Rates: Taming the supply monster

The size of government deficits built to finance the Covid-19 induced lockdown are nothing short of staggering. Now they must be financed. That means lots more government bond issuance. Had it not been for central bank buying, the impact would be for much higher rates. We should see curves steepen. But market rates will not be let rocket higher

View of Federal Reserve Bank of New York during COVID-19 pandemic

Source: Shutterstock

Why market rates must remain relatively low

These are strange times for market rates. On the one hand, there are mega buyers in play, in the guise of central banks; persistent sentiment-immune players on the bid side of the market. On the other hand, there are huge gaps to fill as governments rack up massive deficit obligations that need to be financed on the debt market.

So far central bank buying is dominating, containing the potential impact from the heavy supply. This is a good thing. In fact, it is necessary.

The Fed's corporate bond buying program lite - there just in case

Market rates need to be kept as low as possible, to help provide as much support as possible, all the way from consumer mortgages to corporate borrowing to government financing needs, and all things in between. Central bank buying of government bonds is an important aspect to this but by no means the only one.

The European central bank has been buying corporate bonds for some time now, including participation in primary issuance books, and more recently has extended its influence to include fallen angels.

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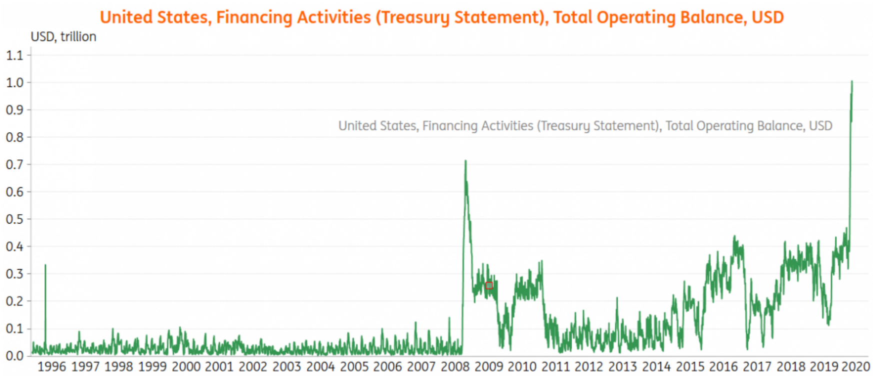
The Federal Reserve has taken a slightly different approach. The capacity to buy corporate bonds is more novel and is not technically quantitative easing.

It is more of an equity-financed SPV with a capacity to buy corporates and exchange-traded funds, and we see ETF buying as a more plausible entry point. Here also the Fed's SPV can buy high yield, albeit on lower leverage to equity relative to investment-grade buying. There are other supportive facilities in a similar vein to aid other types of issuance, from commercial paper to municipal bonds.

Cash balance at the US Treasury

(recently added to through bills issuance)



Source: ING, Macrobond

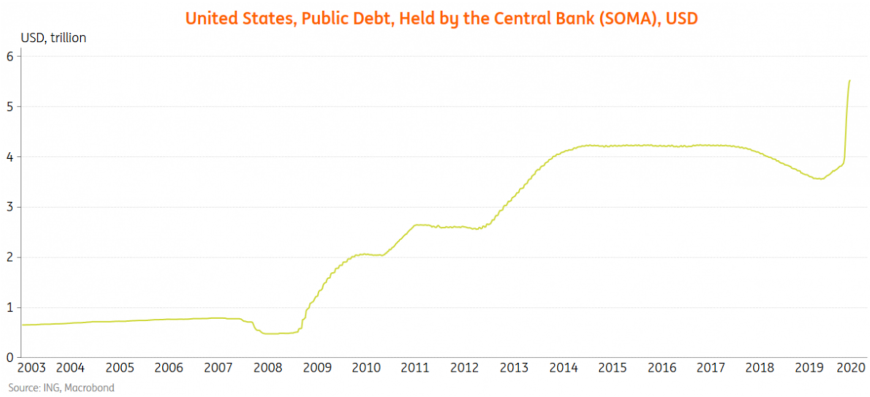
Big bills issuance has managed to keep supply pressure under wraps

Many of these facilities make less sense if market rates were to rise. Put better, maintenance of low market rates pushes in the same direction as the help that these facilities provide. In consequence, it is important that extra government bond supply does not force up market rates, as it would likely push up the cost of funding for all players, right out the credit curve.

There are a couple of factors that are helping to mute the impact of extra government issuance. First, the big push towards extra issuance has been in bills, to begin with. The good news is there is ample of demand for bills, as cash gets parked on front ends of curves. The US Treasury, in fact, managed to push its cash balance up to $1trn, driven primarily by additional bills issuance. Eurozone issuers have adopted a similar strategy. However, this will have to morph into longer duration issuance ahead.

Bonds bought and held by the Federal Reserve

(including recent big buying)



Heavy bond issuance coming, but big buying support there too

The US is instructive, as it is an all-in estimate. And the US curve is the global benchmark curve.

The re-funding estimates for the US in the coming quarter pitches issuance at $3trn, in tune with the congressional budgetary office fiscal deficit estimate of some $3.7trn for the full fiscal year. Normally, these numbers would place material upward pressure on yields.

Offset against that are two factors. First, the Fed has bought an additional $1.9bn of bonds over the past couple of months. On top of that, it now holds $5.5trn, which equates to over a quarter of the total US public debt. The equivalents on the eurozone countries are much higher, in the area of a third for many issuers. Both the stock and flow are important here. The stock effect crowds out available bonds for investors, while the flow maintains a strong residual demand.

> All things considered, government bond issuance increases are staggering, and there is more to come. But there is also an important off-set in place in the guise of central bank mega buyers (flow), and mega holders (stock). This is helping to keep market rates and yields low.

Expect creeping steepening pressure though, as longer maturities will have to discount the rolling nature of this well into the future. So while we see the US 2-year heading towards zero, the 30-year should be eyeing a break back above 1.5%.

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