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Tapering Everywhere

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*** Long Rates Can Still Move Higher**
*** New Supply of U.S. Government Debt is Declining With the Deficit**
*** Demand May Decline Even More**

Long-term interest rates clearly reacted to the expected Federal Reserve tapering and eventual removal of its third Quantitative Easing (QE) program. Most argue the bulk of that impact is now in the market, with the 10-Year U.S.Treasury rate reaching 3% twice last year. Where rates ultimately go depends on many other factors, however, including one larger than Fed QE that has already "tapered" -- net foreign purchases of Treasuries.

There is also growing recognition that certain elements within the demand and supply sides of U.S. Treasury (UST) auctions that are offsetting, notably lower UST supply as the budget deficit declines. But the final balance among all factors is critical, and foreign demand looks to be the swing factor.

Nominal U.S. GDP growth peaked at 5.2% in early 2012 and troughed at 3.1% in mid-2013. Nominal GDP growth historically defines risk-free long rates over time. The 10-Year UST rate has averaged a few basis points above nominal GDP over the last decade. Second half 2013 nominal GDP growth is likely to accelerate, so the 10-Year "normal" could approach a 3.5-4.0% range shortly. This still leaves upside for long rates, although less than the 5.0-5.5% range we suggested a year and a half ago. Nonetheless the Office of Management and Budget's baseline forecast has 2014 and 2015 nominal GDP growth near 4% and 6% respectively, suggesting the higher range may be reality.

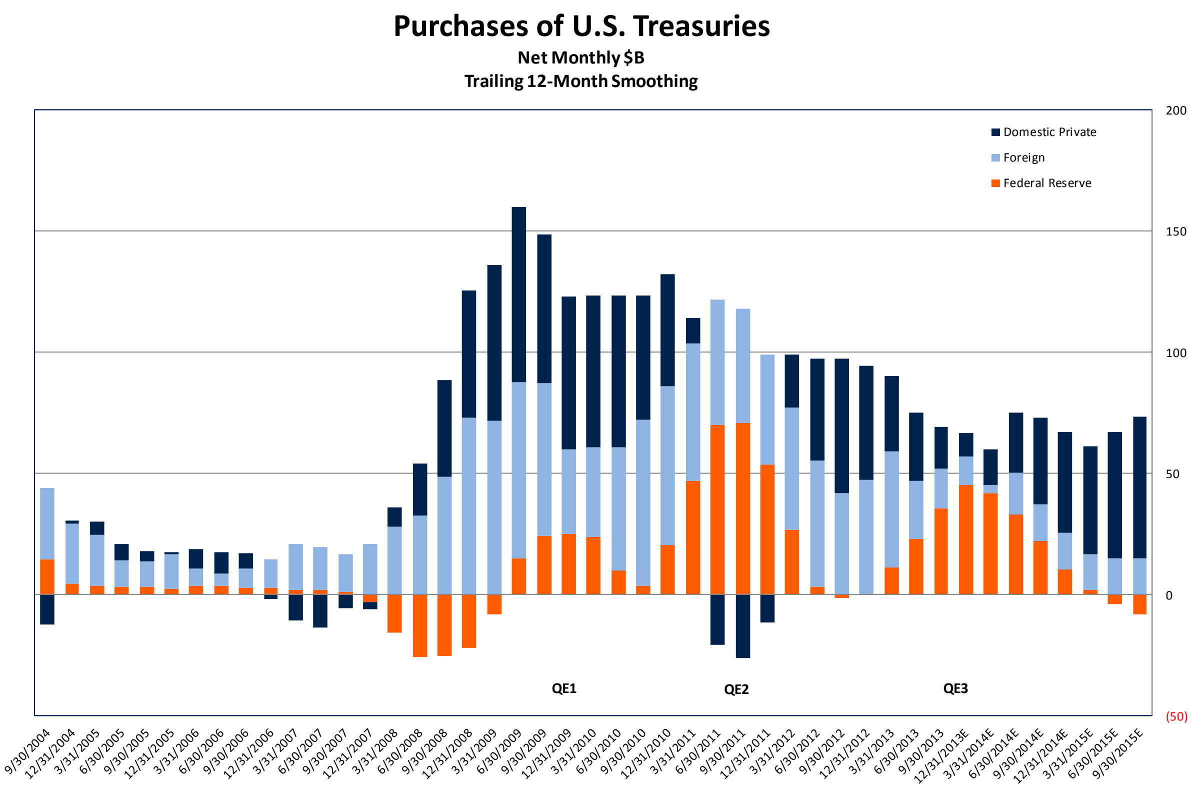
The size of auction supply, based on the narrowing budget deficit, has been quantified in periodic Treasury Borrowing Advisory Committee (TBAC) updates. But these are only estimates which are subject to considerable quarterly variance. The size of Fed tapering is arguably more measurable. Fortunately for declining Fed purchases of Treasuries the amount of net new Treasury debt is probably shrinking faster in the near future. In this sense, tapering comes at a propitious moment. However, the wild card that could swamp the balance is foreign demand.

Looking at rough numbers, as the U.S. budget deficit is projected to decline the TBAC sees net new Treasury borrowing of $874 billion in fiscal year 2014, not dissimilar from actual supply in the prior year, after being already down a sharp 27% from 2012. According to TBAC, Supply dropped from $95 billion per month in calendar year 2012 to $67 billion last year, where it is likely to return later this year. This $28 billion in new supply shrinkage obviously helps as the Fed ultimately removes its $45 billion QE program. However, net foreign demand also fell by $25 billion last year and is likely to ebb further.

