MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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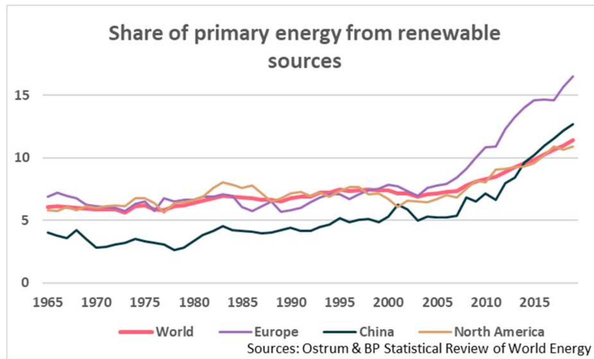
Topic of the week: who want to buy billions (of Treasuries)?

- **With the Biden plan, the US deficit is expected to be around 4 trillion dollars this year, and then 1 trillion a year over five years according to the COB.**
- **Who is going to buy this upcoming Treasury tsunami? Foreigners have not been net buyers for several years. Domestic demand is unlikely to be large enough.**
- **Remains one actor: the Fed. This suggests that QE will be extended and that the Fed will act as a "buyer of last resort". If that is the case, it will also, to a large extent, set the prices.**

Market review: Markets test the Fed

- **T-note yields briefly breach 1.60%**
- **Nasdaq takes a 5% hit, as greenback rebounds**
- **Oil continues higher ahead of OPEC meeting**
- **Credit proves resilient**

Chart of the week



Mega-trend in the world economy: After remaining stable between 1965 and 2000, the share of renewable energies has steadily increased in the world since the beginning of this century.

The good student on this chart is Europe, the highest level (16.5% in 2019) and the strongest progression (+8.7% since 2000).

But we must not forget China, which has more than doubled its share of renewable energy since 2000, a share that has grown over this period twice as fast as in the rest of the world. If China's carbon footprint continues to grow, the carbon intensity of growth collapses. China is close to reversing the trend.

Figure of the week

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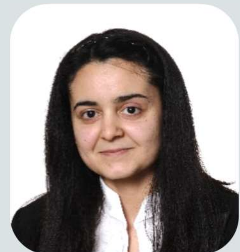
Source : Ostrum AM

The coupon paid on the 5-year note issued by Italy last Thursday. A first.
We previously talked about the shrinking Italian debt service. Here's a concrete example.

Stéphane Déo
Head of markets strategy

Axel Botte
Global strategist



Zouhoure Bousbih
Emerging countries strategist

Aline Goupil- Raguénès
Developed countries strategist

● Topic of the week

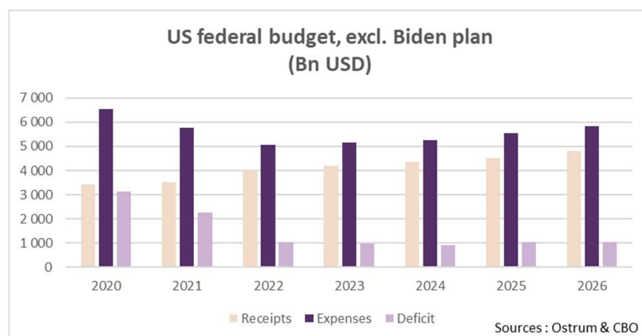
Who want to buy billions (of Treasuries)?

The colossal US budget deficit will result in a record issuance of debt. We look at the other side of the equation: who is going to buy these billions of future debt? The answer is simple, it seems that the Fed, whose balance sheet may extend without limit, will be forced to do the heavy lifting. So, it will also set the prices.

An abysmal deficit to fund

It is worth keeping in mind that despite a very dynamic economy, the Trump administration had put in place an ambitious fiscal stimulus that had deepened the deficit long before Covid-19.

The Congressional Budget Office, is a federal agency that makes reference in terms of budget analysis. It recently released a fiscal roadmap update for the U.S. federal state (see "The Budget and Economic Outlook: 2021 to 2031" February 11, available at: https://www.cbo.gov/publication/56970). The Bureau expects a deficit of 2,258 billion in 2021 after 3,132 billion in 2020. But these figures were calculated on the basis of legal provisions passed up to 1 February of this year. They do not include the $1,900 billion in the Biden stimulus package, which would push the deficit to around $4 trillion.



