSE), including Fannie Mae and Freddie Mac, Agency-guaranteed Mortgage Backed Securities (MBS) and Treasury bonds.

In December 2013, the Fed announced that it would “taper” purchases and buying concluded in October 2014. Since then, the Fed continues to rollover maturing Treasury bonds and reinvests principal payments from its holdings of Agency debt and MBS. Between end-2008 and end-2016 the Fed’s holdings of Treasury bonds increased five-fold from $475bn at end-2008 to $2,465bn at end-2016 and the share of Treasury debt outstanding held by the monetary authority more than doubled from about 6% to more than 15%.

The stated aim of the programme was to reduce long-term rates and make financial conditions more accommodative. Various studies to investigate the impact of QE on long-term bond yields have subsequently been published. Summarising, the estimates obtained indicated that QE has reduced 10-year yields by upwards of 100bp relative to what otherwise would have been the case.

Given the significant impact of QE, it is not surprising that market participants have been sensitive to any likely change in policy stance. Hence, the huge increase in bond yields when former Fed Chairman Bernanke indicated in May 2013 that “tapering” was under consideration, although the Fed did not actually start trimming its purchases until December 2013.

In September 2014, the Fed set out the expected path for normalising monetary policy, including reducing the size of its balance sheet, and this was broadly reaffirmed in March 2015. The first step was anticipated to be an increase in the target range for the Fed funds rate. The Federal Open Market Committee (FOMC) then anticipated phasing out any reinvestments when economic conditions are judged to be appropriate. Ultimately, the Fed clarified that it will “hold no more securities than necessary to implement monetary policy efficiently and effectively, and that it will hold primarily Treasury securities”.

The first step in the process of interest rate normalisation was the decision to increase the target range for Fed funds by 25bp to 25-50bp in December 2015. Two further hikes of 25bp each have been implemented since then. Following the most recent meeting on the 3rd of May, the FOMC directed the System Open Market Desk to continue rolling over maturing Treasury securities at auction and to continue reinvesting principal payments on all agency debt and agency mortgage-backed securities.

The Fed anticipates maintaining this stance until “normalisation” of the Fed funds rate is “well under
Nonetheless, several market commentators have recently started to speculate as to whether action could be signalled before the end of this year and whether holdings of Treasury bonds might be considerably reduced. Surveys indicate that an announcement is expected later this year or in the first half of next year.

**Strategy Conclusions**

We can identify at least three major structural changes in the ownership of Treasury bonds over the past several decades. Two of these, foreign central bank ownership and the Fed’s QE, have played a significant role in suppressing yields in recent years but have now been reduced and may be reversed. The only partial offset in structural demand might be increased holdings by banks under the more conservative balance sheet management rules of Basel 3.

If economic conditions evolve in a manner consistent with the Fed’s expectations, then its own guidance suggests the time is approaching for normalisation of its balance sheet, presumably involving lower holdings of Treasuries. The bond market will need to incorporate both expectations of higher interest rates and some reversal of structural demand for Treasury bonds. All else equal, this skews the risk for bond yields to the upward side of what is currently priced into the forwards. This risk would be accentuated by any shift towards an expansionary fiscal policy and higher bond issuance.
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