Since Treasury borrowings and the deficit do not follow a tight correlation, it is also useful to look at longer period averages when considering supply/demand balances. During the four years (2009-12) of $1 trillion plus deficits, net monthly borrowings averaged $109 billion. During this same period, Fed net purchases averaged $25 billion per month representing 23% of demand. However net foreign buying averaged $48 billion per month during these four years, representing a far larger 48% of demand at auction and have already fallen by $33 billion!

None of this is meant to ignore or minimize the relevance of Fed tapering but rather to place it in context with other variables. Perhaps a graphic schematic is more helpful. Below we have assembled a quarterly bar chart stacking that shows average monthly demand across three major categories: foreign, Fed and the domestic private sector. Of these three, the latter is arguably the most sensitive to interest rates and other market alternatives. Foreign buying is also, but to a lesser extent, as the accumulation of U.S. dollar reserves is a byproduct of both cross-border trade and investment. Countries must decide where to put those reserves and/or spend them. Federal Reserve demand is almost completely driven by policy and politics.

We show the Fed in red and can quickly see the three easings and their relative importance to the demand total. In light blue we see the episodic role of foreign purchases, driven heavily by emerging markets' swelling reserves as trade and current account surpluses exploded until 2006, followed by industrial market buying to escape several phases of the euro crisis. Contemplating the chart carefully. domestic private purchases in dark blue must now take up substantial net demand slack.

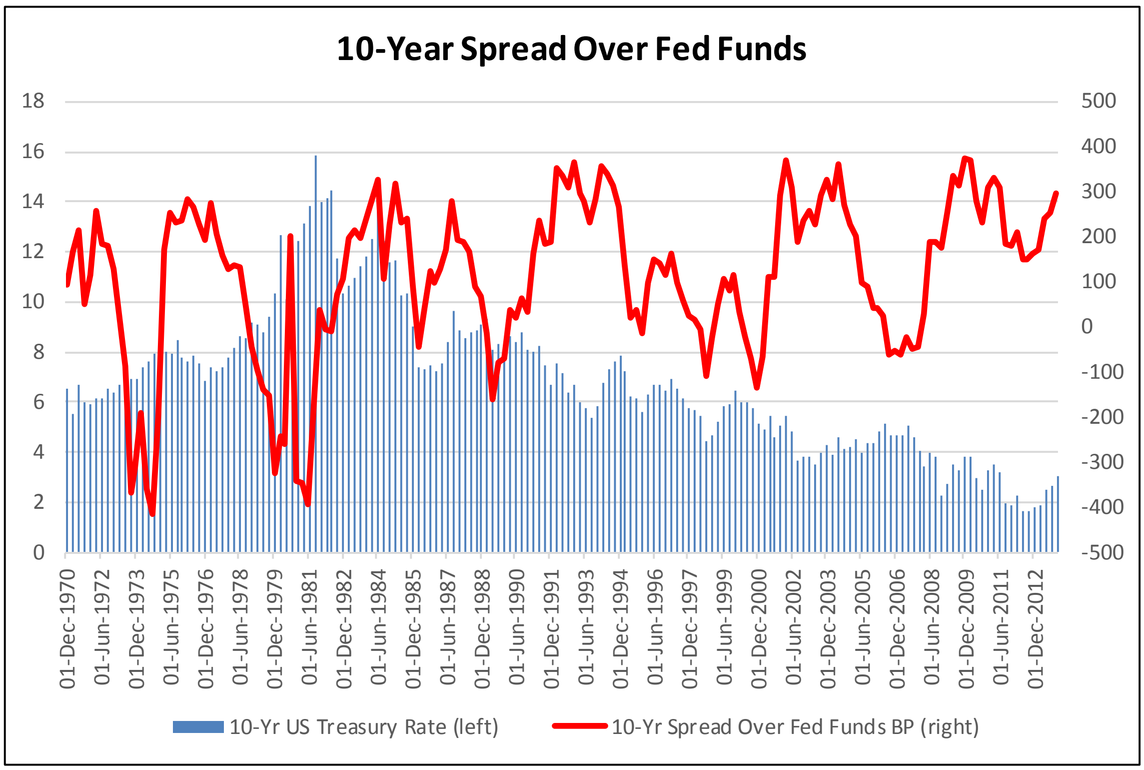


Sources: CBO, UST, SOP

We are using a combination of CBO and Treasury forecasts to display average monthly supply for the 2014 and 2015 fiscal years. We assume the level of net foreign purchases remains near current levels barring any significant rebound in world trade. We also assume the Fed completes tapering by the third quarter of this year and then only modestly reduces its bloated balance sheet of Treasury holdings.

Utilizing these assumptions, domestic private buying (retail and institutional) must essential quintuple back to their levels during the financial crisis. This seems unlikely without additional yield as investors continue to flee bonds for equities, ironically a shift the Fed intended.

This also leaves a quandary for short term interest rate policy. Should the 10-Year reach 4%, the spread over Fed Funds will be confronting its well-defined historical peak. In our view, the Fed would be highly



likely to adjust the policy rate upwards in this situation to avoid further market distortions and a potential explosion in carry trade and other counterproductive rate arbitrage activity. If this is correct, short term interest rates might no longer be simply anchored to employment metrics.

We still see foreign demand for U.S. debt as the more powerful influence on interest rates. If this demand remains low, or even moves into negative territory, rates are poised to move up farther and sooner than the market expects. Conversely, if foreign demand were to swell again, long rates could certainly stay where they are or even retreat.

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