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iFlow

SHORT THOUGHTS

October 29, 2024

Politics, the Term Premium, and Cross-Border Flows

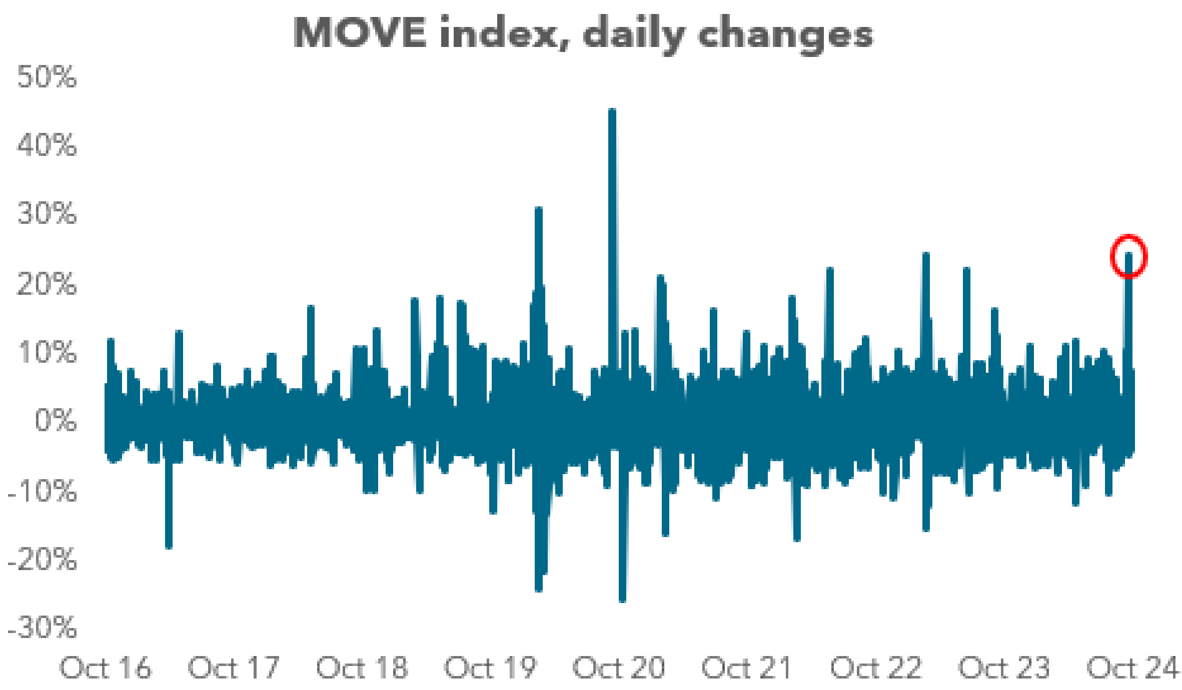
- The rise in UST volatility is partially due to electoral expectations in the market
- Rising odds of a Trump victory have led to an increase in the Treasury term premium
- Cross-border investors are attracted to positive premia and have re-entered the market

The next two weeks – and possibly beyond – promise to feature several events that will challenge already elevated Treasury market volatility. Before we reach the pivotal and too-close-to-call US election on November 5 and an FOMC meeting on November 7, we must navigate a tricky data week this coming week. September JOLTS and PCE inflation and spending, Q3 GDP, and of course the October jobs data will all be released this week.

Bond markets have already been rather volatile. On October 7, for example, the MOVE index of implied UST volatility featured its largest 1-day increase since March 2023 during the regional banking crisis. Before that, one has to look to the early months of the pandemic lockdowns for higher daily movements in the index. MOVE is a 1-month forward looking implied volatility gauge, so the October 7 jump reflected the inclusion of the election date in its forecast. Exhibit #1 shows the behavior of this implied volatility index and illustrates this spike.

