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CREDIT MARKETS

Flood of New Debt Tests Bond Market

Supply seen as one factor driving yields higher as investors anticipate economic resurgence fueled by vaccinations and government stimulus

Net new supply of Treasury notes and bonds is projected to be sharply higher this year, while the Federal Reserve is expected to purchase less U.S. government debt.

PHOTO: MANDEL NGAN/AGENCE FRANCE-PRESSE/GETTY IMAGES

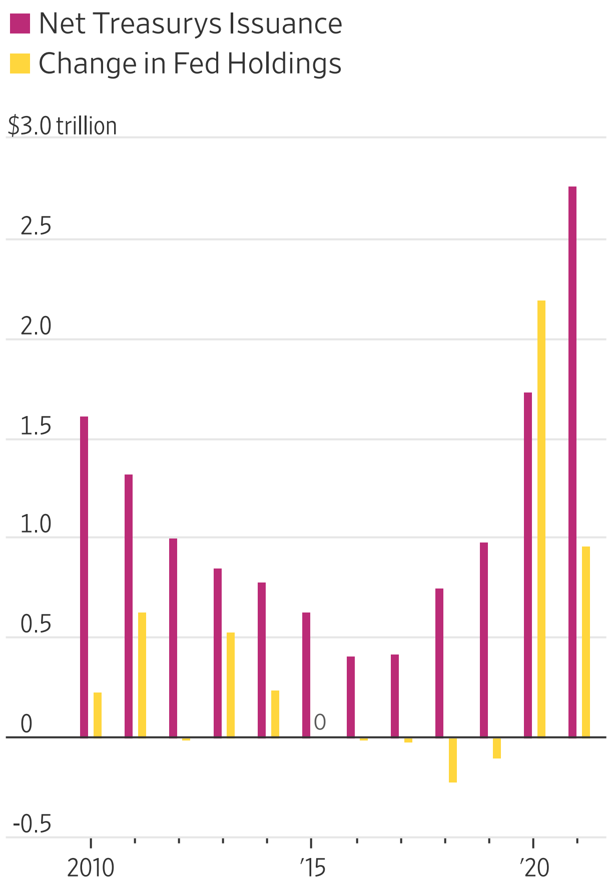
By Sam Goldfarb
Updated March 10, 2021 4:25 pm ET

Some on Wall Street see signs the U.S. government's extraordinary borrowing spree is starting to test investors' appetite for new Treasury debt.

Over the past few months, falling bond prices have pushed the yield on the benchmark 10-year U.S. Treasury note from about 1% to more than 1.5%, around its highest level in more than a year. Most investors think the climb largely reflects expectations for a vaccine- and stimulus-fueled economic resurgence that could eventually lead the Federal Reserve to raise short-term interest rates.

Another factor pushing yields higher, many analysts and traders say: the sheer volume of Treasurys now flooding the market—a byproduct of the trillions of dollars the government is spending to support the economy during the coronavirus pandemic.

Treasurys Supply Vs. Fed Buying



Source: BofA Global Research

Net new supply of two- to 30-year Treasurys is expected to reach $2.8 trillion this year, according to BofA Global Research, up from $1.7 trillion last year and around $990 billion in 2019. The Fed, meanwhile, is expected to purchase $960 billion of Treasurys, down from more than $2 trillion last year.

Supply may not be the primary factor driving yields higher. But it has been an accelerant, weighing on the market precisely because the economic outlook has already made investors hesitant to buy bonds, traders say.

“It just makes everything so much worse,” said Daniel Mulholland, a senior bond trader at Crédit Agricole. The size of Treasury debt auctions “are completely out of control,” he added.

Investors pay close attention to U.S. Treasury yields because they help determine borrowing costs across the economy. Investors generally welcome higher yields if they come about slowly and are clearly the result of an improving economy. They tend to be less enthusiastic about the type of sharp rise that has occurred this year, when other factors also seem at play.

One piece of good news for investors is that the Treasury Department may not need to increase the amount of notes and bonds it issues to fund the $1.9 trillion coronavirus relief package that President Biden is expected to sign shortly, analysts said, given its cash on hand and the size of current auctions.

