Daiwa's View

Improvement in liquidity of US Treasuries is likely still a ways off

- US Treasury Department announced scale of US Treasuries issuance
- Information related to buybacks was not announced

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US Treasury Department announced scale of US Treasuries issuance

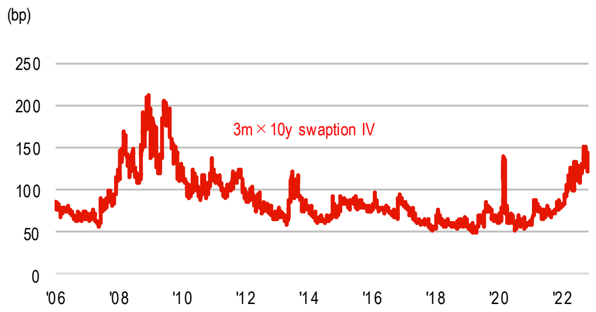
On 2 November, the US Treasury Department announced the scale of its quarterly US Treasuries issuance. The issuance of 10-yr, 20-yr, and 30-yr bonds during November 2022-February 2023 remained unchanged from that in the previous quarter. The issuance of 2-yr, 3-yr, 5-yr, and 7-yr bonds remained unchanged from that in October. Currently, with liquidity of the US Treasury market worsening, market interest in trends with the issuance of US Treasuries is greater than usual. In this report, we discuss liquidity in the US Treasury market based on discussions at the Treasury Borrowing Advisory Committee (TBAC), which were announced together with the latest quarterly refunding schedule.

Low liquidity in the current US Treasury market has been confirmed by the decline in market depth and widening of bid-ask spreads, as pointed out by the Financial Stability Report announced on 4 November. It was reported that a primary reason for this was that it was a consequence of the elevated interest rate volatility associated with uncertainty about the economic outlook (Chart 1).

US banks are not in a situation to aggressively buy US Treasuries

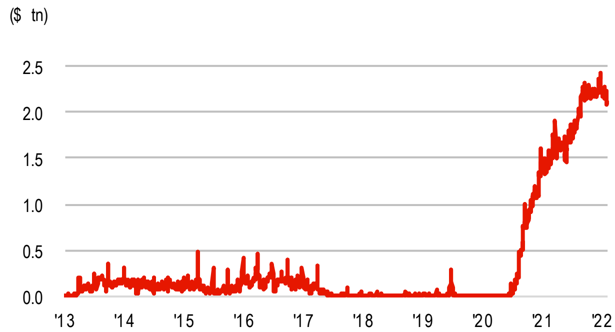
US commercial banks, major investors in US Treasuries in the US, have been reducing the outstanding amount of US Treasuries and MBSs they are holding since the end of February 2022 when the outstanding amount hit a peak, partly due to the impact of higher interest rates on bond prices. Cash in the US financial system is sufficient, as shown by the fact that the outstanding amount of the Fed's reverse repo facility has been at a high level (Chart 2). That said, the loan-deposit gap, which serves as an indicator of leeway for purchases of US Treasuries at US banks, is still at a high level, but it has been declining since its peak at the end of 2021 (Chart 3 on next page). We, therefore, think that US banks are not in a situation to aggressively buy US Treasuries, given the ongoing rate hikes by the Fed and the expected decline in cash going forward due to the impact of QT.

Chart 1: US Yield Implied Volatility



Source: Bloomberg; compiled by Daiwa Securities.

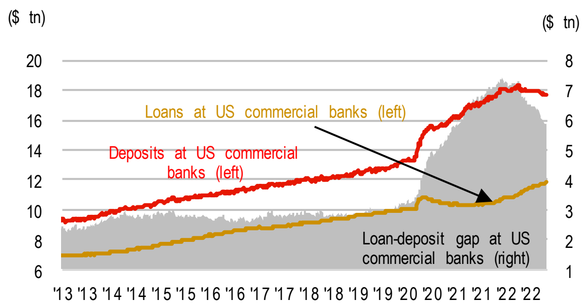
Chart 2: Outstanding Amount of RRP



Source: Fed; compiled by Daiwa Securities.

