# GLOBAL MARKETS UPDATE

## How demand and supply affect Treasury term premia

- **Estimates suggest that the term premium of US 10-year Treasuries has bounced back to positive territory. We think that this can be at least partly explained by demand and supply factors. And we suspect that term premia might rise a bit more, even though that will not prevent the 10-year yield from falling further.**
- In principle, the yield of a bond can be broken down into a "risk-neutral" yield, which captures expectations for short-term interest rates during its lifetime, and a "term premium", which captures the combined influence on the yield of all other factors. While it is not directly observable, the term premium can be estimated. **In the case of 10-year US Treasuries, it is the first time since 2017 that two of the main models, ACM and DKW/KWW, both estimate that the term premium is in positive territory.** (See Chart 1.)

**Chart 1: Model Estimates Of US 10-Year Treasury Term Premium (%)**

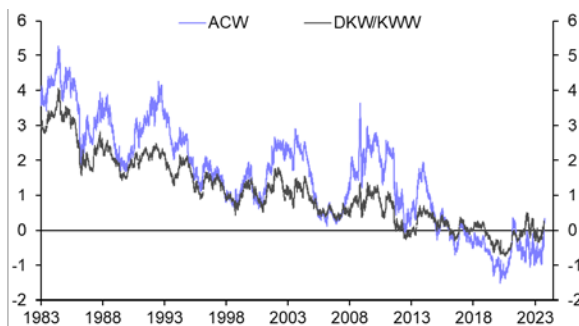
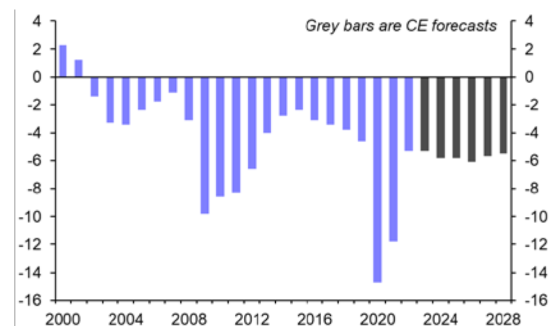



**Chart 2: US Central Government Annual Budget Balance (% Of GDP)**




Sources: Refinitiv, Capital Economics

- There are many reasons why term premia might have rebounded, such as higher expected rate volatility and higher uncertainty about US solvency. **Another key driver of this rise is supply and demand dynamics.**
- On the supply side, issuance of Treasuries has increased rapidly since 2015, as evidenced by the growing US government budget deficit. And we think that the deficit will remain high in the coming years. (See Chart 2.) In fact, Treasury issuance has been quite big so far this year, as the deficit has widened more than expected and the Treasury has refilled its account following the debt ceiling crisis. What's more, the Fed's unwinding of its balance sheet via quantitative tightening should add to overall supply. **This suggests to us that supply dynamics will not ease the upward pressure on the term premium.**

**Chart 3: Current Account Balances (USD Billion)**

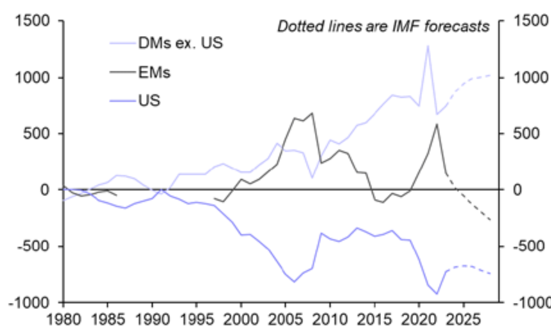
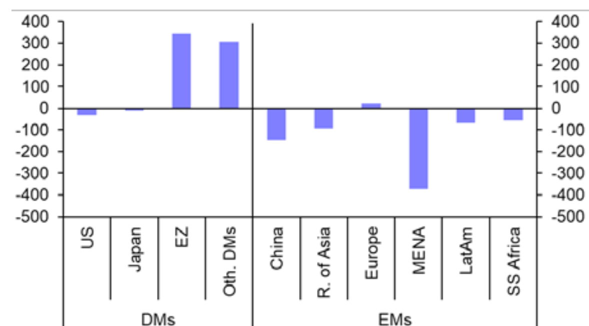



**Chart 4: Changes In CA Balances Between 2008 & 2023 (USD Billion)**




Sources: Refinitiv, Capital Economics

- **As far as demand is concerned, international capital flows are one key determinant.** The period before the Global Financial Crisis (GFC) was characterised by a "global savings glut". In some developed markets (DMs), such as Japan and Germany, an ageing population meant growing national savings. In emerging markets (EMs), painful financial crises (Mexico in 1994, East Asia in 1997-98, Russia in 1998, Brazil in 1999, and Argentina in 2002) provided strong incentives there to reduce reliance on foreign investors and

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build reserves, leading to bloated CA *surpluses* across EMs. (See Chart 3.) The period was also marked by substantial reserve accumulation in China, not only to insulate itself against the crises that had affected its neighbours, but also in response to a policy aimed at keeping the renminbi undervalued.

