American Treasury bonds

Among the missing

Oct 6th 2005 | LONDON AND WASHINGTON, DC
From The Economist print edition

Behind the Treasury-bond market's recent ups and downs

THE Federal Reserve took to the pulpit in force this week to preach against the dangers of inflation. On October 3rd, the president of the Atlanta Fed gave warning that monetary tightening still had “a way to go”. The next day, his St Louis counterpart said the futures market was “reasonable” to price in the near-certainty of two more rises in the fed funds rate this year. The heads of the Dallas and Philadelphia Feds railed separately against inflation.

They almost managed to scare bond yields much higher. Ten-year Treasury yields touched 4.4%, on October 3rd, their highest in almost two months. News that input prices had risen sharply in manufacturing added to the gloom. Investors then broadly regained their nerve and despite more bad news about prices, this time in services, yields ended October 5th at 4.34%. That was still far above the 3.98% that they hit just after Hurricane Katrina.

What really drives yields? Fed-watching matters a lot at the shorter end of the spectrum. And concern about inflation is arguably the main determinant of long-bond yields. But the appetite of foreigners and especially foreign central banks—many of whom, the theory goes, have to buy Treasuries willy-nilly—has played a big role. What is pushing yields now: a reservoir of foreign official buyers desperate to recycle surplus trade dollars at any price, or the economic fundamentals, expectations, and law of supply and demand that drive most markets in most places?
The question has taken on a new urgency with what looks like the fading of foreign central banks' interest in Treasuries. Purchases by Asian banks, in particular, shot up in 2003 and 2004, financing America's fast-growing deficit. While official reserves are still piling up, foreign central banks' buying of Treasury bonds has plunged as the chart shows.

That is partly because the banks are getting nippier at managing their portfolios. They have been buying more of other things, mainly higher-yielding bonds issued by government-backed agencies such as Fannie Mae, the mortgage giant. Some, too, are choosing to buy in the secondary market abroad, which shows up in private rather than official flows.

This may be especially true of many OPEC countries, including those, such as Kuwait, with national wealth-management funds. (Just how the oil-exporting countries are deploying their soaring surpluses—some $400 billion this year, more, on the IMF's figures, than the surpluses of Asia's main economies—is far from clear, but their holdings of Treasuries are declining these days, says Bulent Baygun, head of US fixed-income strategy at Barclays Capital.) On October 5th it emerged that Venezuela, perhaps for political reasons, had apparently transferred as much as $20 billion—most of its reserves—out of Treasuries and out of America.

Indirectly, central banks' diversification out of dollars may also be boosting private-sector demand for dollar assets. Moving more into euros, they are helping to push down yields in Europe. Private investors there are eyeing Treasuries with greater enthusiasm: the yield on the ten-year is now 1.2 percentage points above that on German bunds, the most since 2000. And the dollar has stayed stronger than almost anyone imagined. So while foreign official purchases of Treasuries fell in July, private flows increased sharply.

How much have central banks—and foreigners in general—kept down interest rates for the world's biggest borrower? Economists disagree. Alan Greenspan, the Fed's chairman, has suggested that the effect of official flows is “modest”. Brad Setser and Nouriel
Roubini, of Roubini Global Economics, a consultancy, reckon that central-bank buying at its peak could have dampened Treasury yields by up to two percentage points. And a new paper by Francis Warnock and Veronica Caecac Warnock, of the University of Virginia, published by the Fed, finds that if foreign central banks had bought no Treasuries over the past year, ten-year yields would be 60 basis points higher. If all foreigners had boycotted American bonds, the increase would be 1.5 percentage points.

Gerald Lucas, Bank of America's chief Treasury strategist, thinks the Warnocks' estimates are “exaggerated”. He reckons that the Fed's credibility as a dedicated inflation-basher has a lot to do with why long-term yields are low. The remarks by the tub-thumping quartet of Fed presidents will have done nothing to dispel it.

A curious new trend in the eurodollar-futures market, however, hints that interest-rate hikes may end sooner than most assume. Alex Patelis, of Merrill Lynch, points out that the market has begun to price three-month money two years from now more cheaply than three-month money in a year's time. There have been only four such inversions in 20 years, he says—and three were followed within two months by the end of a rate-tightening cycle. Is the market betting that Mr Greenspan's successor will be less hawkish than he has been?