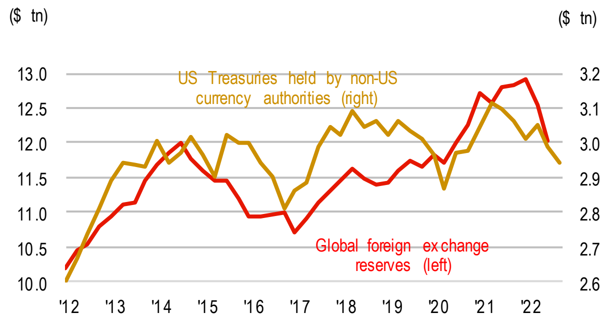
Buying US Treasuries is made difficult for US banks partly because of the impact of the supplementary leverage ratio (SLR) regulation. According to the SLR regulation, the ratio of exposure (such as securities held and derivate trading) to Tier 1 capital should be kept within the standard level. As these securities include US Treasuries, US banks have an incentive to refrain from purchasing US Treasuries to comply with this regulation. When the COVID-19 pandemic occurred, the regulation was temporarily eased (US Treasuries and reserve deposits at the Fed were excluded from the SLR), but this easing ended in March 2021. In his speech on 30 September, Fed Governor Michelle Bowman touched on easing the SLR. However, concrete measures have not yet been implemented.

Chart 3: Loan-deposit Gap at US Commercial Banks



Source: Fed; compiled by Daiwa Securities.

Chart 4: Global Foreign Exchange Reserves, US Treasuries Held by Non-US Currency Authorities



Source: IMF, Fed; compiled by Daiwa Securities.

Foreigners have a large presence in the US Treasury market

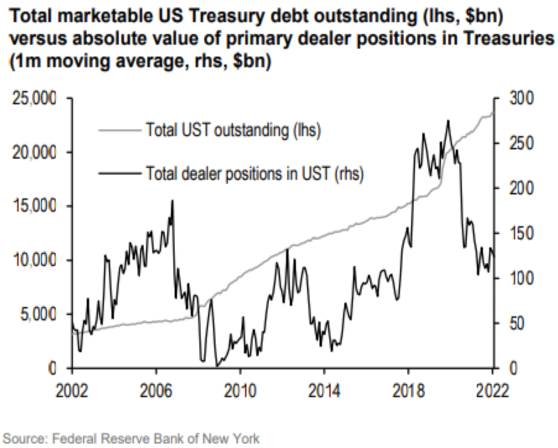
Foreigners have a large presence in the US Treasury market. According to TBAC materials, foreigners hold US Treasuries amounting to around $7.5tn, which accounts for slightly less than 40% of the total. Among foreigners, non-US currency authorities hold high ratios, and they are stable holders of US Treasuries. Under ordinary circumstances, currency authorities are not entities that often trade US Treasuries. However, they appear to be selling US Treasuries in order to (1) intervene in the currency market to respond to the current appreciation of the dollar and (2) cope with domestic shortages of the dollar (Chart 4). Despite the fact that an end to dollar appreciation is beginning to come into sight (refer to our 15 Nov *Daiwa's View*: MOVE index pointing to end of USD appreciation?), the US's monetary tightening is continuing. Therefore, we will likely see a downtrend in US Treasuries held by non-US currency authorities.