- **But the savings glut is arguably over now.** Apart from a period of high volatility due to the trade and investment disruptions caused by the COVID-19 pandemic, the situation seems to have "normalised" since the GFC. (See Chart 4.) After all, investments should naturally flow from DMs to EMs, as capital is scarcer and therefore investment opportunities and potential returns are higher in emerging countries.
- **These dynamics are evident when looking at net purchases of Treasuries by type of buyers.** (See Chart 5.) In the 2000s, foreign investors were by far the main buyers. This remained the case in the 2010s, although the Fed and the US financial sector also bought a lot of US bonds, in part due to post-GFC regulatory requirements. In 2020 and 2021, a new round of QE made the Fed the major purchaser. Since then, the Fed is *tightening* policy and shrinking its balance sheet. As a result, households and non-profit organisations – a category that includes hedge funds – are now the main purchasers of Treasuries. (See Chart 6.)

**Chart 5: Net Purchases Of US Treasuries (USD Billion)**

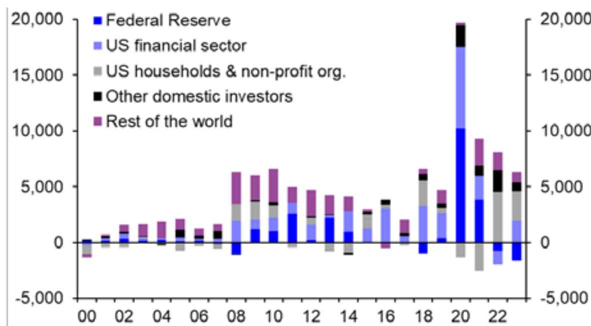
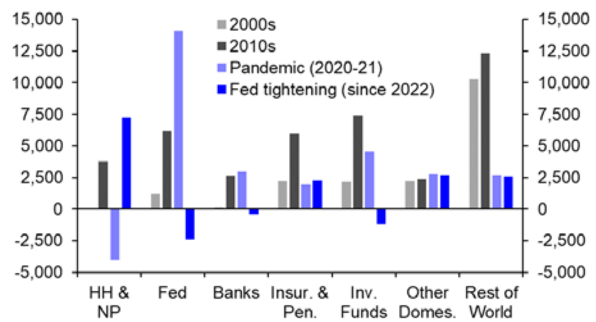



**Chart 6: Net Purchases Of US Treasuries (USD Billion)**




Sources: Refinitiv, Capital Economics

- Overall, foreign investors and institutions now hold about 28% of all Treasuries outstanding, which is roughly 15 percentage points lower than at the start of the GFC. (See Chart 7.)
- **We should probably not expect EMs to help again hoovering up Treasuries. And we doubt that DMs will pick up the slack, notably as central banks there reduce or remove their support to their own government bond markets. What's more, barring another accident in the financial system, the Fed is likely to continue unwinding it balance sheet. This means that private domestic investors will probably keep filling in the gap. The big difference with the Fed or reserve managers is that these investors are much more conscious about prices and might therefore ask for a higher premium. This suggests to us that the Treasury term premium will not fall back to its pre-pandemic lows; indeed, we suspect that it will rise a bit more.**
- Admittedly, we expect that Treasury yields will fall further. This is because we think that disappointing growth and lower-than-expected inflation will lead the Fed to cut rates sooner and by more than what is currently discounted in the markets. However, our view that the term premium will rise a further suggests to us that yields will not settle as low as they were before the pandemic. The upshot is that we forecast the 10-year Treasury yield to drop to 3% by the end 2025. This compares to its current level of about 4.6%, and to an average of 2.4% during the 2010s. (See Chart 8.)

**Chart 7: Selected Holders Of Treasuries (% Of Total Outstanding)**

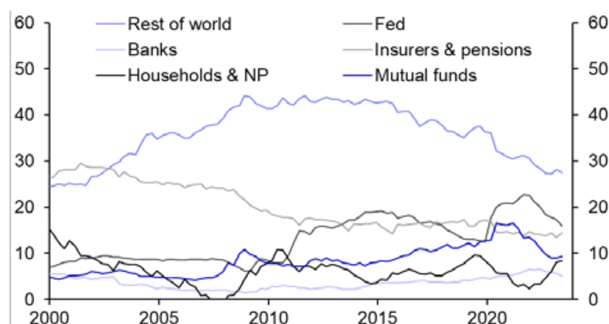



**Chart 8: US 10-Year Treasury Yield (%)**

Sources: Refinitiv, Capital Economics

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