October 3, 2023

Econ 101 Lessons & The US Bond Selloff

Banks Slimming Down Along With The Fed

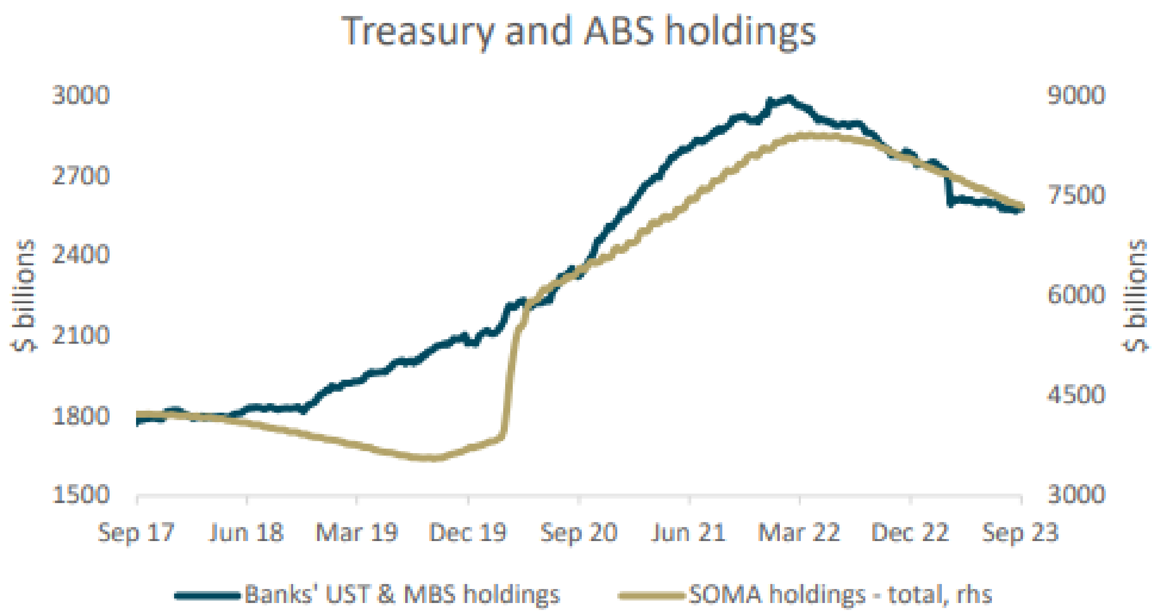
Last week in this space we discussed some of the factors behind rising Treasury yields (see here). Our arguments included a rising term premium and market perception of the long-term neutral policy rate moving higher. We also noted that primary dealers' inventories were lower than they had been pre-pandemic, signaling weakening in one of the channels of demand for Treasuries. There was an iFlow data takeaway as well: real money demand for USTs, which had been persistent while yields rose this summer, was showing signs of having plateaued.

We further develop the argument here by adding a demand and supply imbalance: current and future heavy coupon issuance by the Treasury portends more upward pressure on yields. Our focus this time is a combination of potential real money capitulation on the long duration trade, and commercial banks holding fewer Treasuries. In short, Treasury supply is heavy and demand is waning. As we are taught within the first few weeks of our Economics 101 courses, this is a recipe for falling prices (higher yields).

Let's consider first commercial banks' positioning in Treasury and MBS securities. As the chart below shows, it peaked – not coincidentally – at the same time the Fed's System Open Market Account (SOMA) portfolio of Treasuries and ABS securities did, around May/June 2022. This is a noteworthy contrast to the 2017-2019 period, when SOMA was falling (post-GFC QT episode) but banks were continuing to add to their holdings. This time around, both banks and the Fed are reducing securities holdings apace – and have been doing so for over a year now. Last week we showed that primary dealers' holdings were inching up. However, given the heavy Treasury issuance over the last three months, the accumulation was at a much slower pace than during the pre-pandemic period.

