

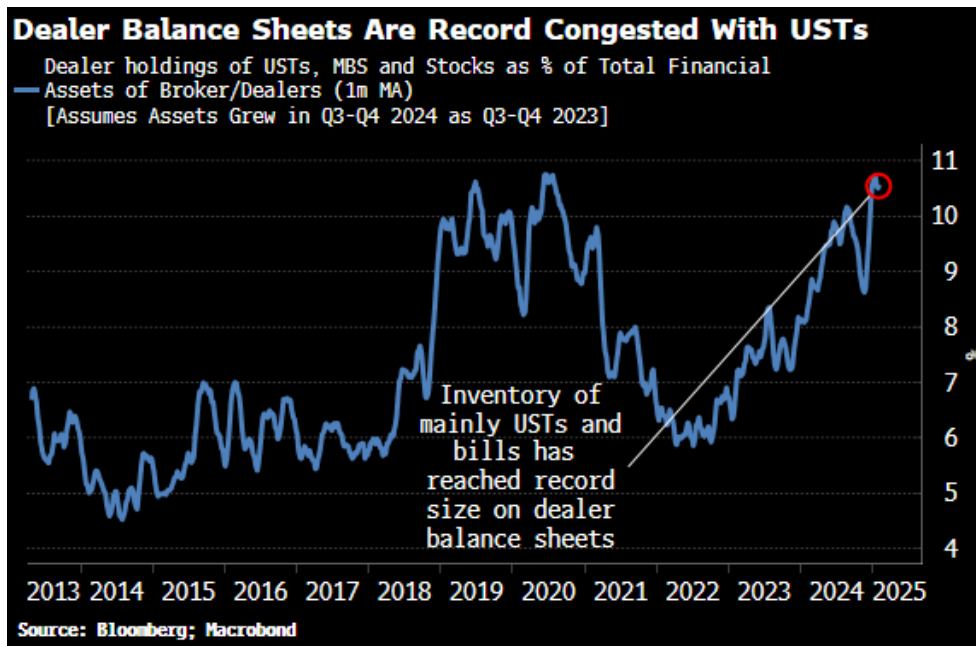
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The Treasury Market Has a Demand Problem: MacroScope

By Simon White

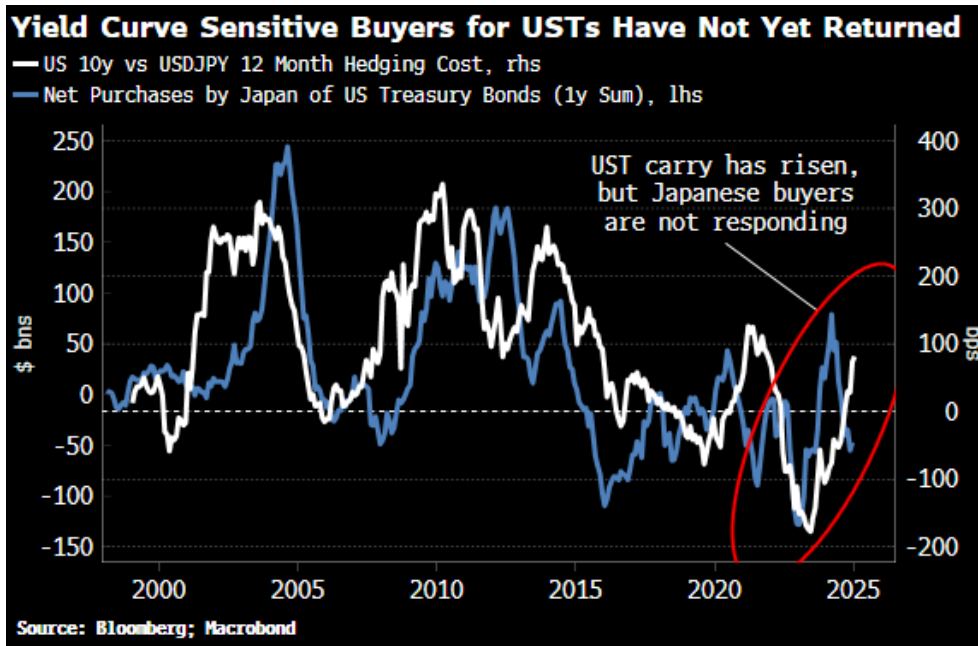
(Bloomberg) -- Deficits, inflation, political uncertainty - whatever you want to pin the blame on, US Treasuries look like they have an increasingly entrenched demand problem.