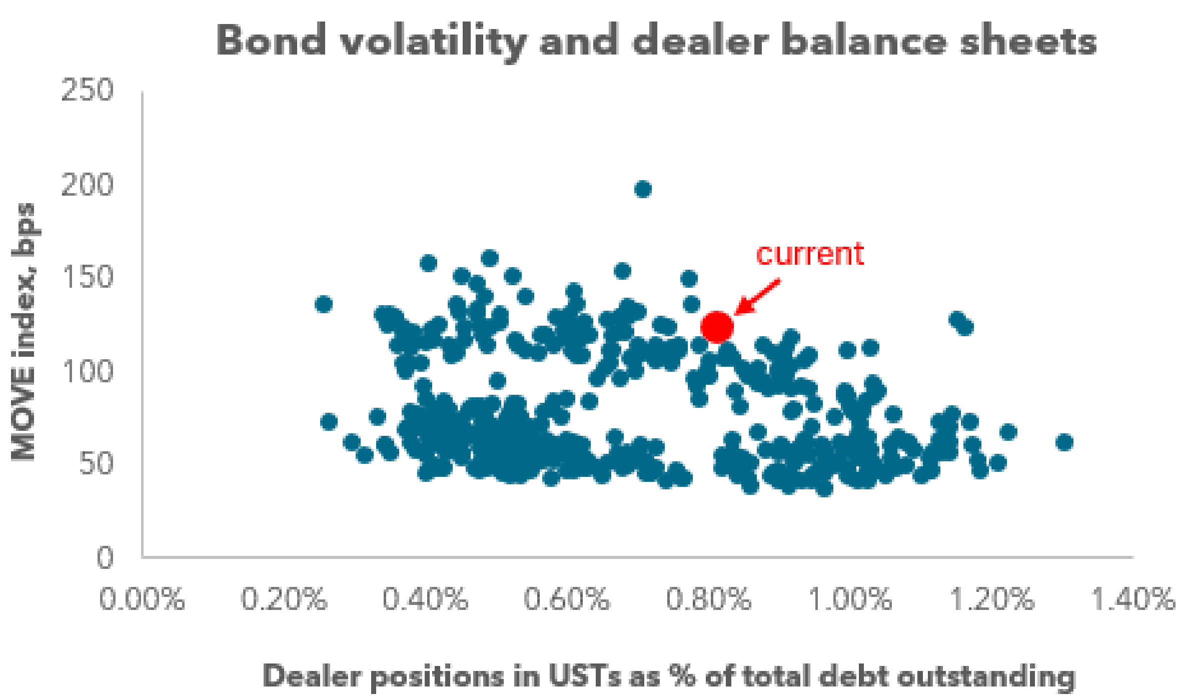
With dealer balance sheets bloated, elevated volatility could turn into a liquidity issue given these constraints. Exhibit #2 shows combinations of dealer balance sheet holdings of USTs (relative to total debt outstanding) and MOVE volatility. The latter is not quite at but close to its higher observations, while balance sheets – when adjusted for the total stock of publicly traded UST – show fairly elevated holdings. In the chart, should the red dot move up and to the right, we could indeed see liquidity issues pop up in the longer end of the coupon curve.

