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US Rates Viewpoint

UST demand in 2024: cautiously optimistic

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Rates Research
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UST = US Treasury

QT = quantitative tightening

USD = US dollar

DB = defined benefit

Slowdown is good for demand backdrop

We are cautiously optimistic on a more supportive demand outlook next year. While duration supply next year will be historically elevated, buyers can step up and meet this financing need. The clearing level hinges on greater conviction that the US economy is slowing and Fed cuts are up next. In this note we detail our framework for assessing demand across key buyer bases in 2024.

Foreign investors: bid with weaker USD and steeper curve

Foreign private demand has the potential to be stronger next year should FX hedged pickup improve as implied in forwards. The official sector could see stronger demand if our FX strategists' view for around 7% depreciation in DXY is realized. Deprecation of >5% historically corresponds with buying of around $200bn annually. Rather than selling USTs to generate USD liquidity, foreign central banks may buy USD assets vs their currency to stem appreciation pressure.

Pensions: slow but steady

In 2024 we pencil in defined benefit (DB) private pension demand of around $75bn, roughly consistent with observed buying in 2023. This is still below the $100-150bn annual bid approximated from DB private pensions fully de-risking over a 5y period. Pension fund demand could accelerate closer to our previously estimated pace with greater conviction around a peak in rates. However, a more significant growth slowdown next year, which could adversely impact DB private pension funded status, leave us more cautions on this annual estimate.

Banks: buying on hold until 2H

This past year, banks were net sellers of USTs and MBS. QT put pressure on balance sheets and a strong macro environment drove a preference for loans vs securities on the asset side. Through the middle of next year, we think bank liquidity constraints are likely to prevent buying, especially due to underwater securities. Should the Fed cut starting in June alongside a cooling economy, banks are likely to make fewer loans and will have a greater appetite to buy USTs. Securities growth trends well with front-end curve slope. Should this turn positive in 2H with cuts and growth concerns, banks are likely to buy.

Domestic investment funds: some room to add

We anticipate that investment funds and asset managers will remain some of the strongest end buyers. This past year, investment fund demand was historically elevated with strong inflows into UST and mixed allocation funds. Investment funds also took down the bulk of auction supply. This demand could accelerate but conviction in macro momentum turning is needed.

Refer to important disclosures on page 7 to 8.
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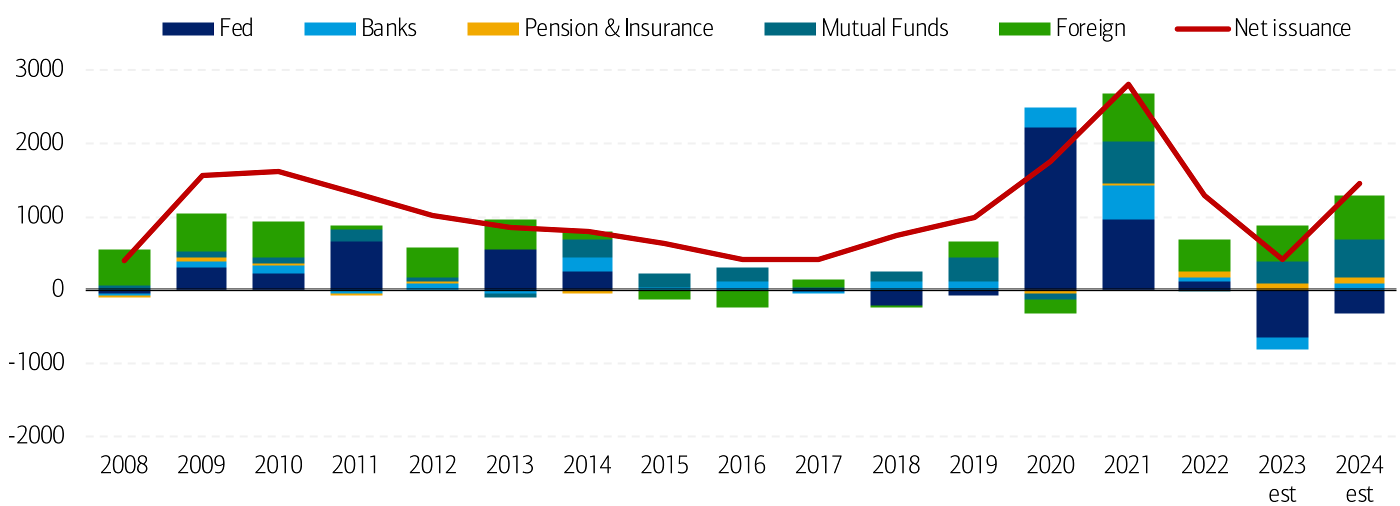
Demand in 2024: cautiously optimistic