This is ultimately a positive development in terms of financial stability, as it suggests that by reducing Treasury holdings, banks are becoming gradually less exposed to mark-to-market losses on these interest-bearing securities, which of course decline in price as yields rise.

Shedding Holdings



Source: BNY Mellon, Federal Reserve Board of Governors, Federal Reserve Bank of New York

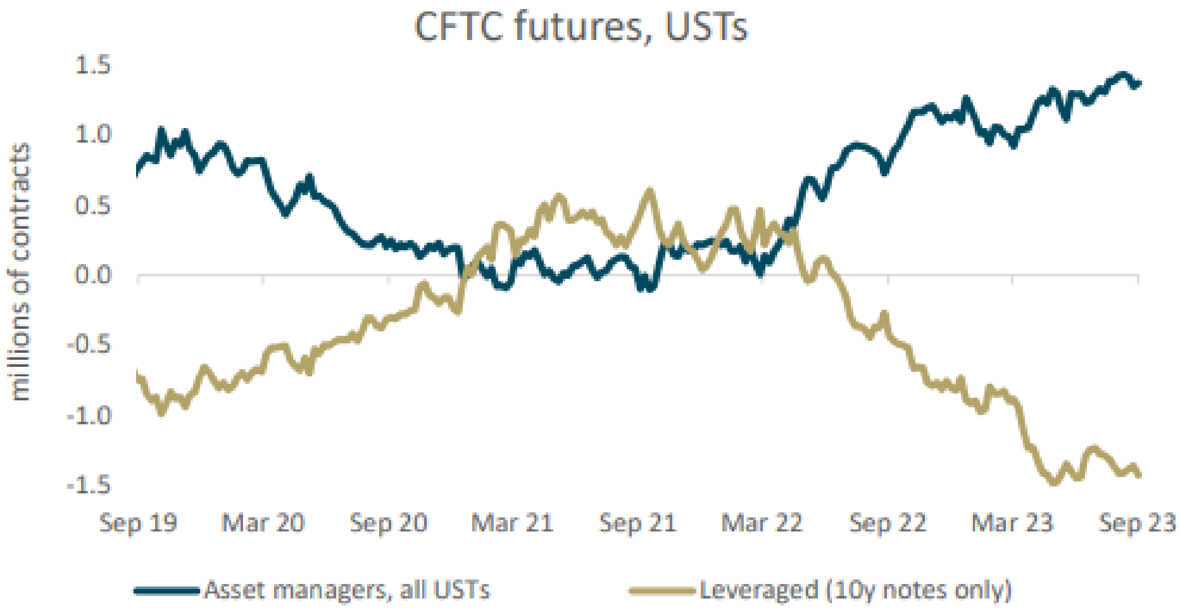
Long Only Goes Long Duration

A few weeks ago, we discussed the mechanics of the basis trade which has been popular of late (see here). This involves a leveraged market participant (hedge funds) holding a long cash position in Treasuries and short futures position, seeking to profit from falling bond prices and rising yields. The trade has been identified as potentially risky. The Federal Reserve Board of Governors, the Bank of International Settlements, and the global Financial Stability Board have all warned about the impact of a sudden deleveraging of this trade.

We examine here the seemingly looking glass-type behavior in the futures market by real money (asset managers, in this case) and leveraged money. The chart below shows long-only money's net futures position in USTs, as reported by the Commodity Futures Trading Commission. We also plot real money's net positioning in futures for 10y UST notes. The two appear to consistently mirror each other. Real money has been getting long Treasuries, while hedge funds have been increasingly shorting via the basis trade.

The difference in directional behavior is eye-opening, and illustrates the asset manager community's steadfast adherence to the long duration trade, even as yields have risen across the curve (and especially in the long end). However, the most recent data for asset managers suggests a plateau. Going long bonds has been a losing strategy all the way up, and capitulation is likely to happen soon, in our view. Meanwhile, the persistent and increasing shorting activity by hedge funds continues. If asset managers start to close these long futures positions, that's yet another important (and large) channel of demand that will be absent from the market, adding more upward pressure on yields.