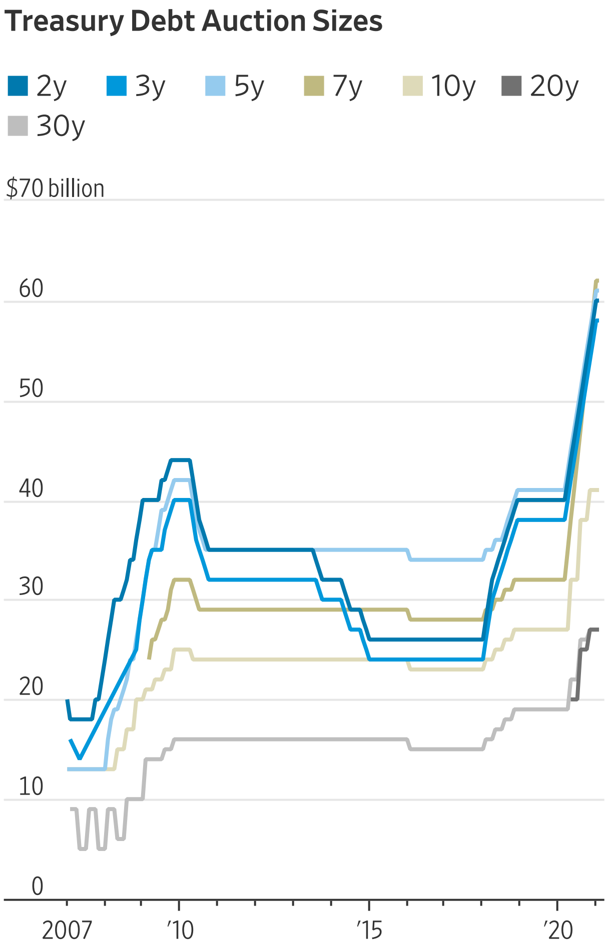
Investors, though, hardly expect any let-up in government borrowing. In recent weeks, congressional Democrats and the Biden administration have signaled interest in another multitrillion-dollar spending package to update the country's infrastructure. Investors also are on edge about the possibility that the Fed could start scaling back its monthly purchases of Treasurys once the economy picks up momentum, putting even more bonds in circulation.

The impact of supply on Treasury yields is disputed on Wall Street. Some analysts are adamant that it historically has had almost no influence on yields and that growing levels of debt could even push yields lower over the long term by dragging on economic growth.

Still, many say the current situation is unusual and could lead to different outcomes.

In the past, the U.S. has typically ramped up borrowing during economic downturns, when demand for Treasurys from nervous investors is especially strong. That makes it hard to discern any negative effect from increased supply. Now, however, markets are bubbling with optimism about the prospects for a post-pandemic economy.

Some traders and analysts say there has been a clear connection between supply and the recent uptick in yields. They point to Feb. 12, when the 10-year Treasury yield drifted above the top of its previous range of about 1% to 1.2%



Source: BofA Global Research

The Treasury Department had just sold a record $126 billion in three-year notes, 10-year notes and 30-year bonds over the previous three days. Demand was solid for the first of those two auctions but soft for the 30-year sale on Feb. 11.

Primary dealers, financial institutions that can trade with the Fed and are required to bid at auctions, were left with a relatively large share of the total—an outcome that Jefferies analysts noted at the time did "not bode particularly well for the market" given the likelihood that dealers would try to unload some of their new bonds.

Sure enough, Treasurys—and 30-year bonds in particular—fared poorly the following day. Trading volumes were relatively light for the size of the move, and analysts characterized the rise in yields as more of a buyers strike than a surge in selling—one possibly influenced by the volume of new bonds that investors had just absorbed.

Over the following weeks, yields continued to climb sharply, often with heavier trading. More large auctions arrived in the midst of the selling, including a $61 billion sale of five-year notes on Feb. 24 and a $62 billion sale of seven-year notes on Feb. 25 that analysts described as one of the most poorly received of recent decades. Those only added to the selling, with five- and seven-year yields rising nearly 0.2 percentage point during the week of their auctions—a bigger change than other Treasurys.

Investors get only short rests between auctions. The Treasury sold another $58 billion of three-year notes on Tuesday and $38 billion of 10-year notes Wednesday, with a $24 billion auction of 30-year bonds still to come on Thursday. A year ago, auctions of the same bonds totaled $38 billion, $24 billion and $16 billion respectively.

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Supply concerns aside, some investors argue that Treasury yields have climbed too far too quickly based on unrealistic expectations for the U.S. economy. The yield on the benchmark 10-year Treasury note settled at 1.520% on Wednesday, down from 1.545% on Tuesday. Yields fell in the morning after new data showed that inflation remained muted in February and were little changed after investors showed lukewarm demand for the 10-year auction.

Some investors and analysts also say the threat from increased government borrowing and supersize debt auctions might be as much psychological as it is mechanical.

Auctions like the most recent seven-year note sale are "not something we like to see," said Jim Caron, head of global macro strategies for Morgan Stanley Investment Management's fixed-income team. So far, he said, the supply of Treasurys has been manageable in his opinion, but "if we see another one of those then I think we start to get more concerned."

Write to Sam Goldfarb at sam.goldfarb@wsj.com

Appeared in the March 11, 2021, print edition as 'Wave of New Debt to Test Treasury Market.'