Foreigners Avoid US Treasuries, USD Shrugs

Data shows foreign investors are turning their backs on US Treasury debt. Foreign holdings of US government bonds have barely increased in the past year and traditionally strong participants in US bond markets (China and Japan, for example) have actually reduced exposure to US sovereign debt in outright terms over the past few years. This is not, we feel, a reflection of heightened concern about the trajectory of US fiscal policies—though that is not to say it is not (or won't become) a worry for foreign investors—and we do not think the trend represents any immediate threat to the USD.

The US keeps adding to its federal debt pile. Rising nominal debt levels did not register in President Trump's State of the Union speech this week and the President's Chief of Staff and budget chief Mick Mulvaney—very much the deficit hawk whilst serving in Congress during the Obama era—reportedly told Republicans being briefed on the State of the Union speech that "nobody cares" about the deficit any more—echoing former Vice President Cheney's axiom that "deficits don't matter". Except when they do—or when you are the opposition party.

Of course, the overall share of US government debt relative to the size of the economy has grown moderately in the past few years, reaching 105% or so in 2018 after rising more abruptly in the wake of the US financial crisis. And, in truth, government deficits in much of the rest of the world are reaching eye-watering levels. The US is not alone in running high and somewhat concerning levels of government debt.

The surprising development with regard to the US debt market in the past two or three years specifically is the fact that foreign investor participation has dwindled. At the end of 2007, foreigner investors held a little less than 40% of the US Treasury debt float. That proportion has dropped to around 35.5% in the latest data. Indeed, foreign buyer participation in US Treasury auctions through late 2018 was remarkably weak.

Instead, domestic buyers are stepping in to buy US government bonds in a meaningful way. Excluding the Fed's purchases, domestic investors have increased holdings from near 49% of Treasury debt outstanding to a little more than 51% since 2007. These changes do not look significant as a share of overall debt but clearly reflect a meaningful shift in investor behavior over the last few years. Domestic investors include insurance companies and household name asset managers as well as US corporate Treasury functions which—over the past year especially—have repatriated investments previously held overseas.

There are some obvious reasons for the decline in foreign appetite for US bonds; Asian central banks have been less active in managing domestic currency appreciation and might have had to act to stem domestic currency weakness in some cases in recent years. Less reserve accumulation means less recycling of purchased USDs into US government debt. Also, the Russian central bank liquidated a large portion of its (relatively small) Treasury portfolio last year.

Another important reason reflects the rise in short-term rates, the flattening of the US yield curve and low interest rate regimes overseas, we think. Foreign bond investors typically use rolling 3M FX forward contracts to hedge the USD risk in their bond portfolios. Rising short-term US rates have increased the cost of hedging against USD depreciation and hedge-adjusted returns (for both EUR– and JPY-based investors, for example) have fallen dramatically over the past five years. Hedge-adjusted returns are, in fact negative currently (around –35bps for a 10Y bond hedged back to both EUR and JPY).

Fading foreign interest in US Treasuries over the past few years has coincided with

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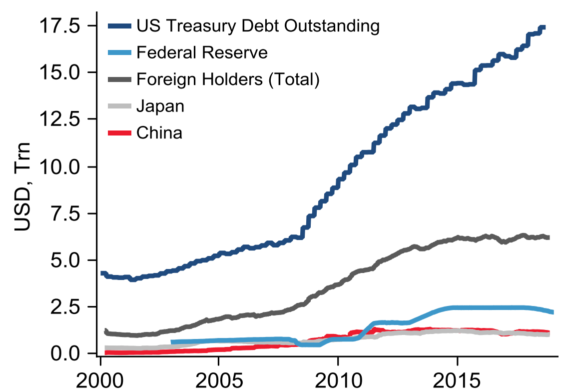
Shaun Osborne
Chief FX Strategist
461.945.4538
shaun.osborne@scotiabank.com

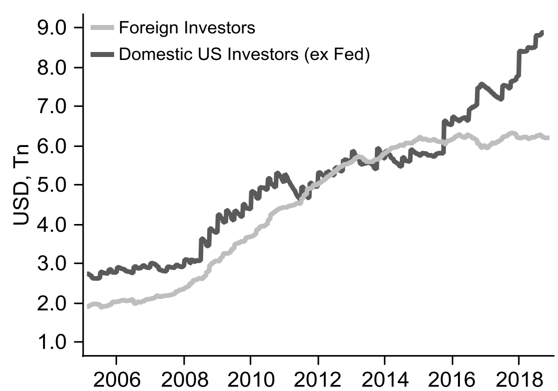
Eric Theoret, CFA, CMT
FX Strategist
416.863.7030
eric.theoret@scotiabank.com

Who's Buying US Treasuries?



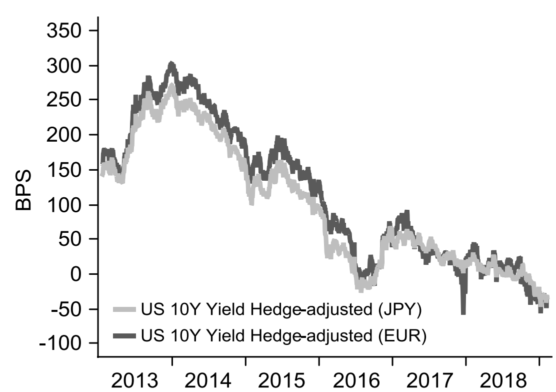
Source: Macrobond, Scotiabank FICC Strategy

Domestic Asset Managers Step Up



Source: Macrobond, Scotiabank FICC Strategy

Rising FX Hedge Costs Diminish UST Appeal



Source: Macrobond, Scotiabank FICC Strategy the decline in hedged returns to near – or less than – zero. Better (hedged) returns for Japanese investors are currently available in Eurozone bonds, for example.

Weaker foreign interest in US Treasury bonds is notable but is not something that the USD should find especially troublesome at the moment. That's because the decline reflects—in our opinion—non-fundamental factors such as 1) reserve management trends 2) unappealing, hedge-adjusted returns. Shifting demand patterns among domestic market participants have offset weaker foreign interest thus far. We remain firmly of the opinion that accumulated and combined (current account and budget) deficits do represent a threat to the USD in and of themselves in the medium to longer run, however.