

iFlow

SHORT THOUGHTS

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Term Premium Keeps Rising, Pushing Yields Higher

Bond Yields and Term Premia Now Closely Linked

A few weeks ago, we wrote about supply and demand dynamics in the bond market (see [here](#)) and argued that significant increases in coupon supply since the middle of this year has been one of the prime drivers of the current yield surge. Furthermore, we argued that there was a dearth of buyers in the market at a time when issuances has increased by several hundreds of billions of dollars since the beginning of July. In this piece, we link this supply and demand imbalance to changes in yields, primarily through the upward movement in the US Treasury term premium.

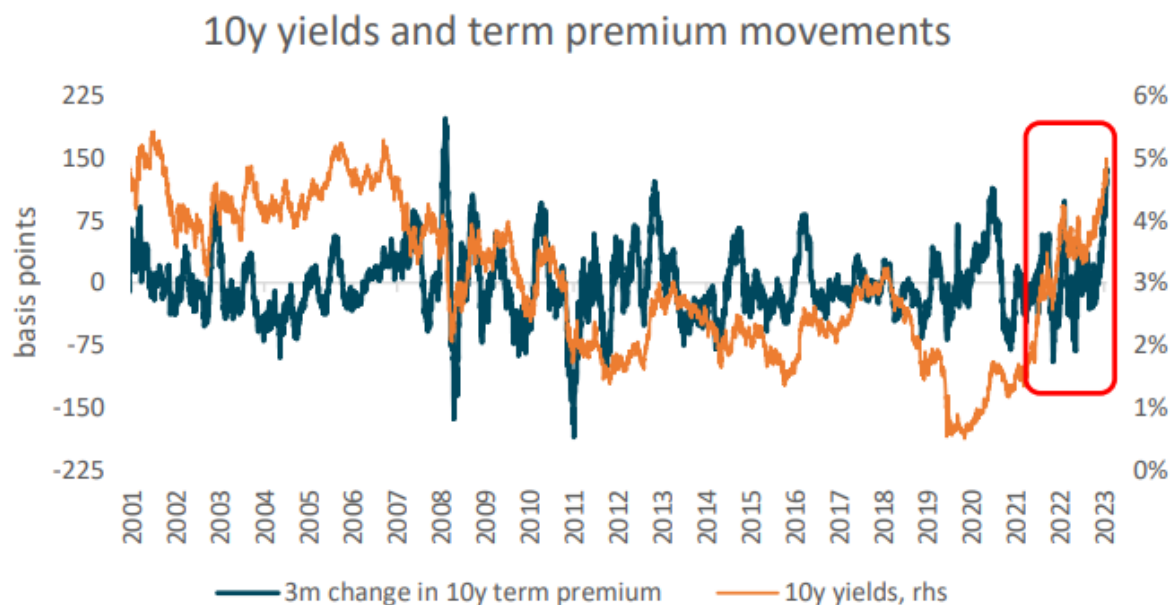
The 10y Treasury term premium reflects the additional interest (or premium) that investors require for lending at a 10-year horizon. The term premium cannot be observed, but instead must be estimated. One of the most popular estimates is derived and furnished by the New York Federal Reserve, in the form of its ACM model – so named for the first initials of the authors' surnames (see [here](#)). They use a term structure model of the yield curve, which calculated daily, going back to 1961.

Generally, considering the 10-year time frame during which investors will have their principal locked up, the term premium should, all else equal, be positive. Lenders to the government typically require an incentive to wait 10 years to get their investment back – plus interest. In recent years, for the few years before and then since the pandemic, the ACM term premium estimate has actually been negative. We attribute this to the enormous quantity of USTs purchased by the Fed during successive rounds of quantitative easing, which put downward pressure on the supply and the perceived riskiness of 10y notes.

Over the last three months, UST coupon issuance is up nearly 10% and the term premium – not coincidentally in our opinion – has risen from a low of -95bp in mid-July to +47bp through Thursday of last week, the last day for which we have data. That 142bp increase nearly mirrors the 120bp rise in 10y yields over the same period. It’s not axiomatic that a move in the term premium should result in a similar (in both magnitude and direction) yield move for 10y notes.