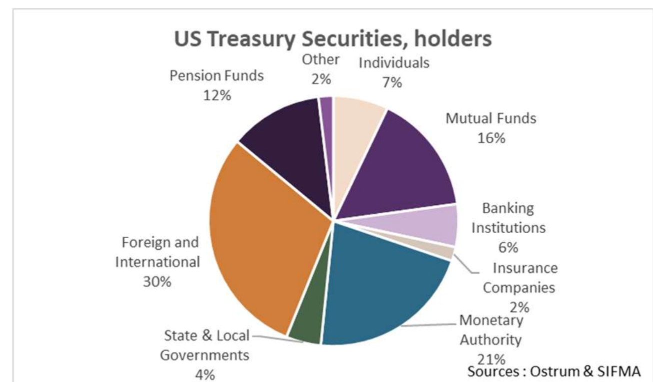
It should also be noted that the deficit does not disappear afterwards; there is almost $1,000 billion a year on average over the next five years. So, it's a total of $9,000 billion over six years that must be funded. Crazy figures, to give an order of magnitude recall that the GDP of the United States in 2020 was 21,000 billion.

So, this is a very substantial amount of money to be funded by the federal government.

To be complete however, it should also be noted that the US Treasury has a liquidity deposit at the Fed of more than 1,500 billion dollars. It is, de facto, the current account of the US Treasury where it retains its liquidity. This amount is abnormally high and the new Secretary of the Treasury, Janet Yellen, wants to use this cash. This is about $1 trillion in deficit that is pre-funded and has to be taken out of the issuance projections. It's a long way from total, but it's still that.

Let us sum up: a deficit with the Biden plan of 4 Tr dollar this year but with 1 Tr pre-funded is therefore 3 Tr of financing need, an order of magnitude close to last year. Then 1Tr a year over five years according to the COB.

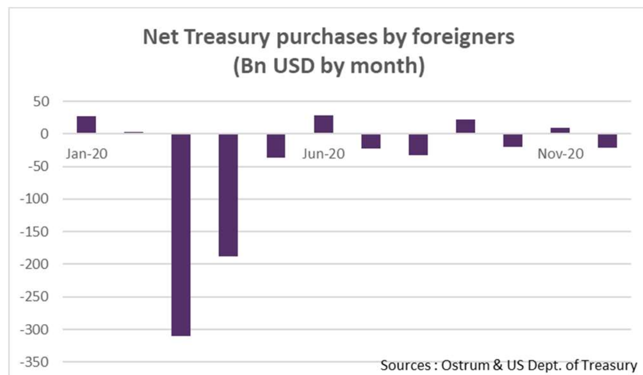
You're going to have to find "deep pockets" as they say on Wall Street to absorb all that paper. In the meantime, and according to SIFMA data, the holding of 24,026 billion US Treasury securities was distributed as follows at the end of September 2020.



Foreigners don’t want it anymore

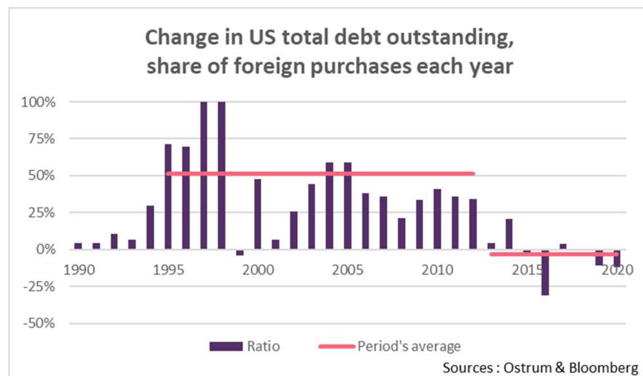
First candidate to absorb this supply: foreign investors.

The US Treasury provides, on a monthly basis, the “TIC”. These are data on purchases and holdings by foreigners of fixed income products including Treasury. Unfortunately, the data do not send a very comforting signal. Over the last year foreigners were net sellers to the tune of 540 billion. Certainly, this figure owes much to the massive (and totally unusual) sales of March and April when foreign investors needed to realize their assets in dollar on the wake of the Covid crisis.



