بنك الإمارات دبي الوطني
Emirates NBD

Interest Rates
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Explaining Rising UST Yields

Although the 10-year US Treasury yield has fallen back below 3.0% this week, it is still close to its highest level since 2012 and more than double of where it was two years ago. On several other occasions in recent years, the yield had climbed to around 3.0% only to fall back again. However, this time around we think the yields may stay at these elevated levels for few months to come, for several reasons as discussed below.

Large New Supply of Treasuries

The annual US budget deficit is likely to exceed $1 trillion by fiscal 2020, from about $666 billion in 2017 as revenue gets reduced due to the recent tax overhaul and expenditure gets increased to fund the proposed infrastructure spending. In order to fund budget deficits, the US Government debt sales are set to swell.

The US Treasury had earlier released data showing it would need to borrow $955 billion in 2018, and more than $1 trillion in the two subsequent years. Those sums are considerably higher than last year's $516 billion in new debt issued.

Rising US Public Debt

Source: Bloomberg, Emirates NBD Research

Weakening Demand for Treasuries

In contrast, the demand for treasuries is unlikely to keep pace with the supply and in-fact may drop from the current level.

- The Federal Reserve is shrinking its bond holdings, rolling off about $250 billion of treasuries in 2018.
- Also buying by other central banks -- a pillar of support in the previous years – is likely to fade, in part as international-reserve growth stabilizes. This will put the onus on more price-sensitive buyers, such as including households, private-equity firms and trusts for wealthy individuals to fill the gap.
- Demand from regular buyers such as China is expected to ebb somewhat. The bulk of China's build-up came as it boosted foreign-exchange reserves to help offset a strengthening yuan. But the dollar taking a strengthening path this year will limit China's need for currency intervention.
- Demand from hedge funds is likely to fall as higher hedging costs in the face of rising USD will diminish their total return.

- A constructive pillar on the demand side maybe the possible increase in demand from pension funds which are trying to avoid penalties related to being underfunded and also possibly the banks that may need to hold more treasuries in order to meet their 'high-quality liquid assets' ratio requirements. However the incremental demand from these players is unlikely to be sufficient to counter balance the QE unwinding.

Ownership of US Public Debt

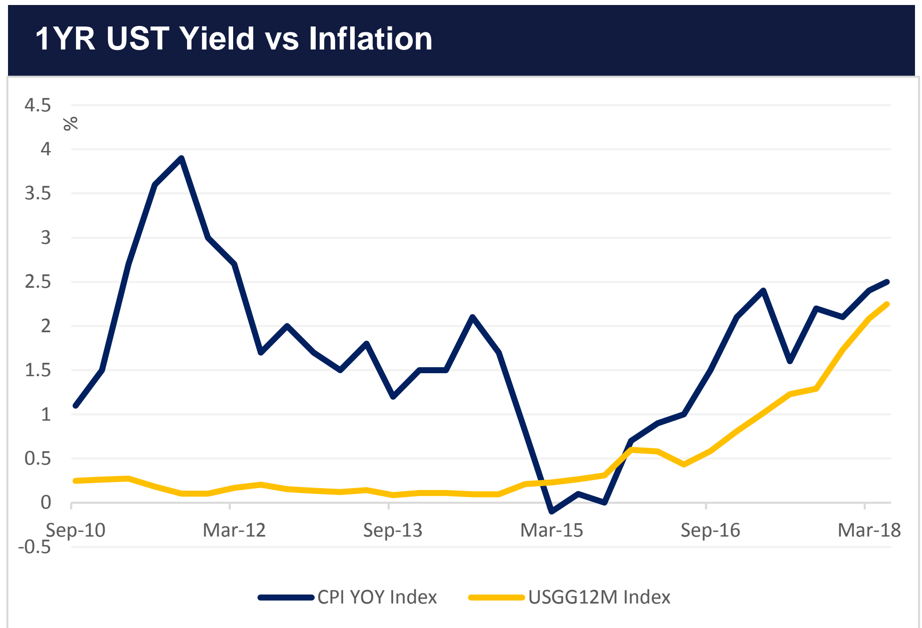
As at September 2017	USD' Billions
Fed and other Govt A/cs	8,037
Banks / FIs	605
Retail saving bonds	162
Private	531
State and local govt	913
Insurance companies	343
Mutual funds	1,651
Foreigners	6,323
Other	1,680
Total	20,245

Source: Bloomberg, Emirates NBD Research

Increasing Appetite for Risk Assets

Since 2010, the U.S. Treasury has been obtaining negative real interest rates on government debt, meaning that the consumer price inflation rate is greater than the interest rate paid on the debt. Such low rates, outpaced by the inflation rate, occur when the market believes that there are no alternatives with sufficiently low risk, or when popular institutional investments such as insurance companies, pensions, or bond, money market, and balanced mutual funds are required or choose to invest sufficiently large sums in Treasury securities to hedge against risk.

In the last decade, investors' confidence that had been shattered by the global financial crisis in 2008, was repeatedly battered by ongoing macro issues such as weak global growth, deflation fears particularly in the Eurozone, Greece debt crisis, China shadow banking fears, Russia/Ukraine war, terrorism etc. Slippery investor confidence kept the safe haven bid for US treasuries high and yields low. However, investors' fears have receded substantially in the last few quarters as the world enjoys synchronized global growth. As a consequence, appetite for risk assets has improved in the recent years.

