Liquid Insight

UST supply higher, demand concern lower

25 January 2024

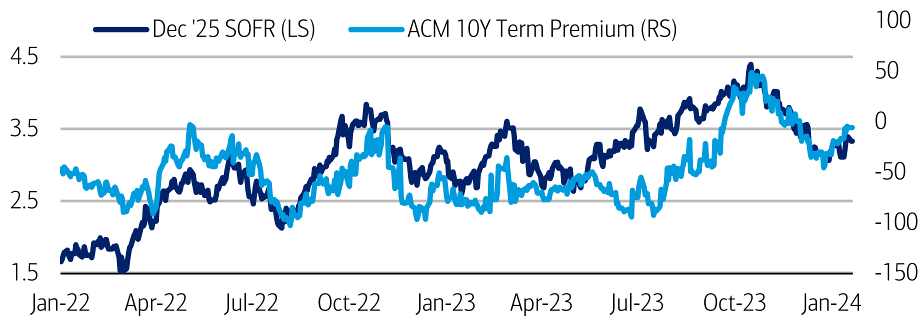
Rates and Currencies Research
Global

Key takeaways

- UST auction sizes will rise again at next week's refunding but we expect minimal market reaction, it is well expected
- UST demand improved w/ confidence in slower growth, lower inflation, & Fed cuts; it is seen from banks, pensions, funds, etc
- Term premium & UST supply concern has been lowered by improved UST demand

By M. Cabana, M. Swiber, R. Axel, & K. Craig

Exhibit 1: Fed term premium (bps) & SOFR '25 implied rate (%)
Fed term premium measures correlate to intermediate-dated policy expectations



Source: Bloomberg

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UST demand & term premium concern: eased away

The US Treasury is slated to announce another increase in coupon supply next week. The supply increase is expected to have limited market impact given it is (1) widely expected (2) likely to be the only coupon increase in CY '24 (3) met with improved UST demand.

Last fall, the US Treasury market was dominated by one question: who will buy the bonds? At that time US data was hot, Fed hikes were in play, term premium (TP) measures were rising, & UST demand was tepid. The macro backdrop is different today: US data is strong but moderating, Fed cuts are in play, TP measures have fallen, & UST demand has improved. What a difference a season makes.

The shift in UST demand is fundamentally rooted in improved macro confidence. The Jan UST refunding announcement will not rock this boat. Below we review our UST refunding expectations, evidence improved UST demand, & caution against reading too much into Fed TP measures. As previously noted, Fed TP shifts likely more reflect changes in intermediate tenor policy views vs elevated UST supply concerns (Exhibit 1).

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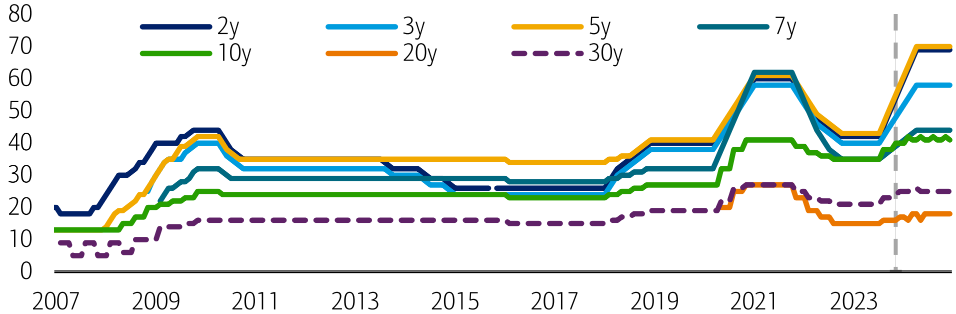
Treasury refunding preview: only coupon size increase in '24

At next week's Jan 31 refunding announcement, we expect Treasury will deliver a repeat of the increase in auction sizes announced in November (See: UST refunding preview, Exhibit 2, Exhibit 3). At the November refunding, Treasury guided that this final increase would be needed for issuance to align with financing needs. This would mark the third consecutive quarterly increase in coupon supply but likely the only increase in FY 24.