Over a longer period of time, however, we get a very similar signal: an indisputable lack of appetite from foreigners. While foreigners absorbed 50% of the net supply of federal paper between 1995 and 2012, the proportion has since fallen to zero. Over the period 2015-2020 they are even net sellers, albeit marginally so. As a result, the holding of federal debt by foreigners has decreased, according to our calculations, from 35% of the total in the middle of the last decade down to 25% in December 2020.

Since 2015 foreigners have been net sellers of Federal debt.



Unless there is a marked and lasting change in the attitude of foreigners, it is therefore unlikely that they will absorb a significant part of the future supply.

American private investors?

First candidate to buy all this paper, banks.

Banks holdings of Treasury securities have increased by more than $750 billion over the past five years. Unfortunately, if this is an interesting candidate, the graph below shows the problem. The banks did buy a lot of government securities, and they are now a very significant part of their assets.

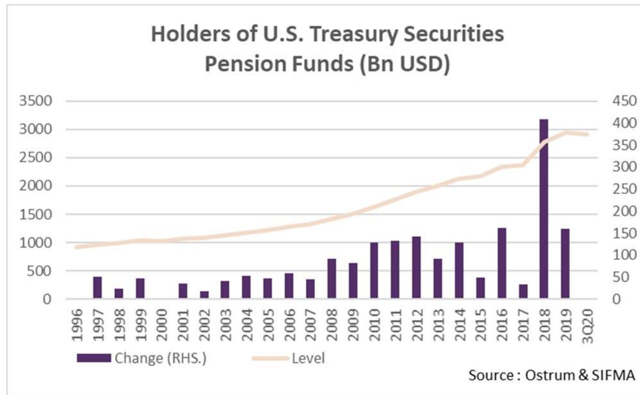
They’re very unlikely to want to increase that much more. The buying will likely calm down.

Let’s try the pension funds.

Essentially, it’s the same story. Pension funds hold a significant share of issued securities, they as well increased their holdings by more than 700 billion over the last five years. Unfortunately, here too the prospects are not very encouraging.

We have to go back to the history of U.S. pension funds over the past decade. Following the great recession at the beginning of last decade many of these funds ended up with a coverage ratio for their liabilities of less than 100%. Many took active bets on the equity markets which enabled them throughout the decade to improve their coverage ratio. As a consequence, a large number of these funds locked their gains and switched back to fixed-rate products, mainly long (or equivalent) Treasuries. This explains in particular the jump of 2018.

But if this story is true, Treasury’s detention is high and would not have a tendency to increase much further.



Remains one actor: mutual funds

They are indeed the largest private domestic holders since they own 16% of the debt as shown in the pie chart on the previous page.

Domestique private demand doesn't seem to be enough to swallow the tsunami of issuances.

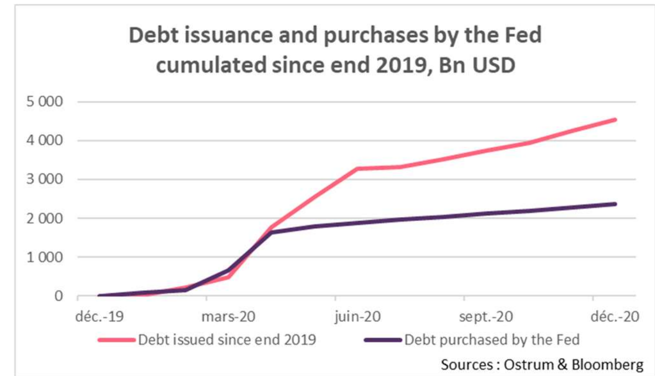
Mutual funds purchases are much more volatile over time but accounted for over $1 trillion in the first three quarters of 2020. We were talking earlier about the $1.5 billion in cash deposited by the Treasury to the Fed, and if that cash is actually used, it will come back into the economy, and it is very likely that some of it will be saved in the form of mutual funds. Not only have purchases been dynamic, but we can therefore reasonably expect that the trend can continue into 2021.

All this nevertheless leaves us far from the 3 Tr necessary to fund the needs of the Federal state this year. The domestic demand for Federal paper has been sustained in recent years but for reasons that do not seem to us to be really permanent. It is rather difficult to imagine that these actors will be able to absorb the tsunami to come.

