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FED, FOREIGN BUYERS RETREAT

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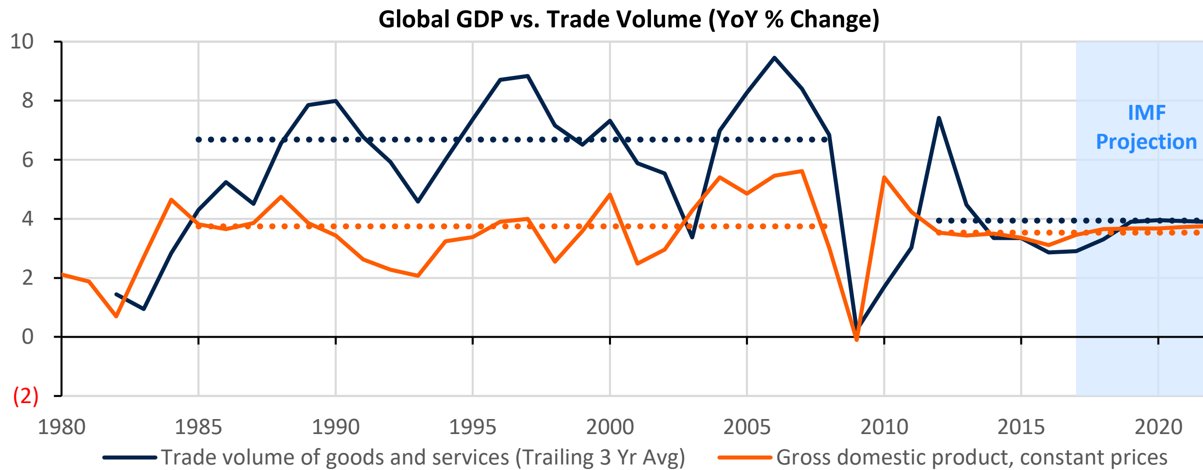
* **Two Largest Buyers of Treasuries Exit Together**
* **Wage Inflation Likely to Exceed Fed's Comfort Zone**
* **Improving Prospects for Rising Rates at Both Ends of the Curve**

Financial services companies will benefit if interest rates continue rising, even more so if a positive-sloping yield curve prevails in the end. The modest move in short rates so far has been helpful, but the slow-drip pace with constant contrary doubts and concerns has left the industry and its investors uncertain. Nonetheless, one of the biggest surprises in first quarter bank earnings was net interest margin expansion well above estimates.

The focus has primarily been on the Fed Funds Policy Rate, but a broader shift in the two largest buyers of Treasuries at auction is brewing. Demand for U.S. government debt is rapidly deteriorating. Both the Federal Reserve and foreign buyers dominated demand in most of the U.S. Treasury auctions following the 2008 recession up until 2015. In combination, they still currently hold over 60% of total marketable U.S. Treasury securities.

The Fed has provided no demand on a net basis in three years while foreign buying has shriveled. Worse is to come as both will likely be in substantial net liquidation later this year. In fact, foreign net liquidation has already begun, averaging $46 billion in monthly outflows during the second half of last year.

There are three reasons foreign buying has been declining. First, the real interest rate differential to U.S. yields has all but evaporated. Exposure to currency risk is no longer adequately covered by a higher yield on Treasuries of equivalent tenor. Second, industrialized countries are no longer amassing other hard currencies in general, as global trade remains in a slump and is no longer forecast to grow faster than fundamental global GDP. Consequently, there is little need for risk-free storage in government markets of the same currency - especially the U.S. dollar. Third, emerging markets still have a domestic market growth edge that requires heavy infrastructure expansion. Such expansion drains hard currency reserves on commodities, equipment and materials spending.



