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Research Briefing | US

Tight Treasury ranges can't last forever

Analyst

John Canavan

Lead Analyst

+1(646) 668-5797

- **Despite bearish seasonal factors, Treasury yields remain pinned within the narrow ranges that have held since July. The market has been supported by rising foreign demand, safe-haven flows, the risk of temporarily lower Treasury issuance due to the debt ceiling, and curve flattening activity as a more hawkish Fed pulls forward rate hike projections and weighs on inflation expectations.**
- **We believe the balance of risks favors a moderate increase in long-end yields later this year. Real yields will lead the increase as inflation expectations remain subdued, and Fed asset purchase tapering will have a larger impact on the more illiquid TIPS market.**

Treasury yields remain steady so far this month despite bearish seasonal factors and supply pressures from large Treasury issuance and huge post-Labor Day corporate issuance that would typically push rates higher. Instead, a jump in foreign demand, lowered expectations for economic growth, equity volatility, debt ceiling concerns, and a more hawkish Fed have kept key technical support levels intact. That has left Treasuries within the narrow ranges that have held since July.

The 1.38% level on the 10-year yield has held four times since mid-July (**Figure 1**). That level represents a technically significant 38% retracement of the March through July rally. The next significant support above there is the 1.43%/1.45% area. The 1.43% area was resistance in June and held as support in July, while 1.45% is the 50% retrace of the rally since March.

The strongest near-term resistance for the 10-year note crops up at 1.26%, which is the September 3 and September 14/15 low yield. The 1.215% low yield from August 17 is the next level, ahead of the stronger 1.13% double-bottom from July 20 and August 4.

Figure 1: Treasury yields struggle to break free from the summer ranges

Treasury yields have been mired in narrowing ranges since July. Foreign demand, and a modest shift away from risk has kept the 10-year yield from penetrating the high-end of its range so far this month.

Contact: John Canavan | jcanavan@oxfordeconomics.com

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Foreign demand leads the way

Increased foreign demand has been a big factor behind the Treasury markets' resiliency. Foreign investors purchased a record $70.4bn of the August Treasury coupon auctions (**Figure 2**). Foreign demand remained strong for the 3-, 10-, 20-, and 30-year Treasury auctions so far this month, including a record $17.2bn foreign allotment for this month's 30-year bond auction.

Signs of foreign demand have been reinforced by the large increase in weekly Japanese purchases of foreign bonds. Japanese investors bought ¥2.8 trillion worth of foreign bonds during the two weeks ended September 10. That's the largest two-week purchase since November 20, 2020 (**Figure 3**).

Currency-hedged Treasury yields are offering foreign investors a significant improvement on domestic yields, which provides at least a partial explanation for the rise in foreign interest (**Figure 4**).

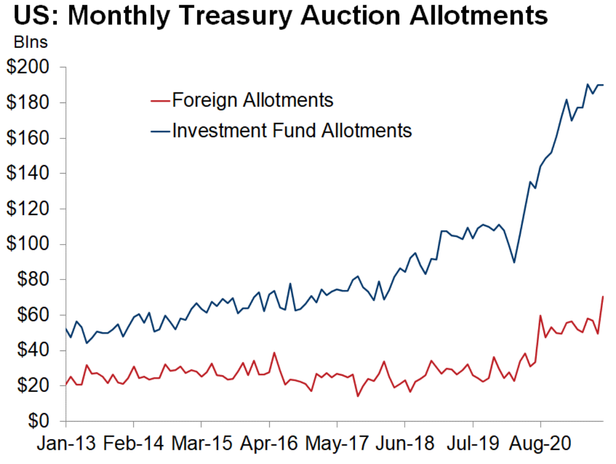
Economic risks also contributing to demand

A near-term cooling US economy, constrained by the Delta wave, lingering supply chain issues, and labor supply constraints, has added to the improved tone for Treasuries. Growth concerns and the recent Evergrande risks for China pulled the S&P 500 Index as much as 5.3% lower on an intra-day basis this month, generating safe-haven support for Treasuries before stocks steadied.

Debt ceiling risks could provide additional near-term support. Treasury will need to make a large trust fund investment on October 1 that could exhaust their special measures. Treasury could be forced to cut the size of the October 3-year, 10-year and 30-year auctions to remain under the debt ceiling as a result.

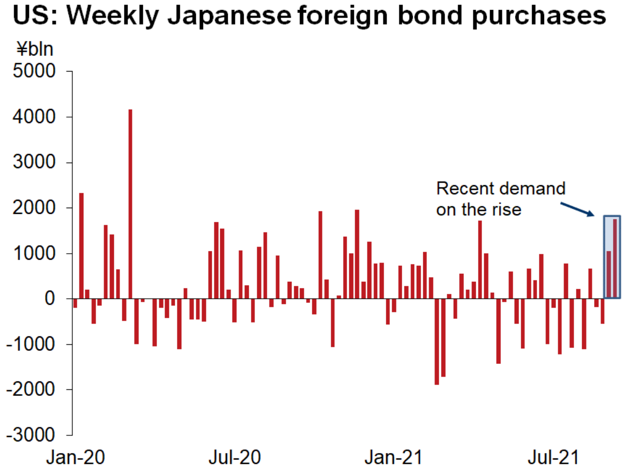
The most recent Federal Reserve decision reinforced support at the high-end of the month's-long Treasury yield ranges. The median forecast in the Fed's Summary of Economic Projections pulled forward the first projected rate hike to 2022 from 2023 and increased projections for rate hikes in 2023. While that spurred selling out through the 5-year note, the long-end was supported by curve flattening flows as a more hawkish Fed will help keep inflation contained.

