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Who Has Been Buying U.S. Treasuries?

Investment Research and Strategy Group
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Executive Summary

Given the recovering economy and large issuance of public debt in recent years, it is surprising to many market observers that Treasury yields are still so low, indicating that demand has not waned. However, when discussing the impact of Treasury bond supply on long-term rates after the Lehman bankruptcy, most market observers seem to have largely overlooked two key issues:

1) The large role of the foreign official sector (it is not all about the Fed), and

2) The distinction between all Treasuries vs. only long-term Treasuries.

Since the beginning of the financial crisis in June 2008 to December 2011, the foreign official sector has purchased a net $1.7 trillion of Treasuries, or 33% of all new supply. This is 50% more than the Federal Reserve's Treasury purchases (Source: Datastream as of 12/31/11). If we only look at maturities of at least 5 years, the Fed's impact becomes larger: out of all new supply since June 2008, the Fed purchased 37%, foreign official sector 33%, and private investors 30% (Source: Datastream as of 12/31/11).

Recently, however, the impact of the non-private investors has grown in importance: In 2011, the Fed purchased 75% of new supply of Treasuries with maturities of at least 5 years, while the foreign official sector purchased 30%. Private investors were actually net sellers of Treasuries (-5% of supply) (Source: Datastream as of 12/31/11).

Going forward, the recent supply and demand dynamics for long-term Treasuries suggest the potential for meaningful increases in long-term yields if Operation Twist is not extended and thus considerable pressure for the Fed to extend the program in some form.

The Fed Purchased Only a Small Fraction of All New Treasury Supply

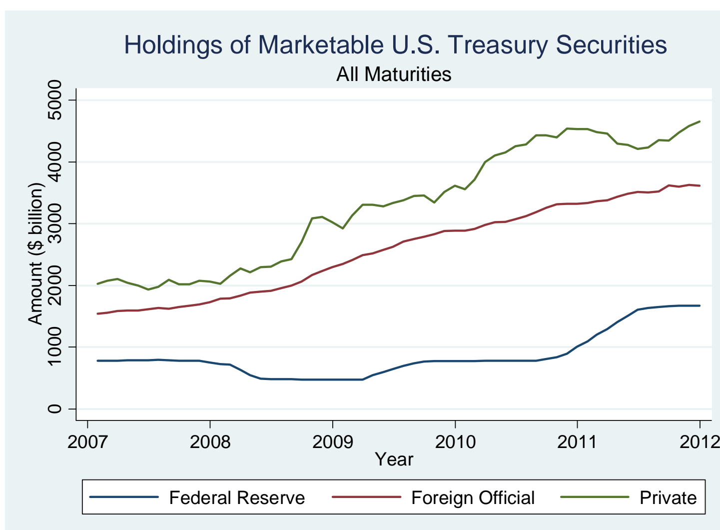
Given the massive issuance of US Treasury debt, it may be surprising that the yield on the 10-year Treasury note still hovers at 2%, especially with headline inflation at 3%. A common explanation for this has been net purchases by the Fed.

However, in its various rounds of quantitative easing, the Fed only has purchased a net $1.2 trillion of Treasuries between June 2008 and December 2011, or 23% of the net new supply of marketable Treasuries. If the rest of the market had to absorb 77% of the supply, or $4.2 trillion of net new issuance, Fed purchases alone cannot explain why the new supply has not resulted in higher long-term yields. Instead, there are two other explanations:

1) The Role of the Foreign Official Sector

The first explanation is the foreign official sector, mainly central banks and sovereign wealth funds. They accounted for a net investment of $1.7 trillion in Treasuries, thus absorbing 33% of the new supply (Figure 1). Interestingly, their purchases were 50% larger than those of the Fed, and their Treasury holdings at $3.6 trillion were over twice the Fed's $1.7 trillion, yet the press has mostly focused on the impact of the Fed during this period. However, the foreign official sector is comparable to the Fed in the sense that its holdings are driven by other concerns besides valuation and risk-return tradeoff, and its purchases have been even steadier (see Figure 1) than those of the Fed in recent years.