Exhibit 2: Treasury auction sizes by tenor with projections through YE '24 ($bn)
We forecast that Treasury note auction sizes will grow through April '24



Source: BofA Global Research, US Treasury

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Exhibit 3: Expected change in auction sizes in Feb quarter from Nov refunding quarter
Expect similar increases at Jan refunding meeting as Nov with continued growth in TIPS

	2y	3y	5y	7y	10y	20y	30y	5y II	10y II	30y II	2y FRN
2/29/2024	3	2	3	1	2	0	1			1	2
3/29/2024	6	4	6	2	2	0	1		1		2
4/30/2024	9	6	9	3	2	0	1	1			2

Source: BofA Global Research

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We see room for Treasury to continue growing coupon supply in 2025-2026 but expect UST to hold off on further adjustments this fiscal year given uncertainty around QT and deficits. Treasury may also prefer to delay further coupon increases given the perception of market sensitivity to supply announcements & a desire to refrain from unnecessary tightening of financial conditions in an election year.

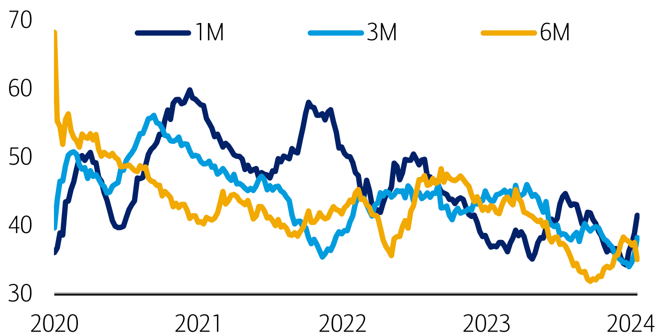
Treasury has recently justified their debt issuance shift to better align supply & demand. This has resulted in Treasury overweighting issuance in short-term bills vs longer-term coupons. Bill supply has been well supported with favorable money market conditions, but this will not always be the case. We believe money market rates will increase in the Fed's target range over '24 which will likely support more coupon supply in '25 or '26.

Treasury auction results: no alarms, no surprises

While Treasury auction stats since November have been mixed, results have generally suggested the shift in issuance strategy has been well received. One proxy of auction demand is primary dealer takedown at auction, since dealers will typically absorb the slack left by end investors.

Primary dealer takedown at Treasury auctions has not increased meaningfully across benchmark bills or coupons (Exhibit 4, Exhibit 5). Dealer short tenor coupon takedown has increased modestly, but lower vs 2021. Overall, elevated Treasury supply concerns have not resulted in a consistent deterioration of auction performance.

Exhibit 4: Primary dealer bill average auction allotment (%)
Dealer bill auction allotment has been trending lower



Source: BofA Global Research, Treasury; note: 12 week moving average
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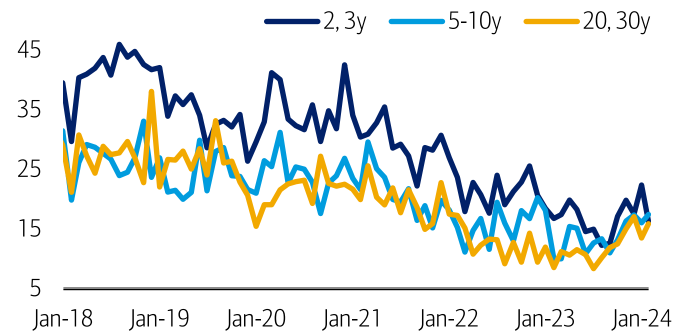
Exhibit 5: Primary dealer coupon average auction allotment (%)
PD auction participation is low but has picked up over recent months



Source: Global Research, Treasury
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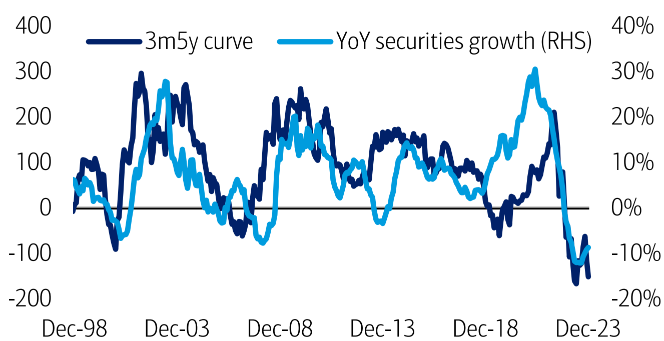
Treasury demand has improved with Fed cut expectations

UST demand has improved with increased macro confidence and building Fed cut expectations. Improved Treasury demand can be observed across a wide range of investors, ranging from banks to pensions to foreign investors.