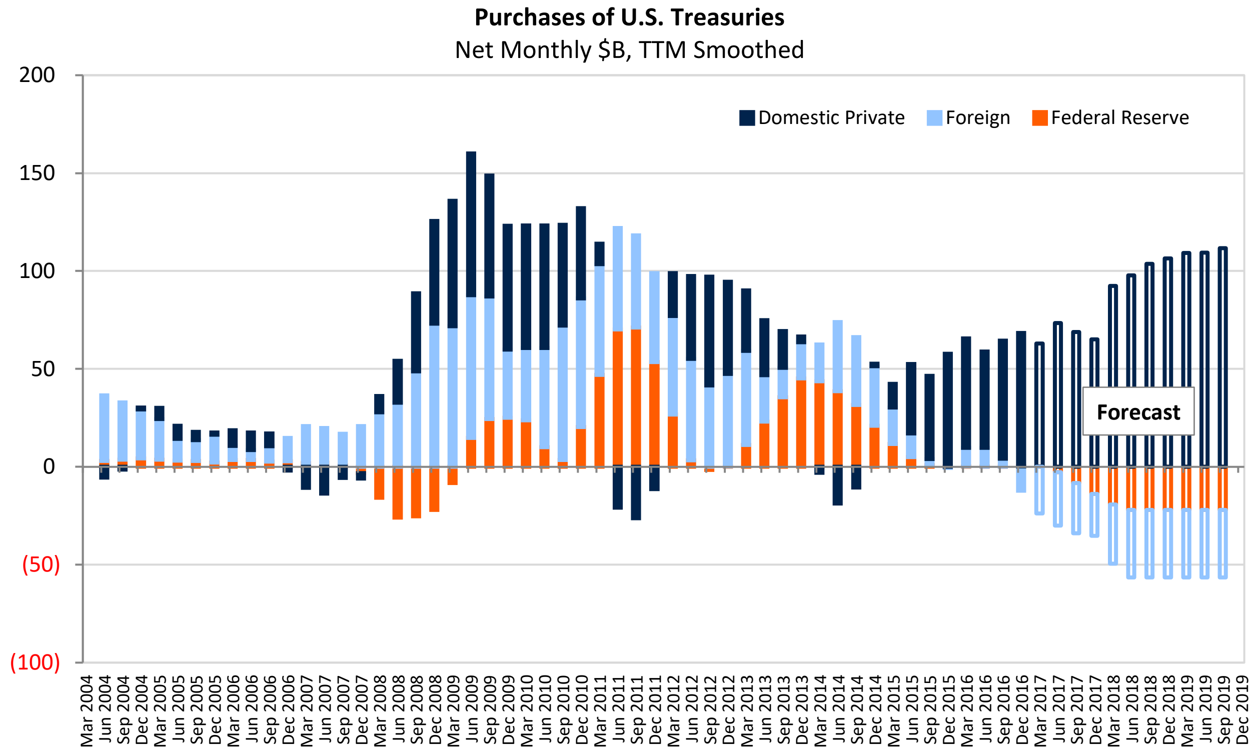
Source: International Monetary Fund (World Economic Outlook Database, April 2017), Sandler O'Neill

The Federal Reserve continues on course to gradually remove monetary accommodation. While two more policy rate hikes remain on the table for 2017, the addition of Fed balance sheet reduction has recently been introduced into the narrative. The former is, of course, a direction reversal in the Fed Funds rate path already underway.

The latter is really the reverse of quantitative easing (QE) and is expected to begin in the near future. Whether this will be in substitute to policy rate tightening or in combination is not clear. But three rounds of QE following the 2008 recession essentially added $3.8 trillion in Treasury, Agency and GSE-backed (TAG) securities to the Fed balance sheet. A gradual runoff of approximately $2.2 trillion has been suggested.

This will presumably not happen by direct Fed selling but indirectly by the cessation of reinvestment. However, this is likely to have the same <u>net</u> supply effect assuming TAG securities are refinanced by their issuers. Assuming a straight line, five-year decline adds roughly $35 billion to monthly net supply, with over $20 billion reflected in U.S. Treasuries. Eighty-nine percent of Fed-owned Treasury securities mature after one year with nearly half carrying maturities between one and five years.

Hence, excess monthly supply of Treasuries should soon be in the vicinity of $60 billion. Coupled with $50 billion in net new Treasury issuance forecast the domestic private sector will need to absorb over double what it purchased during the crisis, as depicted in the bar chart below. (Please note the graph is lagged using a trailing twelve-month average.) This will logically require higher yields. Heretofore we only warned of the decline in foreign net buying and the absence of the Fed. We were not assuming substantial net selling by both, which now looks probable.



Sources: net supply history and projections: CBO & UST; demand projections: SOP

We have long argued that the 10-year Treasury rate should at least match nominal GDP growth (which has slowly been approaching 4%) without external distortion. This has not been the case for a solid decade, between episodes of Fed QE and flights out of the Euro. With the French election over, arguably the biggest single threat to the Euro has been removed, at least for now. In the past we had similarly expected interest rate pressures based on our supply/demand analysis of Treasuries, only to be proven wrong by resurging foreign demand. President-elect Emmanuel Macron's win should ultimately cap episodic flights out of the Euro and into the U.S. Dollar from the first noteworthy shift in populist support for a better integrated Europe.

Separately the real component of U.S. GDP has been improving as well, with steady consumption and a first quarter recovery in fixed investment. Core inflation approaches the Fed's objective, and last week's jobs report shows hourly wages continuing to grow at a 2.6% average rate so far in 2017. Moreover, average job growth has held steady at 1.6% while average labor force growth has slipped from 1.1% in 2016 to 0.7% so far this year, almost certainly adding to wage pressures.

While we use Congressional Budget Office and U.S. Treasury projections for the deficit and net borrowing through 2019, additional infrastructure spending and lower tax revenues are entirely possible and could well exacerbate pressure for interest rates to rise further.