Mirror Images



Source: BNY Mellon Markets, CFTC, Bloomberg

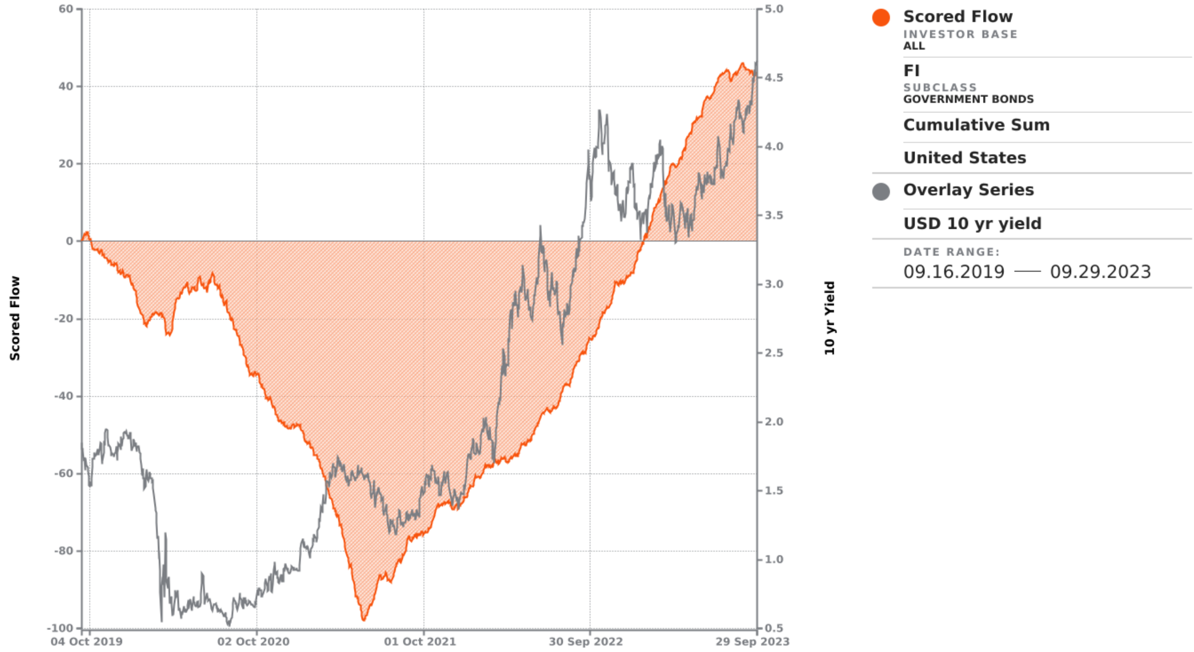
Real Money Really Long USTs

Next we look at our iFlow data, which reports demand for US Government securities from our custodial client base. The chart below shows cumulative UST flows since the end of September 2019, roughly six months before the onset of the pandemic. We see similar behavior in our data, which shows investors starting – and continuing – to buy in the summer of 2021, all the way following rising yields. That is, until very recently when it appears that they have ceased buying and are beginning to slowly reduce positions.

In summary, real money has been wrong-footed on the duration trade for a while, banks have been shedding their holdings, and leveraged money has been shorting the market since the late-summer 2021. The lattermost has been on the right side of the duration trade since then; the real money community hasn't been. If real money capitulates while hedge funds persist in shorting – and with banks out of the equation – we expect yields to grind ever higher. A 5% yield on the 10y note could be within the market's sights before too long.

Riding Duration All The Way Up

FI Scored Flow



Source: BNY Mellon Markets, iFlow

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

John Velis

FX AND MACRO STRATEGIST FOR THE AMERICAS

CONTACT JOHN