The chart below shows the relationship, or lack thereof, between the term premium and the bond yield. We plot the 3-month change in the ACM 10y term premium and Treasury yields going back to 2001. Very often – indeed much of the time – there has been a significant or persistent relationship between the two. In fact, there have been periods when the behavior of the two series have contradicted one another – for example, during the years before the GFC. However, since mid-2022, movements have been closely aligned.

Term Premium and Yields Now Linked



Source: BNY Mellon, Bloomberg, Federal Reserve Bank of New York

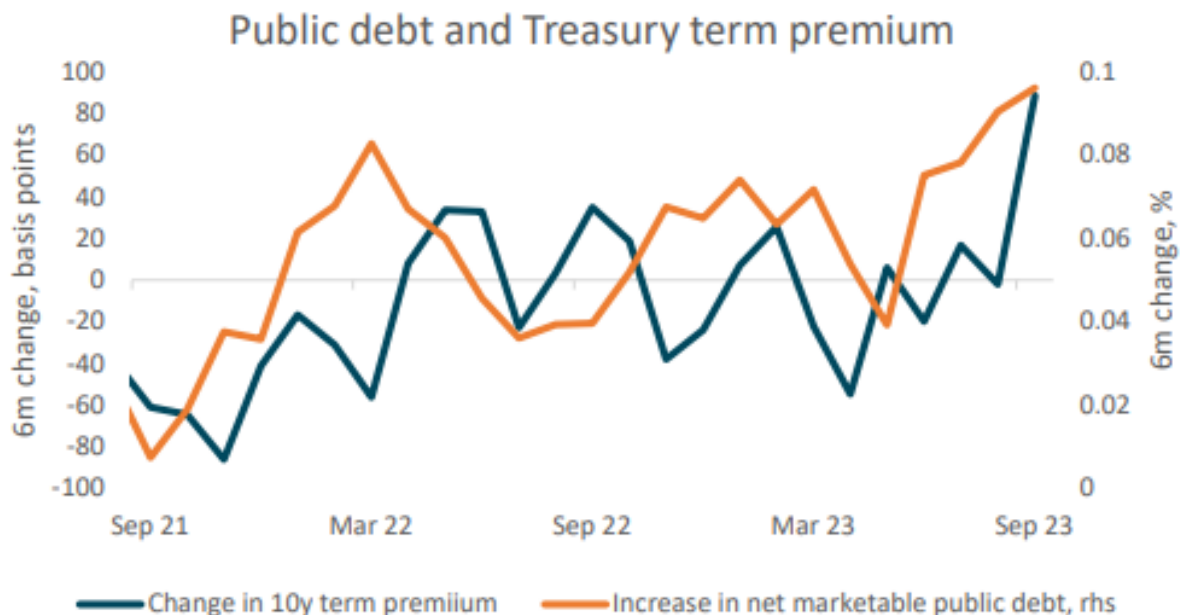
Coupon Supply and Term Premia

Having established the current close relationship between term premium and bond yield movements, let’s discuss coupon supply, which has been increasing of late, and which is unlikely to relent going into next year. The term premium has adjusted higher to reflect such pops in supply. In essence, the recent additional supply has been too big for the market to absorb at current prices, requiring higher term premia (hence lower bond prices and higher bond yields) to clear the market.

In the chart below, we plot the three-month change in coupon issuance versus the three-month change in the ACM term premium estimate. Note the close correspondence between the two. The quick increase in the term premium since this summer tracks the 9.6% increase in supply since the end of May. Similar behavior was observed between September 2021 and March 2022. Given current fiscal policy in the US, we expect this relationship to stay steady and positive.

To this end, the quarterly refunding announcement due from the US Treasury on November 1 will be an important event. We expect total issuance from Treasury (i.e., both bills and coupons) to easily exceed \$1trillion. The split between bills and coupons could be close to 50-50, meaning well over \$500bn in coupons. We remind readers that this is the same day that the next FOMC meeting is scheduled. It could be a seminal day in fixed income markets next week.