Bank demand: commercial bank demand for securities has recently increased with a dovish Fed, lower rates, & potential increased confidence in deposit stability. Bank UST & MBS holdings have increased $113b since mid-Oct, in a roughly even split. Banks typically grow securities holdings with stable retail deposits and as the 3m-5Y UST curve steepens (Exhibit 6, Exhibit 7). Fed cuts should see these trends continue.

Exhibit 6: Front-end curve and YoY bank securities portfolio change
Securities portfolio growth picks up historically with steeper front-end curve



Source: BofA Global Research, Bloomberg
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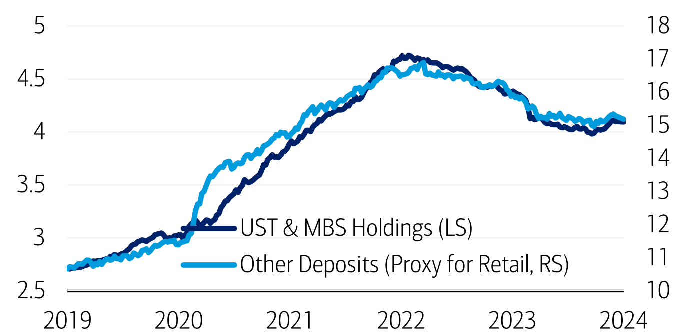
Exhibit 7: Bank securities holdings & retail deposits ($bn)
Banks tend to grow securities holdings as retail deposits grow



Source: BofA Global Research, Bloomberg
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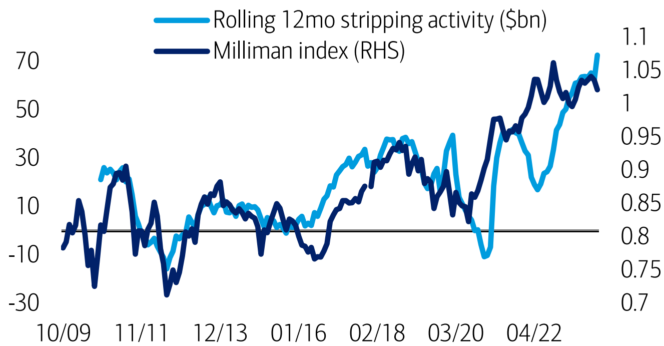
Pension & insurance demand: long-dated liability driven investors have also likely increased their duration demand over recent months. This can be seen via historically elevated stripping activity in December alongside elevated funding ratios (Exhibit 8).

Foreign demand: UST demand has recently improved from overseas investors. Rolling 3m FX hedge UST returns have recently turned positive for UK, EU, & CAD investors. Japanese longer-term investors are still sidelined given prohibitive FX-hedged returns, but Japanese banks have increased foreign bond buying likely as more tactical trades.

Investment funds**:** Inflows into UST funds historically slow with lower rates (Exhibit 9). We have also seen a retreat in overweight positions suggested by our FX and Rates Sentiment Survey. We tend to also see overweights pull back as the Fed cuts (see: Longs under pressure). While investment fund demand may retreat as rates decline, we think that this can be offset by other buyers in the market.

Exhibit 8: Milliman index and 12mo increase in USTs held in stripped form
Higher pension funded status aligns with higher stripping activity



Source: BofA Global Research, Bloomberg

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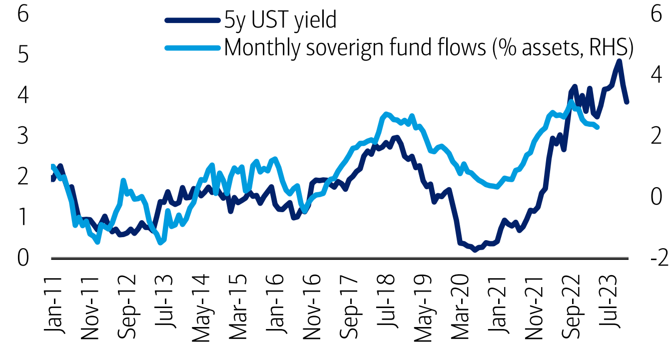
Exhibit 9: Sovereign fund flows and UST yield
Inflows higher when yields are higher



Source: BofA Global Research, EPFR. Note: sovereign fund flows are midpoint of 12mo average

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Fed: QT is a wild card for UST supply & demand. An earlier QT slowdown or end would be a positive for UST supply / demand dynamics. If the Fed ends QT, we expect they will still desire a UST only portfolio and reallocate MBS repayments into the UST market. For MBS, this would mean QT never ended; for USTs, it would mean small scale QE started. Details here: Fed MBS reinvestments into USTs explained.