We are cautiously optimistic on a more supportive demand outlook next year. While duration supply next year will be historically elevated, (see: Global Supply section in Global Rates Year Ahead) buyers can step up and meet this financing need. The clearing level hinges on greater conviction that the US economy is slowing and Fed cuts are up next. In this note we detail our framework for assessing demand across key buyer bases.

Our view on demand is highly conditional on the macro backdrop. If the economy moderates, inflation cools, and the Fed cuts, we expect increased UST demand from a variety of investors (Exhibit 1). However, if the US economy remains resilient and inflation sticky, we expect a more challenging demand backdrop with large UST supply. To position for the uncertain demand dynamics we prefer steepeners: bull steeper if economy slows & Fed cuts, bear steeper if resilient economy & elevated UST supply. We also see room for front-end spreads to compress but think concerns around supply/ demand have largely been priced at the back end; this argues for a steeper spread curve (see: US spreads section in Global Rates Year Ahead).

Exhibit 1: Large Treasury investor demand & coupon issuance ($bn)

Expect more supportive demand backdrop in 2024 alongside higher supply



Source: BofA Global Research, Federal Reserve, Note: only reflects real money categories from flow of funds that generally invest in Treasury coupon securities, excludes households. Last data point for 2023 is June from Flow of Funds, 2023 reflects estimate based on realized flows from other data sources since end of Q2. Net issuance is coupon supply excluding Fed flows, which are shown as negative for periods where Fed is reducing size of its balance sheet.

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Foreign investors: bid with weaker USD and steeper curve

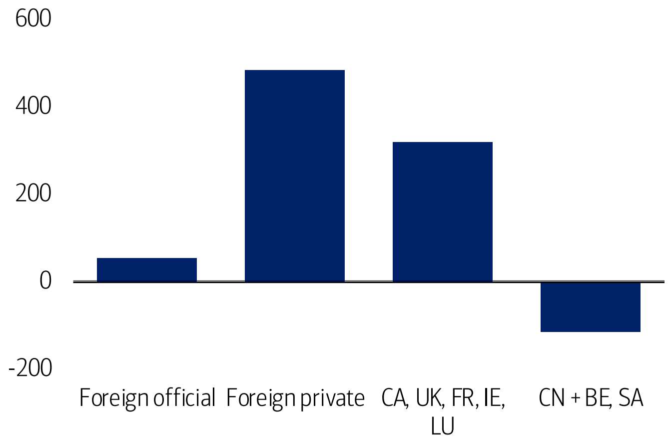
Despite USD strength and unfavorable FX hedged pickup, foreign demand for USTs was strong in 2023. This demand stemmed from foreign private investors and countries including Canada, UK, France, Ireland, and Luxembourg (Exhibit 2). Their demand was likely driven by investment fund inflows and a preference to be overweight USTs vs benchmark, as indicated by our FX and Rates Sentiment Survey (see: FX and Rates Sentiment Survey).

Absent buyers in the market were the large single holders of USTs like China and Japan which together still comprise about 29% of total foreign UST holdings (down from 32% as of end 22).

Demand may be even stronger next year given an expected improvement in FX hedged pickup of USTs vs local alternatives and a weaker USD supporting official sector buying.

Foreign private: Foreign private demand has the potential to be even stronger should FX hedged pickup improve as implied in forwards (Exhibit 3). Market forwards suggest that USTs will look more attractive on an FX hedged basis in the next 3-9 months for buyers in the UK, Germany, and Canada—regions that have already proven strong buyers recently. However, we are expecting Japanese investors to remain on the sidelines as they largely were this year without a meaningful improvement in the outlook for FX hedging costs.

