Changing demand is key to outlook for yields

Demand for US Treasuries will be lower going forward than it has been in recent years, and this will continue to drive yields higher. However, the market dynamics of the past couple of days suggest the future move higher will continue to be very gradual.

A forceful dynamic

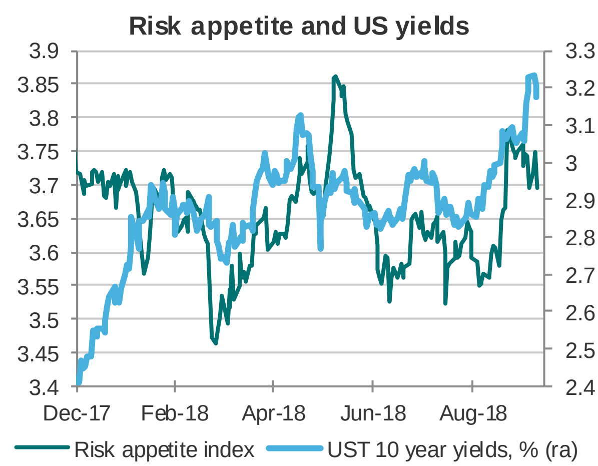
The sell-off across global equity markets today and yesterday was triggered by concerns over higher yields in the US, as the yield on 10-year US treasury notes rose above 3.2% last week, reaching the highest level since 2011. The equity sell-off has been driven by tech stocks in the US, which gives a good illustration of why higher yields are a concern to investors. As Treasury yields rise, it makes safer investments comparatively more attractive, and makes it harder to justify the high pricing in some pockets of the global equity market, like US tech stocks. As risk appetite takes a dive due to rising yields, however, it triggers flight to the safety of US Treasuries, which thus pressures yields lower again. This dynamic has proven forceful so far this year, as time and again when yields have been on a steady upward path, something has happened that has triggered flight to safety, and prevented yields from rising further. While we believe yields in the US will continue to rise going forward, this dynamic will limit how much and how fast yields will rise. Our forecast is for 10 year US swap rates to reach 3.75% in 12 months, but if anything, we think the risk to this outlook is slightly skewed to the downside.

The recent rise in yields not only driven by economic data and the Fed

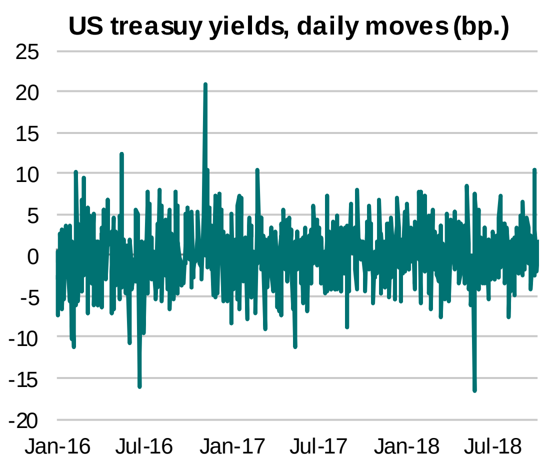
First of all, the jump in yields last week must be put in some context. The move was triggered by better than expected economic data and an upbeat assessment of the US economy by Fed Chair Powell. In combination, this led investors to expect the Federal Reserve (Fed) to raise rates a little bit more and a little bit faster than previously thought. As a result, the 10-year real yield rose above 1% for the first time since 2011. While there is little doubt the sell-off in Treasuries was triggered by this, a daily rise of 11 basispoints in 10 year yields, as seen last Wednesday, has been rare in the past few years. It has not happened since November 9th 2016, the day after Donald Trump's victory in the US presidential election. It is not as rare, however, that economic data surprises to the upside or that Fed speak is hawkish. As such, we believe there is a different factor at play, besides changes in growth- and interest rate expectations, which can help to explain the sizeable move in yields.

While the outlook for short term rates is the most important driver of long term yields, other factors also play a part. These factors are captured in what is usually referred to as the term premium: the difference between the yields on long-term notes and the expected return from rolling over short term notes. Usually, the term premium is positive, as longer term investments are seen as riskier than shorter-term investments, all else being equal. Currently, however, the term premium is negative, but it has risen over recent weeks, and the forces behind this move could thus help to explain the recent jump in yields.

Lower risk appetite pushes yields lower



Large daily moves in US 10 year yields are rare



Source: Thomson Reuters Datastream/DNB Markets

Less QE by central banks means less demand for treasuries

Several factors have been put forward to explain why the term premium has been so low in recent years. They all involve some form of structural demand for Treasuries. The most important has been the asset purchases by global central banks, or so-called quantitative easing. This has contributed to artificially strong demand for Treasuries, and thus a lower term premium. The Fed ended its asset purchase program in 2014, however, and has thus not contributed directly to the demand for Treasuries since then. Other central banks, on the other hand, most notably the ECB and BoJ, have been running asset purchase programs of their own in this period. Indirectly, this has probably contributed to the demand for US Treasuries by foreign investors. Indeed, foreign investors have been the biggest buyers of US Treasuries during the past 10 years. So quantitative easing, not just by the Fed, but by central banks in other parts of the world, has helped keep the demand for treasuries strong, and the term premium low.