- It wasn't supposed to be like this. Buyers that can normally be relied upon to step in to the Treasury market when the yield curve disinverts have not so far done so to a meaningful degree. Two immediate impacts are structurally higher yields, and a greater risk of funding flare-ups as primary-dealer balance sheets become more congested with unsold Treasury inventory.
- The tranche of securities accumulated on dealer balance sheets - the bulk of which are Treasuries - has risen to all-time highs in outright terms and relative to the financial assets they hold.

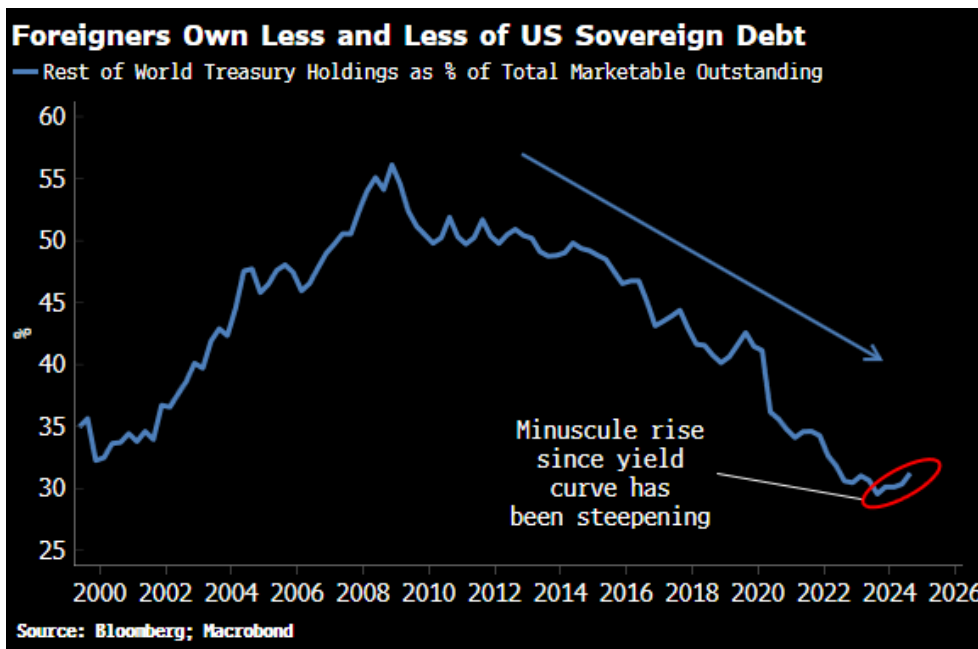


- Carry traders have not sufficiently returned to the market as the yield curves that mattered disinverted (ie those such as the 10y vs 3m and 10yr versus SOFR curves), and longer-term Treasuries began to yield more than funding costs.
- Hitherto strong sources of demand, such as Japan, have not yet come back to the extent that would have been expected. Even though the 10-year yield in the US is now about 80 bps higher than the 12-month USD/JPY hedging cost, the net annual purchase of Treasuries by the Japanese is negative after a short-lived burst higher.