US Treasury market's tolerance to shocks is weakening

Moreover, it is thought that the US Treasury market's tolerance to shocks is weakening. The outstanding amount of US Treasuries more than doubled over the past ten years, but the outstanding amount of US Treasuries held by primary dealers has not caught up with that. Therefore, the presence of primary dealers has been diminishing in the US Treasury market (Chart 5 on next page). It is said that this was due to the impact of the difficulty of holding US Treasuries due to regulations for capital and liquidity, which were introduced after the Global Financial Crisis. Instead, principal trading firms (PTFs) have been increasing their presence. Although there is no formal definition for PTFs, it is generally said that they are considered to be non-banks that are mainly involved in automated high-speed electronic trading. As a result, the Financial Stability Board views the deterioration of the liquidity of US Treasures as being due to the decline in the trading volume of US Treasuries by PTFs during the COVID-19 shock, despite aggressive trading by dealers amid a sell-off of US Treasuries due to a flight to the dollar[1].

[1] https://www.fsb.org/wp-content/uploads/P201022.pdf

Chart 5: Total UST Outstanding, Total Dealer Positions in UST

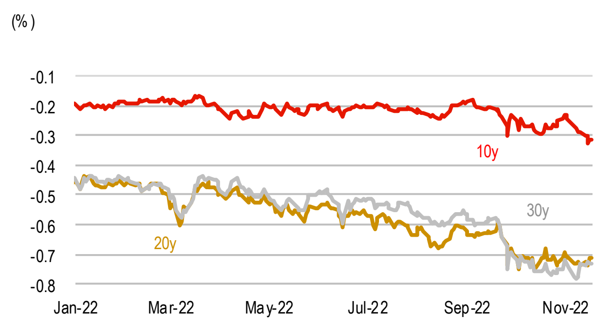


Source: Reprinted from US Treasury Department materials.

Market watching for buybacks of US Treasuries

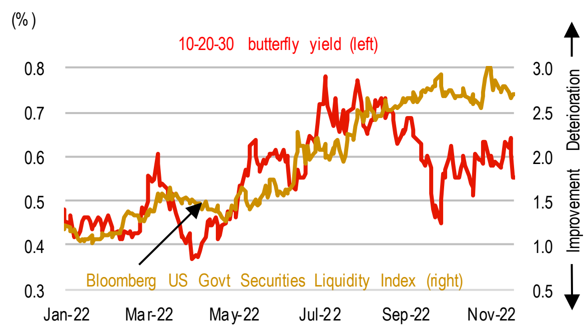
When the scale of US Treasuries issuance was announced, the market also paid attention to whether the Treasury Department would announce information related to buybacks of US Treasuries. This was because there were questions regarding buybacks in the quarterly survey for primary dealers that was announced on 14 October by the Treasury Department. As expectations of buybacks increased, we temporarily saw the outperformance of 20-yr bonds, which are considered to have the lowest liquidity in the US Treasury yield curve. The low liquidity of superlong US Treasuries can be confirmed by the deepening of negative swap spreads since the beginning of 2022. Liquidity has worsened further particularly since end-September when we saw turmoil in the UK financial market (Chart 6). The liquidity of 20-yr bonds is particularly low, as can be seen by the rise in the 10-20-30 butterfly yield in line with deterioration in liquidity (Chart 7).

Chart 6: US Swap Spreads (swap rate – US Treasury yield)



Source: Bloomberg; compiled by Daiwa Securities.

Chart 7: 10-20-30 Butterfly Yield, Liquidity Index



Source: Bloomberg; compiled by Daiwa Securities.

With no details about buybacks announced, improvement in market liquidity is likely still a ways off

However, the Treasury Department announced that it would continue to conduct surveys on buybacks and announce survey results/decisions in the future. Materials as of August stated that buybacks can enhance liquidity. Meanwhile, it also stated that there was a need to create the cash to fund buybacks, which may eventually worsen liquidity. It also pointed out issues, such as compatibility with predictable debt management strategy for the market. It would seem that it will take time for these issues to be resolved. Due to the slowdown in October US CPI, yields have declined with slight improvement in liquidity. However, the Fed's stance of continuing monetary tightening (incl. QT) is unchanged. Therefore, with investors discouraged from buying US Treasuries and buybacks by the US Treasury Department not being implemented, improvement in the liquidity of the US Treasury market is likely still a ways off.

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