Exhibit 2: Foreign buyers and sellers of USTs in 2023
Foreign demand from private investors was strong in 2023, while China and Saudi Arabia were the largest regional sellers



Source: BofA Global Research, Note: TIC data YTD through September adjusted for valuation
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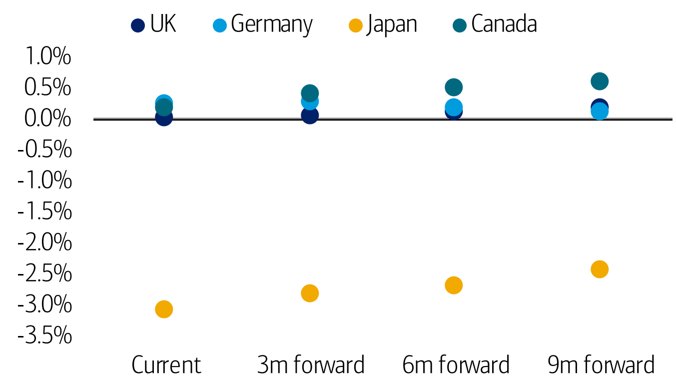
Exhibit 3: FX hedged pickup of TSYs vs local alternatives implied by forwards
Market pricing does not reflect attractive environment for FX hedged carry trades in TSYs currently but forwards suggest improvement



Source: BofA Global Research, Bloomberg, Note: pickup vs 10y local alternative except Japan which is relative to 20y JGB using 3m forward FX hedge
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Foreign official: The official sector could see notably stronger demand next year vs this past year if our FX strategists' view for around 7% depreciation in DXY is realized. As shown in Exhibit 4 and Exhibit 5, deprecation of >5% historically corresponds with buying of around $200bn annually. Rather than selling USTs to generate USD liquidity, foreign central banks buy USD assets vs their currency to stem appreciation pressures.

We assume foreign buying of about $600bn, the upper end historically, based on stronger official sector demand and continued private sector inflows.

Exhibit 4: DXY and NY Fed custody holdings
Depreciation of DXY usually coincides with official sector buying

Source: BofA Global Research, Bloomberg
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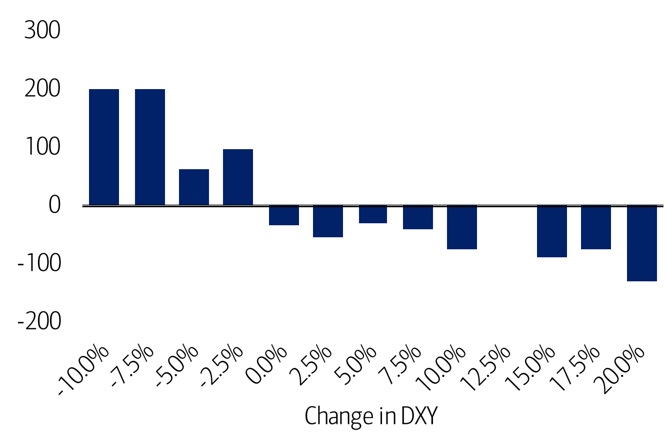
Exhibit 5: YoY change in DXY and change in NY Fed custody holdings
>5% USD depreciation expected could drive notable increase in reserve manager TSY holdings($billion)



Source: BofA Global Research, Bloomberg, Data since 2015
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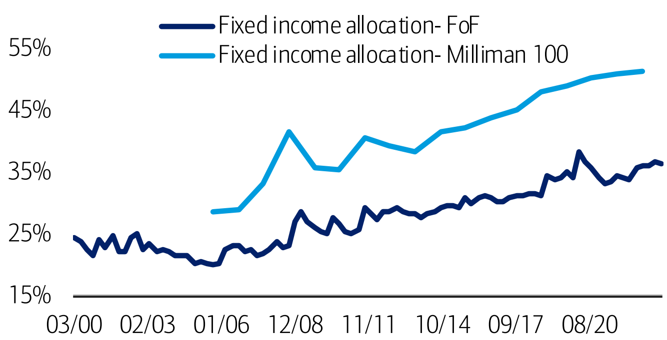
Pensions: slow but steady

With defined benefit (DB) private pension funded status still historically elevated, we expect their bid for USTs to remain an ongoing theme in 2024. Latest data from Milliman and the Fed though suggests that pension funded status is still highly sensitive to changes in interest rates. While pensions have increased allocations to fixed income over the past decade (Exhibit 6), they remain vulnerable to sharp declines in rates that would cause liabilities to increase in value (see: Pension de-risking opportunity may narrow with lower rates). A sharp decline in rates alongside a selloff in risky assets could meaningfully worsen funded status and weaken their bid for duration.