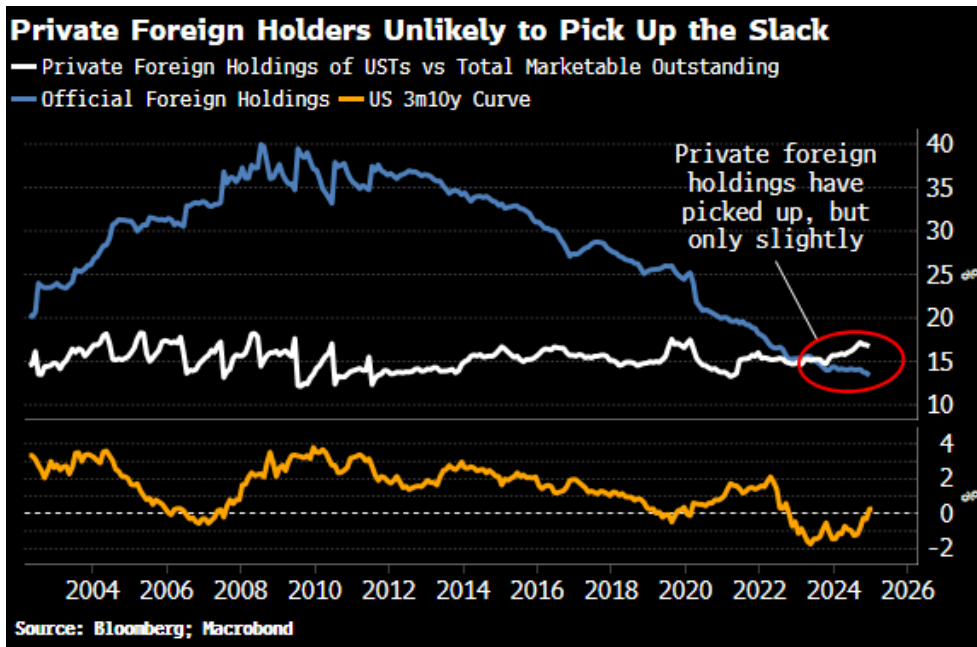
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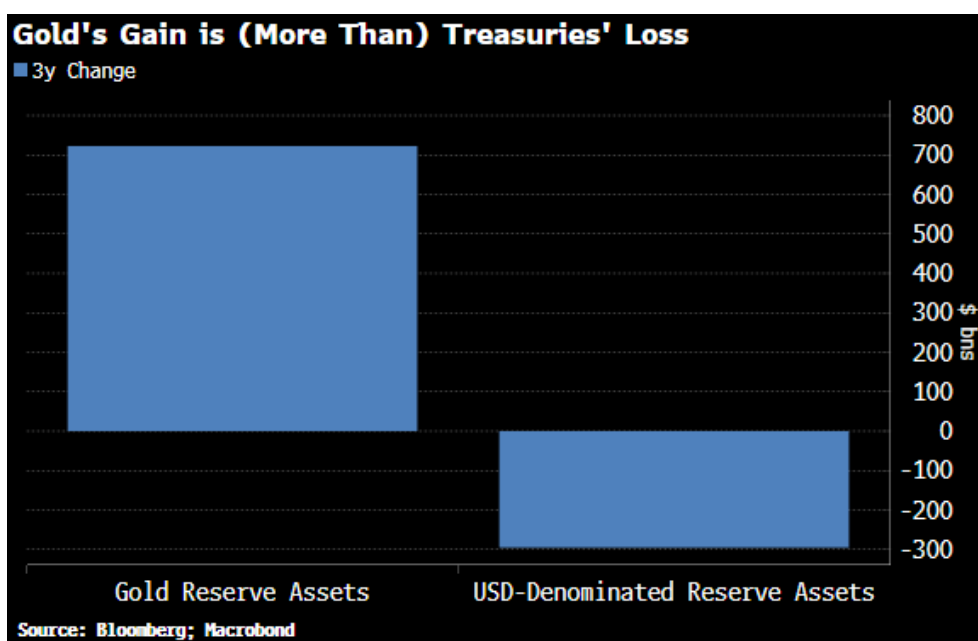
- Japan has seen the largest drop in its Treasury holdings since 2022, only beaten by China as it strives to diversify away from the dollar. Regardless of the reason, the biggest customer for US savings is currently taking a back seat.
- It's a problem not just confined to Japan. Even though purchases by the rest of the world as a whole (as of the latest data in 3Q24) have picked up in dollar terms, so has the amount of US sovereign debt outstanding. Foreigners, from owning over 50% of marketable public debt in the US, now hold less than a third, a proportion that has risen only a soupçon since the yield curve started to steepen.