Overall, UST demand has improved with increased macro confidence & expected Fed cuts. These factors have unsurprisingly overwhelmed lingering UST supply issues.

Treasury demand heavily influenced by fixed income utility

Our takeaway from recent signs of improved UST demand suggests less concern about UST supply but more concern about UST hedge value. Traditionally, USTs are valuable investments because they have virtually no default risk and have proven a safe store of value, i.e., UST total returns typically realize positive or with marginal losses.

The utility of USTs changed post COVID. USTs saw their traditional utility eroded with higher inflation & rapid Fed rate hikes. This drove USTs to experience large negative total returns. Heavy supply further dampened investor confidence in USTs.

Investors are now more willing to own USTs with the belief inflation is moderating, Fed hikes are done, and cuts are coming. This should support positive UST total returns and overwhelm concern about UST supply. We suspect this will persist as long as inflation remains low & the Fed delivers on their expected cutting path. This should also keep investors from worrying much about increasing term premiums near term.

Fed term premium measures: use at your own risk

TP measures are designed to reflect the additional investor compensation to own bonds vs the expected Fed policy path. TP is conceptually thought to reflect macro uncertainty, Treasury supply, investor risk preferences, and other factors.

Fed measures of TP increased over the summer and helped drive shifts in official sector policy. Fed officials suggested that higher TPs did some monetary policy tightening for them, reducing the need to further hike rates. Treasury officials likely believed higher TPs reflected a supply / demand imbalance & pushed them to issue more bills vs coupons.

Our research has long been skeptical of reading too much into TP measures, given estimation challenges. We have also written in the past that Fed TP measures typically correlate well with the UST curve shape. We assume most investors don't require a model to tell them how the curve is moving.

Fed TP measures may not accurately reflect shifting policy expectations at intermediate tenors. Indeed, Fed term premium measures recently correlate well with 2-3Y ahead

SOFR expectations (i.e. SFRZ5) or neutral rate proxies (3y1y OIS). These typically fall outside of the typical term structure or term premium model horizons where changes in the policy path are expected to occur (i.e. in the 0-1Y horizon). Our prior work has also shown 10y rates closely track a linear combination of 2 rates: the overnight Fed policy rate and the expected Fed policy rate 1y ahead (see: big picture for rates). Typical term premium models would assign either no TP or little TP to these two underlying rates.

The official sector may have conflated TP with supply concerns and eased conditions to offset. This easing pushed the policy path lower & better aligned supply with demand. Overall, official sector easing to offset higher TPs likely supported UST demand.

Treasury supply heavy, but not an issue till macro uncertainty rises

US deficits are still large & growing which means that UST supply will remain heavy. We expect reduced macro uncertainty & Fed cuts will be supportive of UST demand in the near term. However, Treasury supply concerns are likely to resurface over time.

We expect UST supply concerns to re-emerge with US macro uncertainty. If US macro data accelerate, we expect investors will worry about future Fed hikes, USTs as a store of value, & UST supply. We also worry any US election outcome with a sweep for either party will increase odds of fiscal easing, stronger growth / inflation, & higher supply.

While UST supply / demand concern is lower today, it could resurface in the future. We expect the root cause of any resurgence in supply / demand concern will be driven by higher growth, inflation, & Fed hike risks. Higher TPs will likely follow.

Bottom line: Treasury will announce higher coupon supply again on Jan 31. This should be the last coupon increase until ’25 or ’26. Higher coupon supply is unlikely to meaningfully harm UST demand. UST demand has been supported by reduced macro uncertainty, falling inflation, & expected Fed cuts. Increased buying has been seen from banks, pensions, & foreign investors. Higher supply likely doesn’t mean increased term premiums, given issues with their measurement. While UST supply / demand is less of an issue today, it could emerge again with stronger macro data or fiscal easing.

Notable Rates and FX Research

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- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Explaining USD resilience, **Liquid Cross Border Flows**, 15 Jan 2024

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: Destination unknown 19 January 2024

Global Rates Weekly: Longs on ice 19 January 2024

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