In 2024, we pencil in buying roughly like what we observed in 2023, with pensions taking down around $75bn annually. This is roughly consistent with what we see implied from both flow of funds and the monthly Treasury stripping data (Exhibit 7) but is still below the $100-150bn in annual demand we estimated in Pension de-risking: the time for action is now. Near term, pension fund demand could accelerate closer to our previously estimated pace with greater conviction around a peak in rates. However, a more significant growth slowdown next year, which could adversely impact DB private pension funded status, leave us more cautions on this annual estimate.

Exhibit 6: DB private pension fixed income allocation from Flow of Funds and smaller Milliman subset
Milliman funds have shown more de-risking than broader private DB pension funds according to FoF



Source: BofA Global Research, Milliman, Federal Reserve

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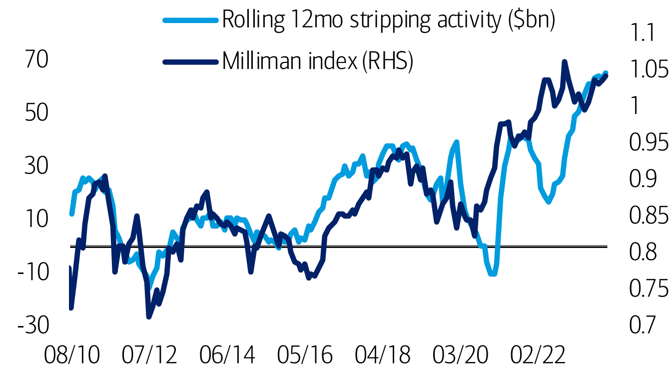
Exhibit 7: Milliman index and 12mo increase in USTs held in stripped form
Higher pension funded status aligns with higher stripping activity



Source: BofA Global Research, Bloomberg

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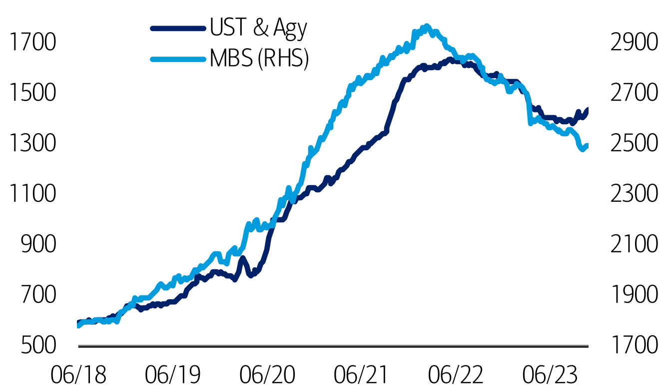
Banks: buying on hold until 2H

In 2023 banks were net sellers of USTs and MBS. QT put pressure on balance sheets and a strong macro environment drove a preference for loans vs securities. As shown in Exhibit 8, UST holdings have recently stabilized after declining from the mid 22 through mid-23.

Exhibit 8: Domestic bank holdings of UST& Agy, MBS
Holdings appear to be leveling off after declining last year