Exhibit #1: MOVE Volatility and Election Spikes



Source: BNY Markets, Bloomberg

Exhibit #2: A Combination of High Volatility and Bloated Balance Sheets

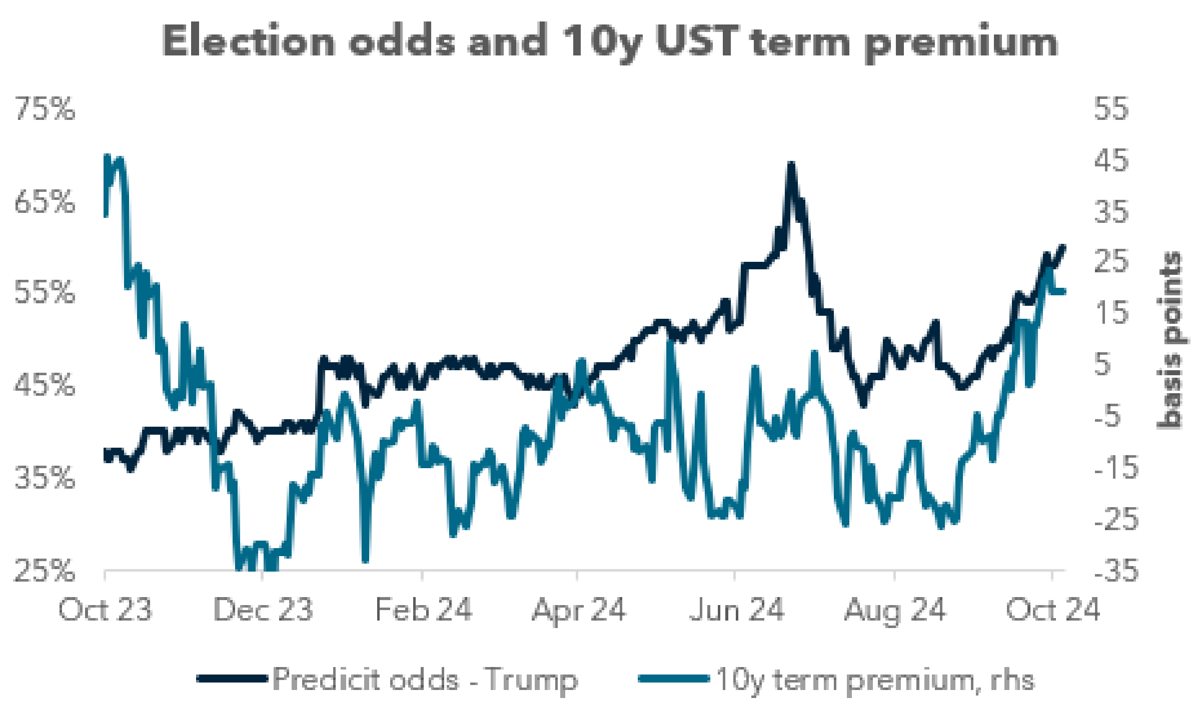


Source: BNY Markets, Bloomberg, Federal Reserve Bank of New York

The Treasury yield curve has been bear steepening since the middle of September, after spending most of the summer bull steepening as the front end started pricing in more and more aggressive Fed easing. The 2s10s yield slope went from -50bp to +10bp over that period. In the last six or seven weeks or so, the front end has given back some of its move lower, while the long end continues to rise.