Conclusion: the Fed, buyer of last resort

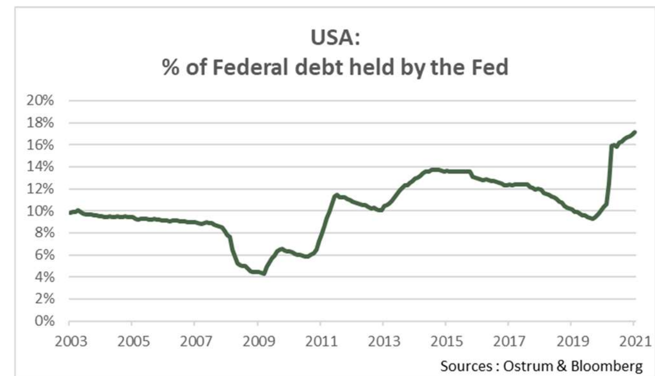
So there is only one actor left: the Fed. The good news is that the Fed has an infinitely expansible balance sheet, which makes it the perfect candidate to swallow said tsunami.

Going back to last year, U.S. debt increased by $4,546 billion, Fed debt holding increased by $2,360 billion. So the Fed bought just over half of the net issue over the year. However, after an orgy of purchases in March-April, almost 1.5 Tr in two months, the pace slowed down thereafter. In the second half of the year, the proportion of purchased by the Fed fell to 38%.



The Fed is therefore by far the most important marginal buyer.

As a result, the Fed's share of sovereign debt holdings rebounded, reaching 17.2% at the end of January 2021. A record.



The solution is probably there. The debt will be absorbed, for the most part, by the Fed. At a minimum, the Fed will be the main marginal buyer not only this year but probably the following years as well. In other words, it is hard to imagine an end to QE this year. An extension over the following years seems more than plausible.

Another conclusion is that if the Fed is the marginal buyer, it will also set the marginal price.

Stéphane Déo

Market review

Markets test the Fed

T-note yields hit 1.60% triggering a sharp correction in Nasdaq. Greenback bounces whilst credit proves resilient.

Tensions in US rates markets remain determining factors for risk assets. On Treasury markets, February 2021 has turned out to be the worst month in terms of total returns since January 2009 (-2.73%). Treasury note yields accelerated to the upside to a 1.60% high on Wednesday sparking a correction in Nasdaq. Despite a pullback in yields last Friday, nervousness continues to prevail across markets. The peak in yields coincided with the weekly low in the US dollar. Greenback remains *the* risk aversion barometer. The dollar rebound, which is traceable to higher US real yields, is jeopardizing the rush for cryptocurrencies and highly valued growth stocks. Furthermore, risk-parity fund managers, whose allocation is derived from relative risk measures across asset classes have been hit by the concomitant sharp rises in bond and equity volatilities, which also fostered dash for cash. The equity drawdown may now impact credit markets. The perception of monetary tightening may ignite a homothetic shift in rates and then spreads. For the time being, credit markets have weathered tensions in risk-free yields.

The argument linking the US equity correction to rising yields is likely to remain valid this week but the market narrative may include incoming economic data. ISM manufacturing points to a solid industrial cycle resilient to climate events and oil output disruptions. Crude prices rose last week (brent $64) ahead of the OPEC meeting. The cartel had vowed more active output management in response to price changes and output increase appears fully justified at present. Political tensions between Saudi Arabia and the United States risk weighing on the Kingdom’s decision. Meanwhile, US consumer spending rose at a solid 2%m pace in January. PCE deflator inflation accelerated to 1.5%. The housing sector continues to expand with strong new home sales and price gains exceeding 10% over the last 12 months. Durable goods orders confirm a pickup in business investment spending. This bodes well for employment going forward. Vaccination however remains key to bring down unemployment in the sectors hit hardest by the pandemic.

In terms of market strategies, elevated rate volatility reflects the difficulty of Central Banks to maintain financial repression policies in the face of higher inflation and stronger economic growth. A cautious stance may be warranted for a time. Short covering towards the end of last week may be traceable to duration adjustments and month-end window-dressing. Financial markets will continue to test the Fed’s commitment to let consumer price inflation drift higher. The observed deficit in central bank credibility appears to be resulting from priori calls for bold fiscal action to take the baton from monetary policy stimulus. For this reason, its is highly dubious that the Federal Reserve will be able to maintain status quo on rates until 2023. Medium-term maturities are most at risk (5-7 years). Indeed, weakness in investor demand at the latest 7-year bond auction only highlights the dilemma that the Fed is facing. The US government bond deal ‘tailed’ by as much as 4bp, an unheard-if gap since 2013. The yield curve also changed dynamics. The volatility spurt favored implementation of long-end flatteners. The 5s30s yield spread brutally shrank last week by more than 20bp, which is fully consistent with the stabilization in long-term inflation expectations even as oil prices moved higher.