Source: BofA Global Research, Bloomberg

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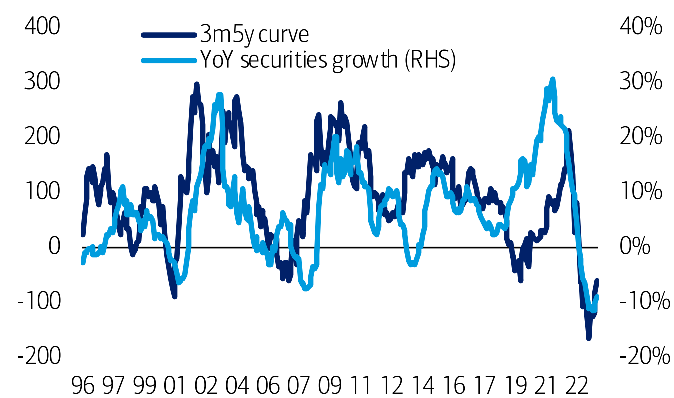
Exhibit 9: Front-end curve and YoY bank securities portfolio change
Securities portfolio growth picks up historically with steeper front-end curve



Source: BofA Global Research, Bloomberg

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Next year we expect banks to remain on hold thorough 1H, with the potential for moderate buying in 2H. Through the middle of next year, we think bank liquidity constraints are likely to prevent buying, especially due to underwater securities. Should the Fed cut starting in June alongside a cooling economy, banks are likely to make fewer loans and will have a greater appetite to buy USTs. Exhibit 9 illustrates that securities growth trends well with front-end curve slope. Should his turn positive in 2H with cuts and growth concerns, banks are likely to also be net buyers.

On net, we pencil in around $100bn of bank buying next year but expect stronger demand to emerge in 2025 should the economy continue to turn and curve steepen.

Domestic investment funds: some room to add

We anticipate that investment funds and asset managers will remain some of the strongest end buyers. This past year, investment fund demand was historically elevated with strong inflows into UST and mixed allocation funds (Exhibit 10). Investment funds also took down the bulk of auction supply (Exhibit 11). We anticipate this strong demand to continue and see some room for it to pickup vs 23, but conviction in macro momentum and direction of rates is needed.

Exhibit 10: Total annual flows by fund type
2023 saw stronger inflows to lower risk assets vs equities & HY

	Equity	HY	IG	MBS	Mixed allocation FI	Sovereign	Equity + HY	IG, MBS, USTs
2023	6	-25	184	14	100	138	-19	435
2022	161	-66	28	-21	-129	144	95	22
2021	387	38	254	8	175	25	425	461
2020	27	25	276	4	169	20	52	469
2019	-54	12	234	24	191	44	-43	492
2018	-38	-45	101	0	52	53	-83	206
2017	2	-8	126	4	122	11	-6	264
2016	-30	21	51	10	60	-2	-9	120
2015	-138	-9	47	14	67	8	-147	137

Source: BofA Global Research, EPFR, note: sum of weekly flows shown, 2023 is YTD as of first week of November

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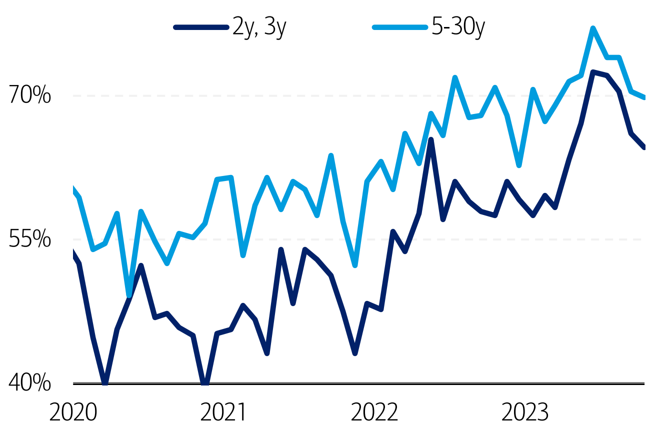
Despite loses in UST funds as rates sold off aggressively this past year, ex-ante yields continued to attract inflows. We saw modest risk reduction in fund flow preference with net outflows from equity & HY funds but significant inflows into fixed income assets lower in risk (Exhibit 10). For this rotation to accelerate, investors will likely need greater conviction around a turn in the macro landscape.