MAJOR FOREIGN HOLDERS OF TREASURY SECURITIES
(in billions of dollars - EOP)

					2nd Half 2016						1st Half 2016					
Country	**6 Mo % Chg**	**6 Mo $ Bil Chg**	**Feb 2017**	**Jan 2017**	**Dec 2016**	**Nov 2016**	**Oct 2016**	**Sep 2016**	**Aug 2016**	**Jul 2016**	**Jun 2016**	**May 2016**	**Apr 2016**	**Mar 2016**	**Feb 2016**	**Jan 2016**
1 Japan	(2.5%)	(29)	1,115	1,103	1,091	1,109	1,132	1,136	1,144	1,155	1,147	1,133	1,143	1,137	1,133	1,124
2 China, Mainland	(10.6%)	(125)	1,060	1,051	1,058	1,049	1,116	1,157	1,185	1,219	1,241	1,244	1,243	1,245	1,252	1,238
3 Ireland	15.9%	42	309	294	288	275	274	271	266	269	270	259	257	264	255	252
4 Cayman Islands	(2.3%)	(6)	258	257	264	261	262	262	264	264	270	261	259	265	255	251
5 Brazil	0.6%	2	258	258	259	258	255	258	256	254	252	250	249	246	247	256
6 Switzerland	(0.7%)	(2)	236	224	230	230	235	241	238	241	237	229	230	230	236	238
7 Luxembourg	(1.5%)	(3)	217	219	223	221	216	227	220	224	225	222	221	221	209	200
8 United Kingdom	5.8%	12	217	214	217	216	207	218	205	210	231	217	216	226	231	210
9 Hong Kong	4.5%	9	200	189	191	186	186	190	192	190	185	192	195	200	202	202
10 Taiwan	(3.4%)	(6)	184	184	189	183	189	189	190	192	188	182	185	182	183	183
11 Saudi Arabia	22.4%	21	114	112	103	100	97	89	93	97	98	104	113	117	120	124
12 India	(8.6%)	(11)	112	114	118	119	123	123	123	124	117	118	122	119	119	120
13 Singapore	1.5%	2	107	103	102	97	99	101	106	103	108	109	109	113	112	114
14 Belgium	(33.0%)	(52)	105	112	120	114	117	143	157	154	156	152	154	154	143	138
15 Korea	7.4%	7	97	96	93	85	87	89	90	86	82	81	83	84	78	74
16 Russia	(1.4%)	(1)	86	86	86	87	75	77	88	88	91	88	83	86	88	97
17 Canada	0.1%	0	82	80	83	81	81	85	82	81	85	77	82	82	69	71
18 Germany	(29.5%)	(31)	73	72	82	87	94	103	104	97	99	97	97	90	81	80
19 Thailand	40.8%	21	71	73	66	71	59	50	51	49	48	48	46	43	43	40
20 France	(7.6%)	(5)	64	61	61	70	63	71	70	63	53	59	56	69	79	58
21 Bermuda	(8.1%)	(5)	61	62	64	67	66	64	67	66	69	65	62	63	61	59
22 United Arab Emirates	(6.6%)	(4)	60	61	61	63	64	64	64	66	66	62	60	63	65	67
23 Turkey	3.2%	2	58	58	59	56	58	62	57	60	59	51	55	53	53	60
24 Netherlands	4.1%	2	53	54	57	54	53	52	51	50	51	48	48	49	51	51
25 Mexico	7.4%	3	50	48	47	47	46	48	46	48	51	60	66	72	72	70
26 Norway	(14.7%)	(8)	46	43	53	48	52	57	54	53	59	62	66	72	70	68
27 Sweden	(2.3%)	(1)	39	38	39	39	39	38	40	40	40	41	41	41	41	41
28 Spain	(3.3%)	(1)	38	38	38	38	38	40	39	39	40	38	37	38	38	37
29 Italy	(7.6%)	(3)	38	38	40	38	41	42	41	41	39	42	39	38	37	36
30 Philippines	(8.0%)	(3)	37	37	39	38	39	39	40	42	42	41	41	41	41	43
31 Australia	8.1%	3	35	37	35	36	34	35	32	31	31	31	29	34	33	32
32 Poland	1.2%	0	34	34	34	34	33	34	34	34	34	34	34	34	34	33
33 Israel	10.2%	3	30	31	32	30	29	29	27	30	31	29	29	26	19	18
All Other	(3.0%)	(14)	469	474	482	467	484	474	484	489	484	486	488	490	494	501
Grand Total	**(3.0%)**	**(184)**	**6,012**	**5,953**	**6,004**	**5,952**	**6,042**	**6,155**	**6,196**	**6,247**	**6,279**	**6,208**	**6,237**	**6,285**	**6,242**	**6,183**
Monthly Average		**(31)**	**59**	**(51)**	**52**	**(90)**	**(113)**	**(41)**	**(51)**	**(32)**	**72**	**(30)**	**(48)**	**43**	**59**	

Source: US Treasury - TIC

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