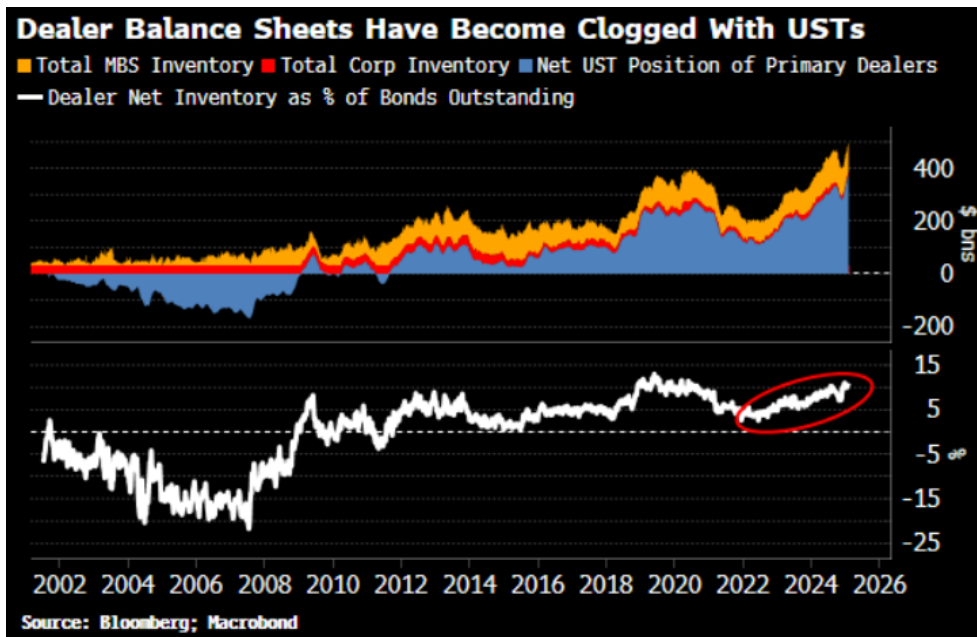
- Foreigners are losing their appetite for Treasuries – specifically, foreign central banks. Official holdings of Treasuries relative to the total outstanding have been in a steady decline since the GFC, the pace of which picked up after the pandemic. Private holdings of USTs, on the other hand, remained roughly stable until early in this decade, rising only marginally over the last three years.