Exhibit 11: Investment fund – average auction allotment
Fund participation still elevated but shows sign of decline



Source: BofA Global Research, Treasury

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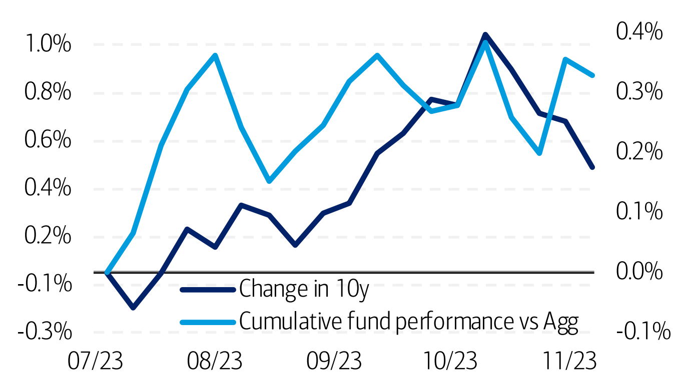
Exhibit 12: Cumulative return of TR FI funds over benchmark vs 10yT
Funds have modestly outperformed since the middle of the year alongside higher rates



Source: BofA Global Research, Bloomberg, Note: Excess returns are fund total returns over Bloomberg Barclays Agg index

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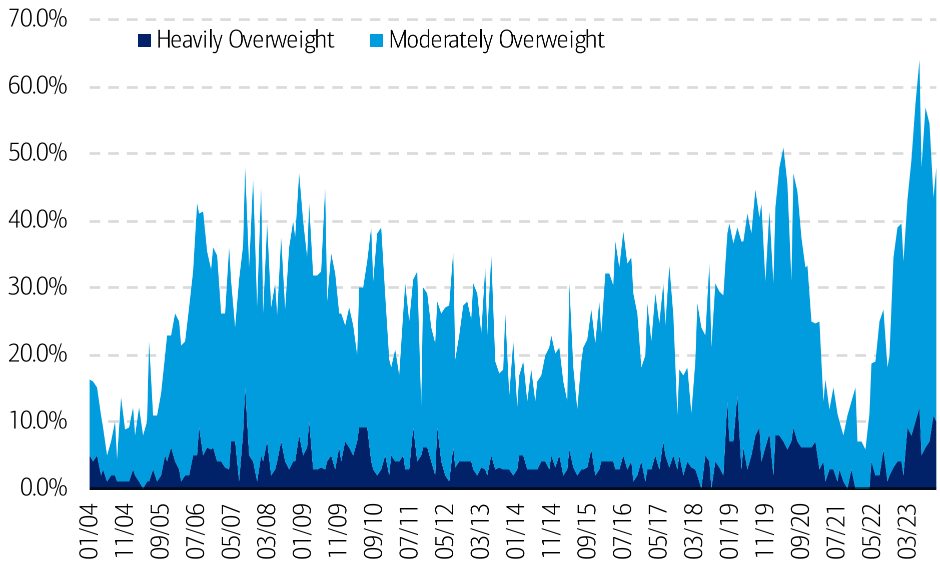
We also see room for domestic total return fixed income funds to add duration from an allocation perspective. Domestic fund performance as well as recorded allocation weights suggest funds have room to add. While recent excess return correlations to 10y UST have broken down, indicating some short covering, there is likely still opportunity for these funds to move to overweight allocations (see: Fund inflows continue to moderate; CTAs show front-end long).

However, our FX & Rates Sentiment Survey has shown that global benchmark investors have been overweight US duration all year and are near capacity vs historical allocations (Exhibit 13). They likely need to see inflows and continued conviction that the path for rates is lower to maintain and extend buying.

Exhibit 13: FX and Rates Sentiment Survey composition of respondents heavily and moderately overweight US duration
Allocations to US duration are near all-time highs



Source: BofA Global Research

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We assume about $500bn demand from investment funds next year but acknowledge their buying will be highly conditional on investor preferences and macro landscape.

Bottom line: our view on the demand backdrop next year is highly conditional on the Fed delivering cuts alongside a cooling economy and investors having greater confidence in the duration outlook. We see room for investors across the board to add to UST holdings with greater macro conviction. Without a strong UST demand backdrop, the significant duration supply we expect next year will have trouble getting digested. We think though USTs will take on a greater role in foreign & domestic portfolios should inflation cool and the balance of risks shift to the downside. However, significant risks remain near-term which supports our view for steepeners in nominal USTs and spreads.

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