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Who Will Buy All Those Treasuries in 2018?

By
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Even before President Donald Trump signed the tax bill into law, the Treasury Department was expected to significantly boost the sale of Treasury securities in 2018.

Wells Fargo economists expect the Treasury to issue about $1 trillion in new securities annually in 2018 and 2019—more than double the amount in 2017.

All else being equal, more supply should mean lower Treasury prices and higher yields. But as usual, there's more to this picture. While additional supply could indeed be a factor that contributes to a modest rise in yields, some market watchers see reasons for investors probably being eager to step in and absorb added supply without major hiccups.

Passive bond investors could be among those underappreciated sources of demand, says David Ader, chief macro strategist at Informa Financial Intelligence.

While the switch from actively to passively managed equity funds gets a lot of attention, the same phenomenon is also occurring in the bond world. When a stock is added to a widely followed equity index, index investors who must match its exposure will increase demand for the shares. The same idea applies to a bond index. The more Treasurys that are issued, the more weight Treasurys have in closely followed bond indexes.

Ader also expects the average maturity of the Treasury market to rise further, despite the Treasury Department's stated desire to maintain it near its current level. "So, not only will there be more Treasurys in the index, but those Treasurys will have a longer duration or average maturity," he says. "So index-oriented investors will have to buy, and I think that's part of the demand we're seeing for the Treasury market."

On a side note, he says, CEO surveys indicate that companies are likely to pay down some debt in the wake of the corporate tax cut, which would increase the weighting of Treasurys in aggregate indexes relative to corporate debt.

Domestic households and a wide range of institutions hold a large chunk of outstanding Treasurys. Over the past five years, households and banks, in particular, have seen robust growth in their Treasury holdings, helping to absorb some of the new supply that has come to market, writes Jay Bryson and Michael Pugliese, the Wells Fargo economists, in a note.

Bank Holdings of Treasury debt rose from $212 billion in the second quarter of 2012 to $479 billion in the second quarter of 2017, a 126% increase, they note.

New bank regulations, including the liquidity-coverage ratio that requires banks to significantly boost holdings of safe, highly liquid assets like Treasurys, probably played a role, Bryson and Pugliese note. They also observe that many banks appear to have largely satisfied their requirements.

"If bank holdings of Treasury bills, notes, and bonds return to a more normal growth rate over the next few years, the softening in demand would occur at a time when the new supply from the Treasury Department is beginning to ramp up," they write.

Foreign buyers, including central banks, stepped up purchases in 2017 but may be unlikely to extend themselves further. That leaves U.S. households as the "most obvious" candidate to absorb much of the new supply, they say, while worrying that a falling savings rate and a quick ramp-up in issuance could test their ability to do so.

But Ader and others also see scope for pension funds and institutions worried about stretched valuations for equities and other risky assets to boost allocations of Treasurys TMUBMUSD10Y, +2.10%

A modest rise in yields would probably be met with additional demand from pension funds and insurers, says Steve Blitz, chief U.S. economist at TS Lombard. "Everyone is looking for duration and looking for yield to match up against long-dated liabilities," says Blitz.