In the euro area, the ECB did intervene verbally to rein in yields. Weekly bond buying data (on the week to last Wednesday) do not fully grasp ECB action as it lacks details in country allocation and duration of bonds purchased. Yet it is worth keeping in mind that the flexibility of APP and PEPP facilities allows for targeted ECB market operations as tensions arise. Bund yields traded up to a -0.20% high and the yield upturn initially led Italian 10-year spreads back above 100bp mark. Italy may lunch its inaugural green bond deal this week. Germany will follow with a 30-year green Bund offering in May.

The increase in bond yields has ignited asset allocation reshuffling among final investors. In the US and Europe alike, credit funds, emerging bond funds and high yield funds have all recorded outflows. Credit spreads have nevertheless proved resilient in the past week. Indeed, Euro investment grade bond spreads rose 3bp vs. Bunds to 89bp. High yield underperformed slightly (+6bp) but the bulk of the February rally (-34bp last month) remains intact.

Equity markets took a turn for the worse last week. The Nasdaq index plummeted by a whopping 5% whilst the energy sector turned in the only positive return last week. VIX shot higher to 30% and up three times last week. In the euro area, yield curve steepening benefitted banks which are now up some 20% from a month ago compared with just 3% for the broad Euro Stoxx market gauge. Basic resources and cyclical sectors fared relatively well against the backdrop of a stronger dollar. Lastly, the weaker Japanese yen (107 against the US greenback) sparked a sharp bounce in the Nikkei. The Japanese stock market is amongst the best performers in 2021 posting an 8% advance compared with 1.5% for the S&P 500, 3.5% for Euro Stoxx and 2.3% for the Shanghai composite.

Axel Botte

Main market indicators

G4 Government Bonds	01-Mar-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.69 %	0	+4	+1
EUR Bunds 10y	-0.34%	+0	+18	+23
EUR Bunds 2s10s	35 bp	+1	+15	+22
USD Treasuries 2y	0.13 %	+2	+2	+1
USD Treasuries 10y	1.44 %	+7	+36	+53
USD Treasuries 2s10s	131 bp	+5	+34	+52
GBP Gilt 10y	0.75 %	+7	+43	+56
JPY JGB 10y	0.16 %	+3	+10	+13
€ Sovereign Spreads (10y)	**01-Mar-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	24 bp	-1	+0	+1
Italy	99 bp	+6	-14	-12
Spain	66 bp	-1	+5	+4
Inflation Break-evens (10y)	**01-Mar-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	101 bp	+7	+4	-
USD TIPS	218 bp	+2	+9	+20
GBP Gilt Index-Linked	337 bp	+9	+26	+37
EUR Credit Indices	**01-Mar-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	89 bp	+3	-2	-3
EUR Agencies OAS	39 bp	+0	-2	-2
EUR Securitized - Covered OAS	29 bp	-1	-3	-3
EUR Pan-European High Yield OAS	318 bp	+6	-30	-40
EUR/USD CDS Indices 5y	**01-Mar-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	49 bp	+0	-3	+1
iTraxx Crossover	249 bp	-1	-18	+8
CDX IG	53 bp	+1	-2	+3
CDX High Yield	295 bp	-4	-21	+1
Emerging Markets	**01-Mar-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	359 bp	+13	0	+7
Currencies	**01-Mar-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.205	-0.94	-0.16	-1.42
GBP/USD	$1.394	-1.02	+1.92	+2.11
USD/JPY	¥106.66	-1.51	-1.56	-3.15
Commodity Futures	**01-Mar-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$64.8	$0.5	$8.7	$13.0
Gold	$1 736.2	-$73.1	-$128.7	-$158.2
Equity Market Indices	**01-Mar-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 895	0.48	3.21	3.70
EuroStoxx 50	3 705	0.15	4.95	4.30
CAC 40	5 795	0.48	6.10	4.39
Nikkei 225	29 664	-1.18	5.60	8.09
Shanghai Composite	3 551	-2.50	1.32	2.26
VIX - Implied Volatility Index	23.65	0.85	-21.79	3.96

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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