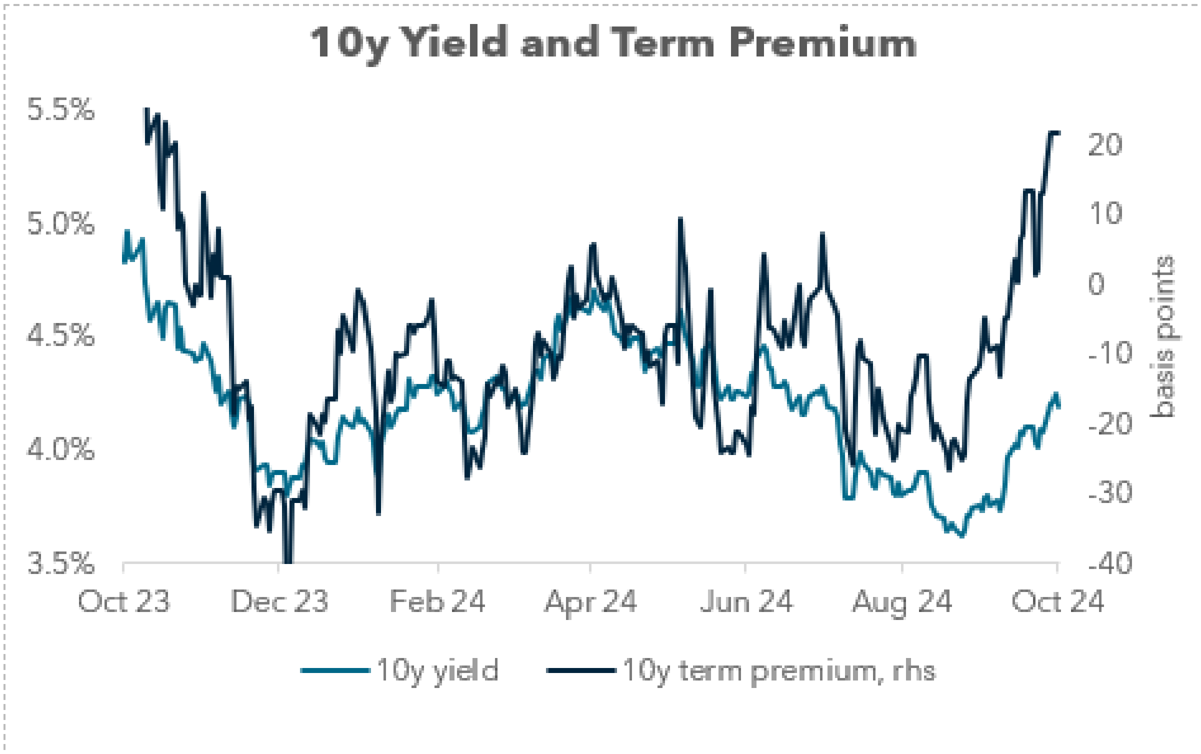
There are a number of factors behind the increase in 10y yields, including strong economic data, and – relatedly – expectations that the Federal Reserve will be much less dovish in coming months, thanks to that stronger data. However, we think there is a bit of a “Trump premium” also at work. Most of the move higher in 10y yields (up 56bp since September 11) has come from a similar move higher in the term premium, up 46bp in the same period. Exhibit #3 shows that as the betting odds of a Trump victory have increased to appreciably above 50%, the New York Fed’s daily estimate of the term premium has risen commensurately. It appears that the inflationary impact of tariffs – long a Trump policy plank – and the fiscally expansionary portion of many of his proposals are driving up perceived Treasury risk. Exhibit #4 shows the relationship in the past 12 months between the term premium and the yield on the 10y note.

Exhibit #3: Trump’s Odds and the Term Premium



Source: BNY Markets, Predictit, Bloomberg

Exhibit #4: Rise in Yields Mostly Down to Term Premium



Source: BNY Markets, Bloomberg, Federal Reserve Bank of New York

Our view is that a Trump victory, but with a split congress (with at least once chamber going to the Democrats), could tame of some of the rise in the term premium. Without a clean sweep of both the Senate and the House, it's likely that some of the more fiscally expansionary and deficit-negative policy proposals on the Republican side will not see light of day, taking some of the upward pressure off yields.