Figure 2: Foreign demand steps up as investment fund demand steadies



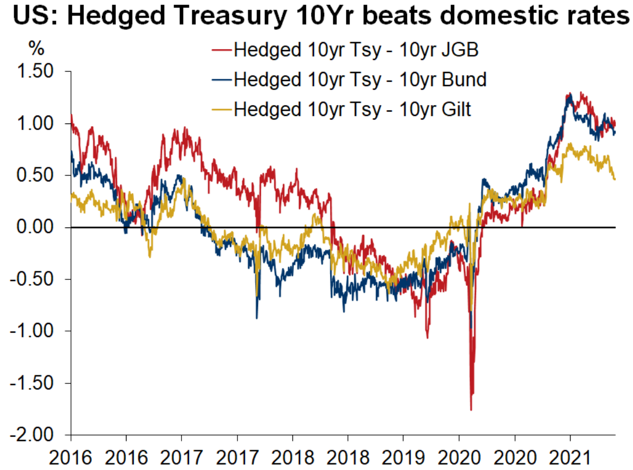
Source : Oxford Economics

Figure 3: Japanese appetite for foreign bonds grows through early September



Source : Oxford Economics/Bloomberg

Figure 4: Currency hedged Treasury rates offer a premium this year, although it's shrinking



Source : Oxford Economics/Bloomberg

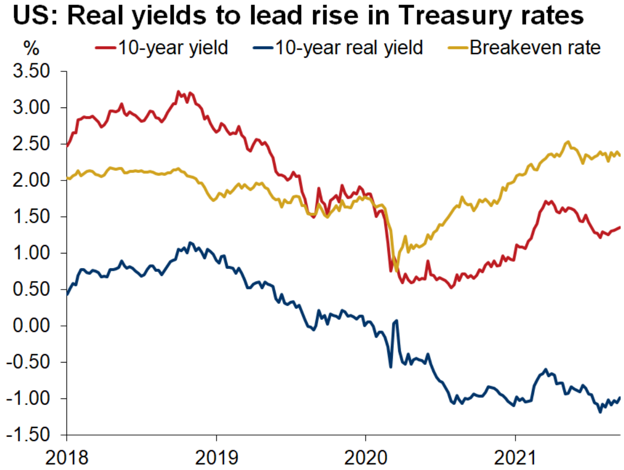
Real yields will lead nominal yields slightly higher as Fed tapers asset purchases

Longer-term, however, we believe the balance of risks favors a somewhat higher 10-year yield through year-end. Support from the currency hedged Treasury yield differential is fading, which could limit additional foreign demand (**Figure 4**). And we expect economic growth will remain robust into 2022, which will alleviate concerns about the slowdown in growth in the third quarter of this year. We foresee the economy growing 5.5% in 2021 and 4.4% in 2022 – double the 2010-2019 pace of growth.

We expect a higher 10-year nominal yield will be led by a rise in the 10-year real yield. Market measures of inflation expectations have ebbed since mid-May, and we do not anticipate a significant rise in break-even inflation rates (**Figure 5**). With aggregate economic demand cooling and supply of products and labor gradually rebounding, we expect inflation will gradually subside in the coming quarters, with core PCE inflation still running around 3% into early 2022.

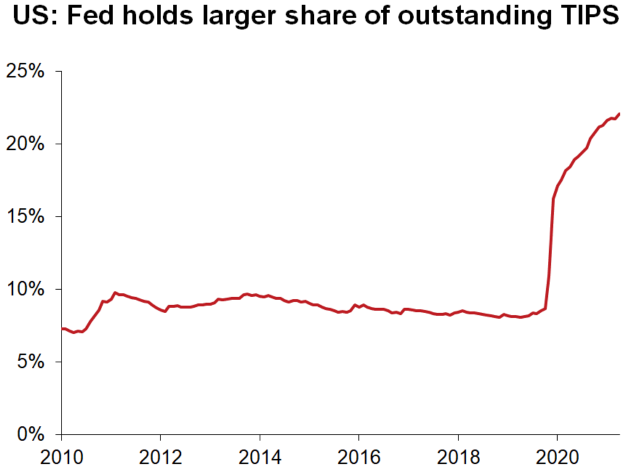
The 10-year real yield has risen back above -1.00% since reaching early August's -1.20% low, and the Fed's asset purchase tapering could add fuel to that increase into next year. The Fed's ownership share of marketable TIPS has increased from below 9% in February 2020 to more than 22% currently. Given the illiquidity of TIPS trading, the strength of Fed demand appears to have had an outsized impact on depressing real yields. As the Fed winds down asset purchases, the shrinking TIPS purchases should have a larger impact in lifting real yields.

Figure 5: The rise in the 10-year real yield from a record low to continue as Fed tapers purchases



Source : Oxford Economics/Bloomberg

Figure 6: The growth in the Fed share of TIPS has an outsized impact in a less liquid market



Source : Oxford Economics/Treasury/Federal Reserve