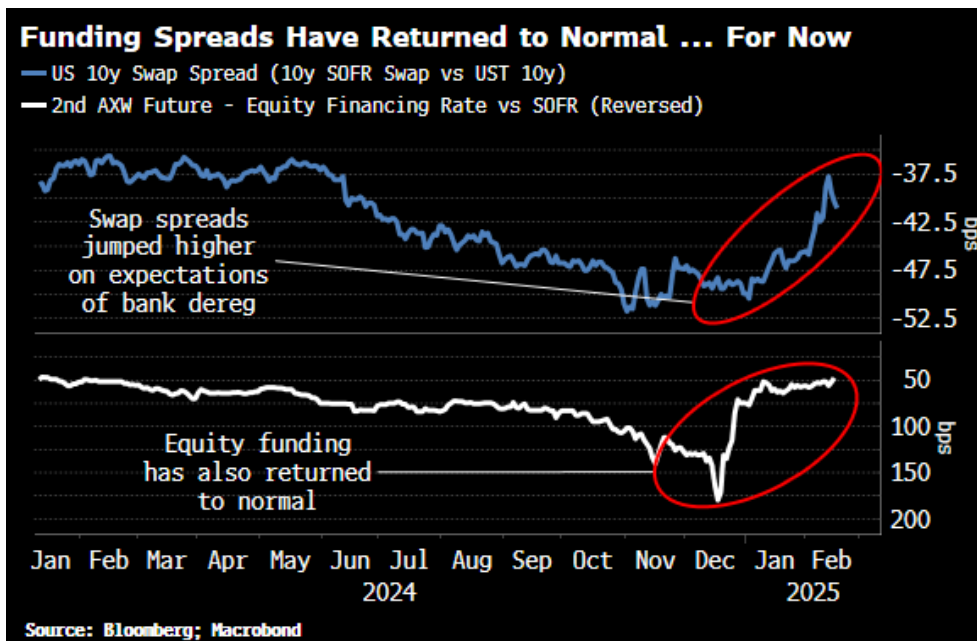
- Private foreign holders of Treasuries recently overtook official holders relative to the total debt outstanding, based on the TIC data. The question is: will private holders be able to keep taking up more slack when many emerging market countries are less willing to hold Treasuries, and many developed countries have significant borrowing of their own to undertake? With fiscal deficits around the world still elevated and Europe's defense spending about to swell, it seems more unlikely each day.
- Treasuries' loss though, is gold's gain. The flipside of their demand problem is the relentless rise in bullion, currently being fueled by a shortage of physical metal in London vaults. The breakdown in the usual inverse relationship between real yields and gold prices makes sense when one appreciates gold reserve assets have risen twice as much as dollar-denominated reserve assets have fallen since 2022.



- Perhaps the other important yield-sensitive buyers of Treasuries – US-based banks – are returning to take up the demand slack? It doesn't appear so.
- Banks typically raise the proportion of USTs they hold relative to their financial assets when rates fall, and vice-versa when they rise. So far there has been a minimal response to the Federal Reserve's recent rate cuts, unlike in 2002, 2009 and 2020 which saw notable rises in Treasury demand from banks.
- All sectors together – foreigners, banks, financials, households, corporates and the Fed – must by definition soak up all new Treasury supply. But if yield-sensitive buyers waver, the price must adjust lower until other sectors are attracted to step in – a process made more acute as one sector, the Fed, continues to shed its Treasury holdings. It's not surprising that a pause in quantitative tightening was discussed in the Fed's minutes for its meeting last month.
- One key buffer as that adjustment takes place is the balance sheets of primary dealers, who must backstop Treasury auctions. The inventory of USTs on their balance sheets had been building as the inverted yield curve made US government bonds less attractive for carry traders. But that inventory has kept rising both in asset terms (as shown in the first chart at the top) and outright, hitting new records – even as the curve has disinverted. The zeal for Treasuries is waning.



- That leaves markets at risk from funding squeezes. Various funding spreads, such as for equity total-return swaps and swap spreads, are the de facto cost of renting dealer balance-sheets to gain leverage. But if their balance sheets are congested with Treasuries, spreads are liable to abrupt flare-ups due to capacity constraints.
- This is what we saw last year, as funding for equity exposure blew out and swap spreads were becoming increasingly negative.



- Both spreads have returned to much more normal levels this year. That's likely on the back of expectations of US bank deregulation and less onerous capital requirements under a Trump presidency.
 - But that might feed the problem. Reduced demand for Treasuries from banks could leave dealers continuing to hold the bag and, ironically, lead to tighter financial conditions.
 - Once again all roads lead back to DOGE. If it can achieve meaningful savings, at the margin this may encourage some buyers to buy more US sovereign debt. But with expected odds barely more than one-in-three that the department can cut at least \$250 billion in the budget this year – still barely a pinprick in the deficit – the Treasury market is likely to have a demand problem for a while yet.
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 - Simon White is a macro strategist who writes for Bloomberg. The observations he makes are his own and not intended as investment advice. For more markets commentary, see the [MLIV blog](#)
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