Supply Increases Driving Term Premium Higher



Source: BNY Mellon Markets, SIFMA, Federal Reserve Bank of New York

Real Money: Wrong and Long

Turning to demand dynamics, we do note a shift in our iFlow data as they relate to the Treasuries trade. iFlow tracks (primarily) real, long-only investor behavior daily. The fact that iFlow data generally exclude hedge funds, central banks, and corporate investor flows is beneficial, in that we see a largely homogeneous investor set. What we observe in the data's behavior year-to-date relative to bond yields is striking.

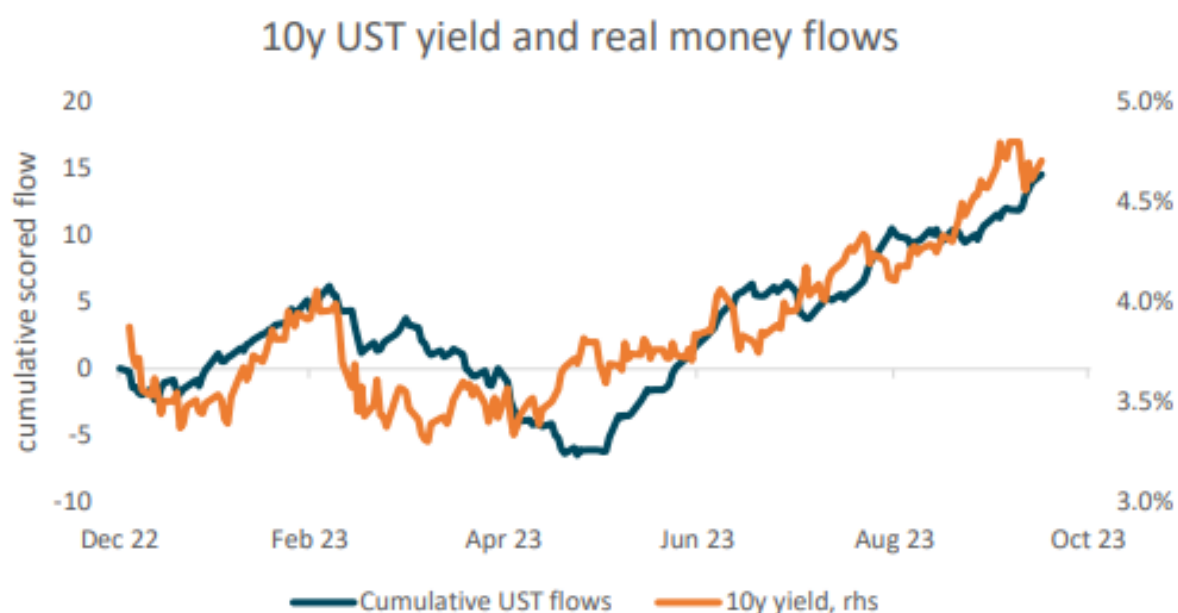
The chart below illustrates the cumulative flow into all US sovereign bonds from our investor base. We merely set December 31, 2022 to zero and accumulate, daily flows into all USTs

across the curve. We see that these flows track yields quite closely. When yields rise, real money starts to buy. This is especially clear from the end of May 2023. After staying neutral – neither buying nor selling – for most of that month, buying has been quite steady ever since the beginning of June, following yields higher.

We presume that higher yields (i.e., lower bond prices) look increasingly attractive as entry points into the market. We have heard anecdotally that such accounts have been seeing key yield levels as potentially good opportunities to step in. Yet such hopes have been inevitably dashed as yields continued to rise, and bond prices fall. There was a brief period between the last week of August and the end of September when this trade took a breather and the market stayed neutral. Yields remained steady between 4.1% and 4.3% during this time, and then took off again. Investors resumed their accumulation of USTs at that point.

Real money, for which we had seen signs of capitulation in September, has reentered the long trade since then. In short, these investors have been long and wrong on this trade, and we wonder at what point, should yields rise further (as we expect they will for reasons discussed above), will long only investors capitulate for good? We don't think we're far from that point at present.

Buying All The Way Up



Source: BNY Mellon Markets, iFlow

Please direct questions or comments to: iFlow@BNYMellon.com

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