DoubleLine®

U.S. Treasury Market Update

July 2021

The second half of 2021 began with a continuation of the strong second quarter rally in the U.S. Treasury market. This performance stands in stark contrast to the first quarter when the yield on the 10-year note rose 83 basis points (bps) as the Treasury market priced in a strong rebound in U.S. economic growth and the prospect of higher inflation. Despite little change to measures of growth and inflation in recent weeks, there has been a sentiment shift and upheaval in positioning on the long end of the Treasury market after the June 16 Federal Open Market Committee (FOMC) statement. In DoubleLine's view, the Treasury market, particularly the long end of the yield curve, tends to reflect economic fundamentals over the long term. Over the short term, the market is prone to overshoot fundamentals due to technical factors.

One such technical factor is the supply of Treasuries. In July 2020, the Treasury General Account (TGA) swelled to a record high of $1.87 trillion as the government issued massive amounts of debt. In February 2021, the Department of the Treasury announced it would return its cash balance to a normalized pre-pandemic level of approximately $300 billion to $500 billion. The reduction of the TGA would be accomplished, according to the Treasury, primarily through limited T-bill issuance. This significantly increased participation in the Federal Reserve's overnight reverse repurchase agreement facility over the past few months as a glut of excess liquidity was left to seek meager yield on the front end of the Treasury curve with limited supply. The Fed's actions to raise the interest on excess reserves (IOER) rate at the June FOMC meeting released some of the pressure on the excess liquidity on the short end of the market.

The mismatch of supply and demand impacting the front end of the market is likely not the key factor affecting the long end of the Treasury curve today, particularly the 10-year yield, which in our opinion is driven more by macro views of growth and inflation. However, supply-demand dynamics for the long end do have an effect on the margin. There is strong pension demand for the long end, driven by elevated funding statuses, amounting to approximately $40 billion to $80 billion in purchases per year. Then there is foreign demand for Treasuries, which has increased due to more-attractive hedged yield profiles. *(Figure 1)*

U.S. Treasury 10-Year Yield | As of July 13, 2021

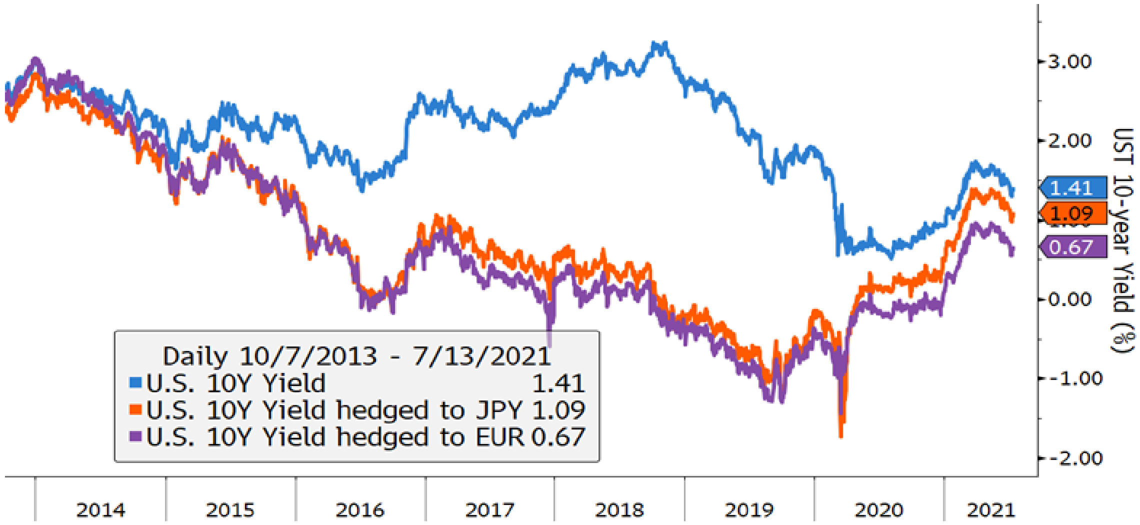

Figure 1
Source: Bloomberg, DoubleLine

Another technical factor pushing Treasury yields lower in the short term is a shift in market participants' positioning along the Treasury curve. As optimism grew around the prospects for high nominal U.S. GDP growth and accommodative Fed policy support seemingly in place for the foreseeable future, market participants largely positioned for a steeper curve. As yields rallied at the start of the second quarter, investors began to unwind those positions. In addition, traders forced to cover short positions on Treasuries could have further propelled the rally in yields. Individually, these factors might not be enough to greatly influence the direction of yields, but taken together they can overwhelm fundamental views of growth and inflation in the short term.

In the long term, we expect long end yields to move higher, although the belly of the curve might increase in yield as well, resulting in a bear flattener. The belly of the curve is more sensitive to changes in Fed policy than the long end because there is generally a less consistent buyer base. Overall, our fundamental macro outlook is unchanged despite positioning changes and shifting sentiment among market participants in recent weeks.

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Basis Points (BPS) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

Bear Flattener – When short-term U.S. Treasury interest rates move up higher than longer-term rates.

Federal Open Market Committee (FOMC) – Branch of the Federal Reserve System that determines the direction of monetary policy specifically by directing open market operations. The FOMC comprises the seven board governors and five (out of 12) Federal Reserve Bank presidents.

Interest on Excess Reserves (IOER) Rate – Tool by which the Federal Reserve moves the federal funds rate into the target rate set by the Federal Open Market Committee by adjusting the IOER rate.

Overnight Reverse Repurchase Agreement Facility – Facility through which the Federal Reserve accepts overnight cash investments from banks, government-sponsored enterprises (the housing agencies plus the Federal Home Loan Banks) and money market mutual funds and provides U.S. Treasury securities as collateral. A reverse repurchase agreement is a transaction where one party (a housing agency, say) purchases a security from another (the Fed) with an agreement that the second party will repurchase it the following day, usually at a slightly higher price in order to provide interest to the cash provider. The facility was created in 2013 as a tool to ensure that the Fed could lift the effective federal funds rate, the interest rate the Fed targets to conduct monetary policy, above zero when it decides it is appropriate to do so.

Treasury General Account (TGA) – General checking account that the U.S. Treasury Department uses and from which the federal government makes all of its official payments. The Federal Reserve Bank of New York holds the TGA.

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