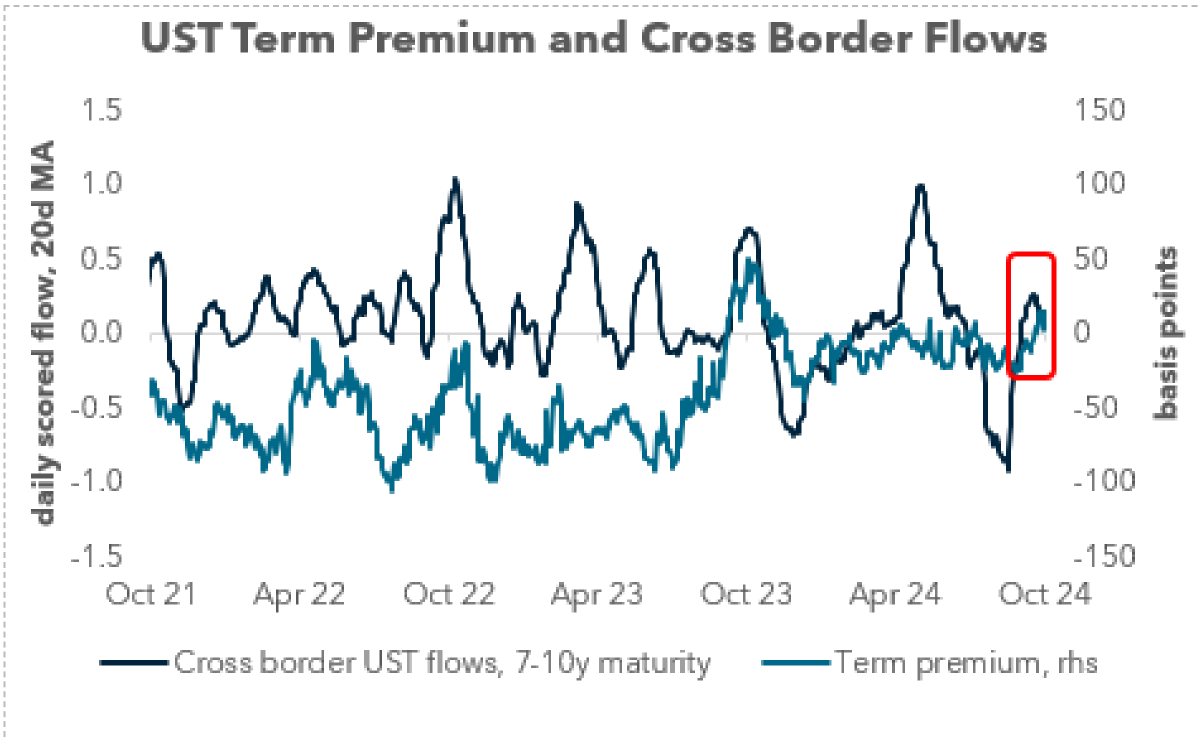
Still, given that we don't see economic data backsliding (see our review of the US macroeconomy from yesterday here), and the Fed is likely to ease policy at only a gradual pace, the long end might not fall that much at all. The current economic setup is such that an upward sloping yield curve should persist into 2025.

Something to watch is the stance of cross-border UST investors. Our iFlow data, gleaned from the over $50trn in custody assets at BNY, allow us to examine client behavior by origin, on- or offshore. We can also look at the maturity of these flows. Focusing on the 7-10y segment of the yield curve, we see that when the term premium rises, overseas money tends to come into Treasurys. This is shown in Exhibit #5 below.

Note that the dark line, which depicts the 20-day rolling average of scored cross-border flows into this maturity bucket, indicates that these investors are induced back into the UST market when the term premium goes above zero. This was especially true in October of last year, when worries about US fiscal policy drove yields toward 5% and the term premium to its highest level since 2014. This indicates that when bond prices become sufficiently discounted (i.e., the term premium and yields rise), cross-border players find enough value to buy.

These dynamics are occurring at present as well. The newly positive term premium has drawn overseas money into the market recently. However, the election (and post-election) uncertainty could dissuade a large increase in flows, even with a positive term premium. If we were to see a drop back in cross-border inflows, even as the term premium rises, we might see a quicker steepening and higher yields at the long end.

Exhibit #5: Cross-Border Flows Attracted by Positive Term Premium



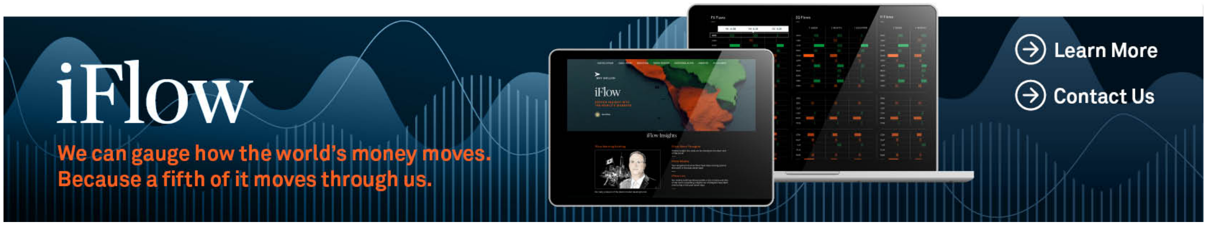
Source: BNY Markets, Federal Reserve Bank of New York, iFlow

Please direct questions or comments to: iFlow@BNY.com

John Velis

AMERICAS MACRO STRATEGIST

CONTACT JOHN



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