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BOND MARKET JITTERS

Bond investors have enjoyed a three-decade long bull run in bonds. There are growing worries that the market is due for a correction. Last month's spike in bond yields (triggered by inflation and unanticipated rate hike fears) was an indication of market jitters. While recent data should appease the inflation worrywarts, others argue the end of quantitative easing and the impending additional supply of US Treasuries (to fund US' higher spending needs) could signal the start of a bond bear market.

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To be clear, budget deficits are a norm in the US and as such not a new cause for alarm. Rising deficits, however, are an issue as the concern revolves around the sustainability of a debt-funded deficit. The US budget deficit is set to worsen as spending limits have been raised further in the recent passing of the budget (see fig.1).[1] In the fiscal

Fig.1: US government balance/GDP and total public debt/GDP

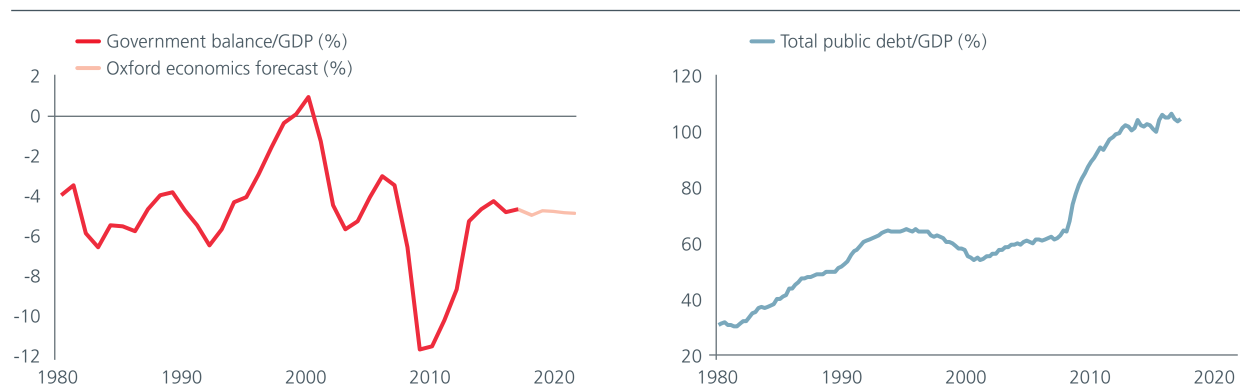
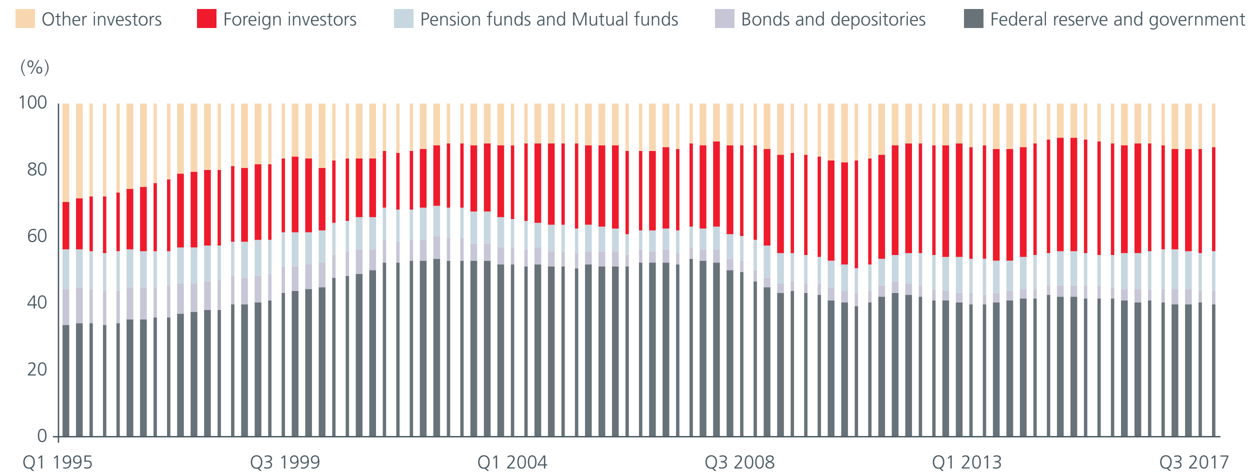


Fig.2: Ownership of US Treasury securities



year 2017, the deficit amounted to USD666 billion. This number is expected to rise to USD833 billion in 2018 and USD985 billion in 2019. To fund this, the net issuance of public debt is expected to increase dramatically. The latest issuance of the US Treasuries worth USD258 billion is unprecedented in size and could just be a preamble of what is to follow.[2]

ARE THESE CONCERNS JUSTIFIED?

On first glance, it appears so. Demand for US treasuries has mainly come from foreigners who form the second largest creditors of the United States after the US government and the US Federal Reserve (see fig.2). Their holdings increased from 24.8% in Q1 2007 to 31.1% in Q2 2017. Fears that fading demand for US Treasury bills from this group of investors could lead to rising yields are growing; the rational being that bond yields will have to rise to make it make it attractive enough for these investors to bear the risk, possibly triggering a bond rout.