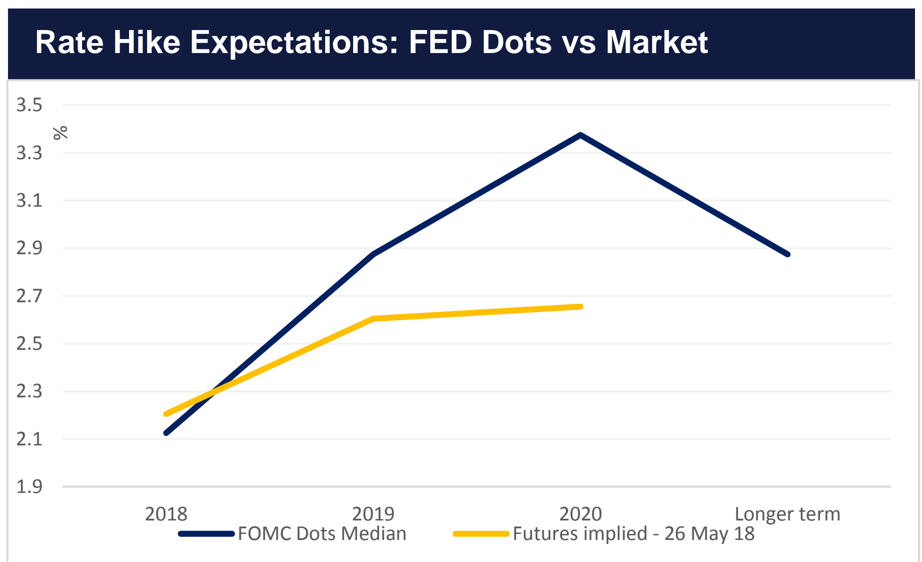


Source: Bloomberg, Emirates NBD Research

Currently while investors remain cognisant of worrisome talks about trade wars and conflicts with N. Korea, their appetite for risk has not been dented materially. In fact any relief on these two fronts will probably trigger a more noticeable increase in treasury yields.

Tightening Monetary Policy

FOMC's current target for the Fed Funds Target Rate at the end of 2018 reflects at least two more rate hikes this year followed by three in 2019.



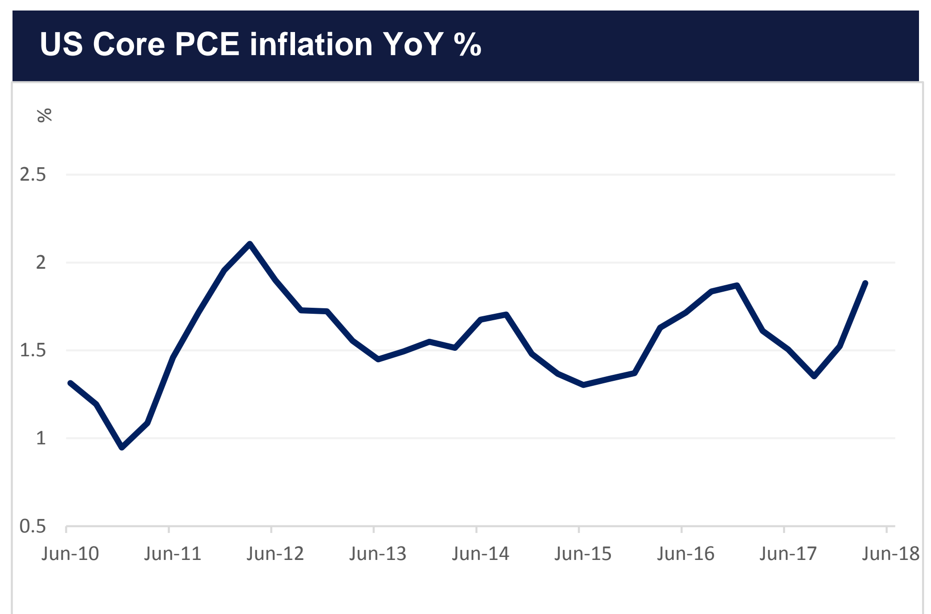
Source: Bloomberg, Emirates NBD Research

The overwhelming assumption among financial-market participants is also that the Federal Reserve will hike rates in June and at least once more this year. Even though, the Federal Reserve's May meeting minutes reflected no urgency in accelerating the

pace of rate hikes, in view of the consumer inflation showing signs of faster ascents, the risk remains to the upside.

Rising Inflation Premium

Core PCE inflation in April came in at 1.9%, a level that Fed officials had originally anticipated to be reached only by the end of this year. With unemployment falling to 3.9% and wage growth remaining healthy at around 2.6%, the expectation for inflation is to continue to rise and in fact breach the Fed's target of 2% sometime very soon. In addition, the recent U.S. tax overhaul and increased government spending budget may cause the economy to overheat and prompt the Fed to become more aggressive than anticipated in its course of interest rate hikes.



Source: Bloomberg, Emirates NBD Research

Long Term Outlook on Yields

Theoretically, all things being equal, yield on longer dated USTs should begin to stabilise at about mid-point in any rate hike cycle. We expect this point to be reached sometime in the first half of next year. The US economy has had more than nine years of expansion and may be nearing a point of inflection. The negative impact of rising rates and tightening financial conditions should begin to have its effect on the economy within the next 12- 18 months.

The current yields rise could also deaccelerate if US Treasury decides to issue long term bonds thereby alleviating short term supply. In early May, Steve Mnuchin, the treasury secretary, had set up an internal working group to take a look at ultra-long bonds. However, this may face internal opposition as it will increase the cost of servicing the debt. Currently, the weighted average maturity of outstanding Treasury debt is estimated at 5.7 years, and the effective interest rate paid on the total pile of debt is at less than 2.5%. The yield on 30-year Treasuries is over 3.05%, so selling longer-dated debt will raise the overall cost. Even a 0.1 % rise would add roughly $14bn to the government's expense.

In view of all factors discussed, we expect 10yr yield to remain range bound between 2.75% to 3.5% for few years to come.

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