Figure1

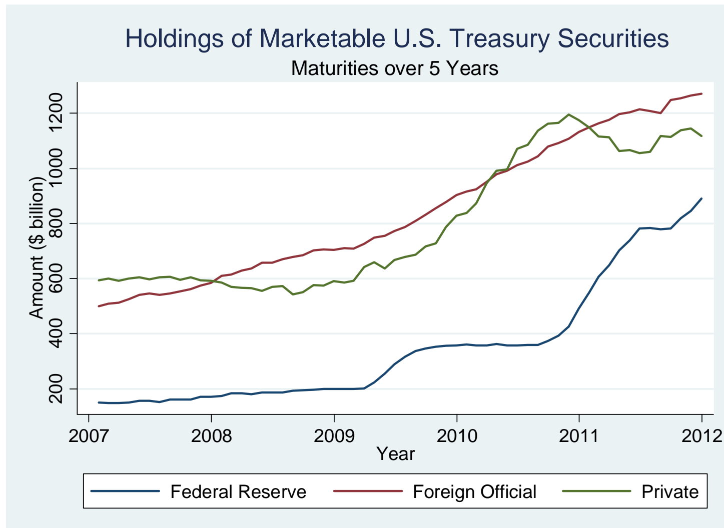


Source: Datastream as of 12/31/11.

2) Need to focus on long maturities only

The second explanation is that the combined impact of the Fed and the foreign official sector has been larger at the long end of the curve: while the two absorbed 55% of all Treasury issuance since June 2008, they absorbed 70% of the issuance with maturities of at least 5 years (Figure 2). Hence, private investors have only had to absorb 30% or $580 billion of new long-term debt over this period. That is still a large amount, but it is significantly less than the almost $2 trillion of net new issuance at the long end.

Figure 2

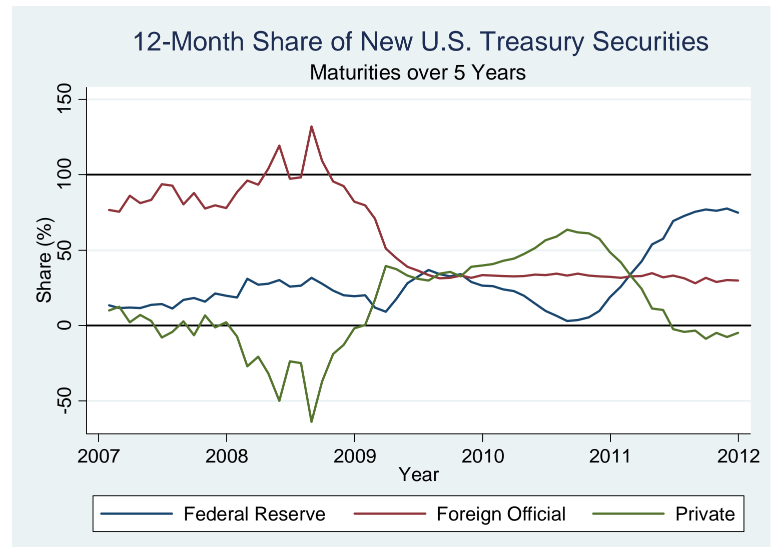


Source: Datastream as of 12/31/11.

Recently, Non-Private Investors Have Been Even More Aggressive

One might also wonder why Treasury yields have been so low at the end of the 3.5-year period, plunging toward record lows in late 2011, in spite of the fact that the worst of the crisis in the United States seemed to be in late 2008 and early 2009 and the economy has been improving since then. Part of the reason could be that the combined magnitude of the actions by the Fed and the foreign official sector has been growing toward the end of the period: in 2011, they actually purchased 105% of the new supply of long-term Treasuries, leaving private investors as net sellers (Figure 3). It may surprise some that despite a federal budget deficit of $1.3 trillion in 2011, private investors did not have to invest a single additional dollar in long-term Treasuries to support their prices; in fact, Treasury prices had become even more expensive, inducing these investors to sell.

Figure 3



Source: Datastream as of 12/31/11.

Conclusion: Outlook for 2012

Given that the current share of long-maturity Treasuries owned by the Fed is now much larger than it has been during earlier rounds of quantitative easing, if the Fed ends Operation Twist as scheduled in June 2012, the impact on the Treasury market could be larger than it was at the end of QE1. Private investors would have to absorb a larger fraction of the new issuance than at any other time in recent years, even as the absolute level of supply is likely to remain very high due to the federal budget deficit. Hence, there will be pressure for the Fed to extend Operation Twist in some form to prevent this increase in long-term rates, until the U.S. economic recovery picks up enough speed to eliminate the need for further stimulus from low long-term rates.

Bonds and Bond funds will decrease in value as interest rates rise.

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