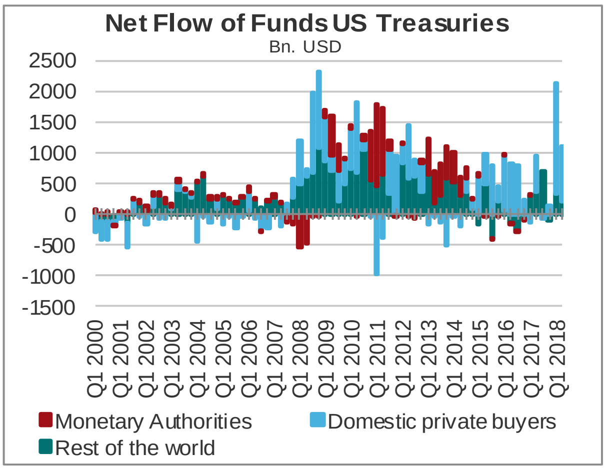
In 2017, however, the combined balance sheets of the Fed, the ECB and the BoJ started to decline. What's more, data from the Fed show that net purchases of US Treasuries by foreign investors have decreased substantially during the past few years. During the first two quarters of 2018, foreign net purchases have averaged at USD 268 bn., down from USD 307 bn. in 2017. Despite this, and the declining demand from central banks, the term premium has continued to decline through 2017, and has remained depressed in 2018.

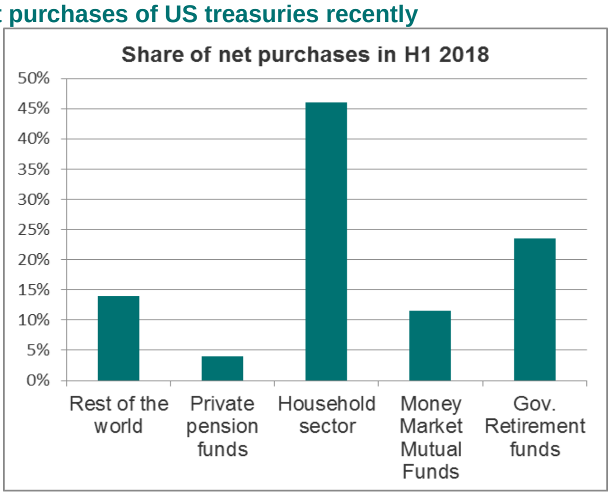
A different kind of investor has soaked up the supply of Treasuries so far in 2018

Data from the Federal Reserve shows that there is a third investor group that has contributed to the strong demand for Treasuries through 2018, namely the US households. The name of the investor group is slightly misleading though, as "households" in the Fed's statistics merely refers to private purchases through funds and investment vehicles not in an investment group of its own. These are, among others, hedge funds, private equity funds and private trusts. So far in 2018, the household sector has bought nearly half of the total net issuance of US Treasuries. The historical pattern of purchases from this group shows that this demand is highly volatile, however. After purchasing large amounts for two consecutive quarters, history suggests that demand from this group of investors will be far smaller in the second half of 2018.

The second largest buyer of US Treasuries so far in 2018 has been the government pension funds, contributing to 23% of total net purchases in the first half of the year. Adding the private pension funds, this investor group contributed to 27% of total net purchases in the first half of the year. While pension funds' purchases of Treasuries are usually more stable than that of other investor groups, it is highly unlikely that their demand will remain as strong as it was through the first three quarters of the year. The reason for this is the grace period that allowed US corporates to deduct pension costs at the old tax rate, of 35%, not the new one, of 21%, until 15 September. This has boosted the demand for Treasuries by pension funds, but suggests that demand will be much lower going forward.

Domestic investors have increased their share of net purchases of US treasuries recently





Source: Thomson Reuters Datastream/DNB Markets

Conclusion: despite less demand from some, the demand for safety will prevent yields from rising fast

To sum up, strong demand from domestic US investors has kept total demand for treasuries high through 2018, despite lower demand from central banks and foreign investors. As some investors buy less, other will buy more, so this development is to be expected. What is less clear, however, is that these domestic investors will be willing to pay a price low enough to continue to depress the term premium. So far this year they have, but this can partly be explained by temporary factors. As these factors are no longer in play, some of the demand for Treasuries has disappeared. Against this backdrop, the jump in yields last week makes more sense.

What's more, it suggests that the rise in long-term yields is not mainly driven by expectations for higher short-term rates, but by a normalization of the depressed term premium. A further normalization of the term premium, as some of the strong demand for Treasuries abates, is one of the main reasons we expect long term yields to continue to rise going forward. However, the move down in yields in the past two days, from a high of 3.26% on Tuesday to a low of 3.16% today, shows that there is a different source of demand out there: the demand for safety, which will prevent the term premium from rising too much. As a result, we expect yields to continue to move higher, but that the rate of increase will remain gradual.

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