While the argument sounds logical, does it hold much merit? A similar rhetoric was touted post the 2008 Global Financial Crisis when the US administration bumped up the spending amount and the deficit figures spiked to USD1.4 trillion in fiscal year 2009. Yet there was no doomsday scenario for bonds. What then followed was a long period of decline in yields (see fig.3).

Fig.3: Is the long decline is US yields over?

COULD IT BE DIFFERENT THIS TIME?

These fears have intensified as the US Fed has begun paring back its asset holdings from October last year. The shrinking of the Fed's balance sheet will lead to an even greater supply of bonds, thereby depressing yields.

In our view, two relationships need to be analysed for the above scenario to hold water. First, examine the relationship between treasury flows and yields, and if indeed it exists, a further analysis of the relationship between flows and debt levels is required.

We tested changes in quarterly multiple flows data for both the net foreign purchases of the treasury bills and the net foreign purchases of notes and bonds against the respective quarterly changes in the yields across the yield curve. The data shows some relationship exists in that net foreign purchases of treasury bills decline as the yields increase (see fig.4). This observation also holds true for the 3-month, 2-year and 10-year yields. Interestingly, the net foreign purchases of notes and bonds have no observable relationship to yields.

Given some observable relationship between the net foreign purchase of treasury bills and yields, we went on to test if these flows decline and turn negative when the public debt/GDP ratio in the US is high. The evidence seems to suggest that no such relationship holds (see fig.5).

PAST EVIDENCE SUGGESTS NOT

Concerns that foreign demand for US paper will decline as the level of debt rises seem unfounded. Rather than speculate on such technicals, we prefer to look at a wide range of indicators. Our fundamental indicators signal that growth is still strong which forms the basis for our overweight stance on equities over bonds.

Fig.4: Q1 net foreign bill purchases vs Q1 actual change in US Treasury 30-year yields (since Q1 1994)

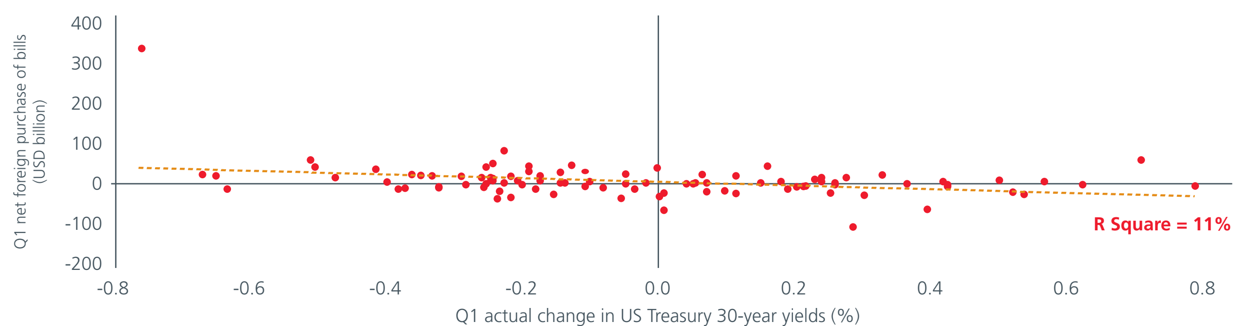
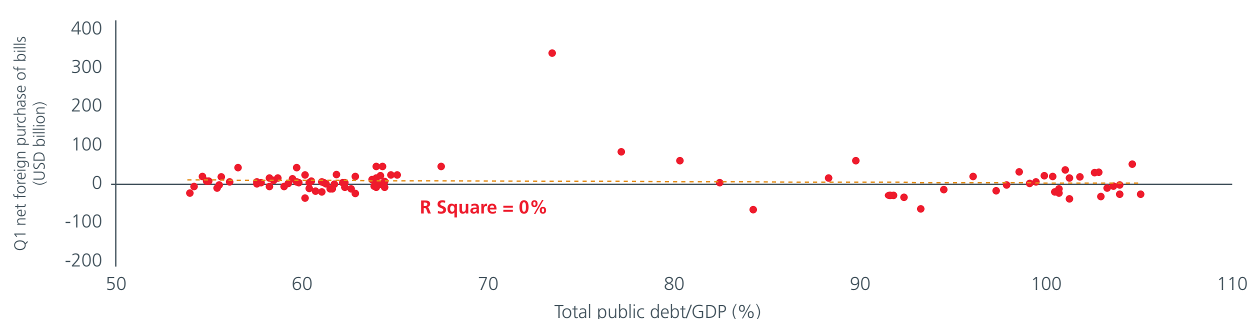


Fig.5: Q1 net foreign bill purchases vs total public debt/GDP (since Q1 1994)



Sources: [1]The New York Times – Trump Signs Budget Deal to Raise Spending and Reopen Government, as at 8 February 2018. [2]Bloomberg L.P. – Treasury $258 Billion Bond Auction Is Hogging All the Attention. Fig.1. Thomson Reuters Datastream, as at 22 March 2018. Fig.2. Thomson Reuters Datastream, as at 22 March 2018. Fig.3. Thomson Reuters Datastream, as at 22 March 2018. Fig.4. Thomson Reuters Datastream, as at 22 March 2018. Fig.5. Thomson Reuters Datastream, as at 22 March 2018.

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