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FOREIGN DEMAND FOR TREASURIES CONTINUES

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KEY TAKEAWAYS

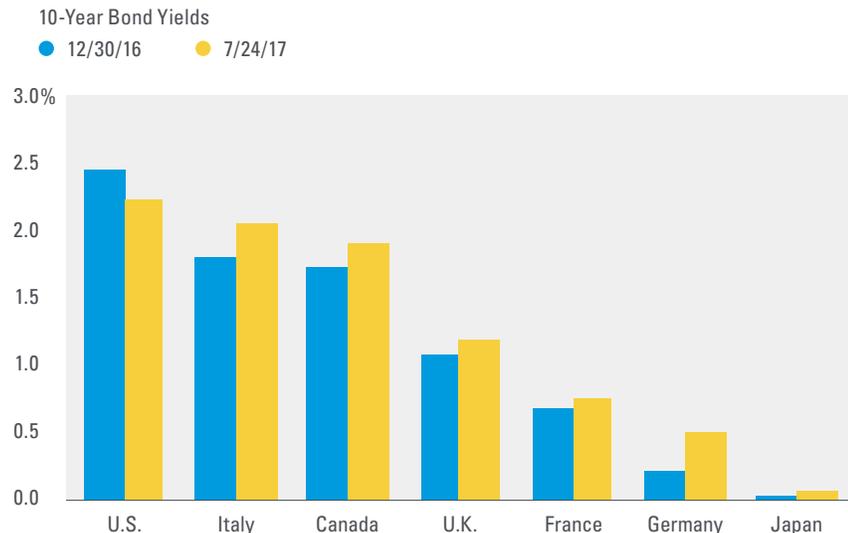
The 10-year Treasury's yield advantage to the German bund is back to pre-election levels, though it remains elevated relative to history.

Low yields in Europe and other developed nations will likely continue to put downward pressure on Treasury yields.

Year to date, yields have moved higher for many developed foreign government bonds, while Treasury yields have moved lower. Foreign demand has been a source of strength for Treasuries in recent years, as low overseas yields have pushed foreign investors toward relatively higher yielding U.S. bonds. The 10-year Treasury's yield advantage to the German bund reached a 28-year high earlier in 2017, but a combination of rising yields in Germany and falling yields in the U.S. has pushed this advantage back to pre-election levels. Although this declining differential may cause some to worry that foreign demand may begin to fade, it is important to note that the yield advantage of Treasuries to other major foreign bond markets remains substantial by historical terms.

The yield advantage of U.S. Treasuries, coupled with strong credit quality, would seem to make them a logical choice for foreign investors. Central bank stimulus in the Eurozone has pushed rates for even peripheral countries with lower credit ratings below those of higher-quality U.S. Treasuries. As **Figure 1** shows, even after accounting for the fact that yields for all G7 nations, other than the U.S., are higher year to date, the 10-year Treasury still offers a yield premium, even to lower-rated nations such as Italy.

1 THE 10-YEAR TREASURY'S YIELD ADVANTAGE TO FOREIGN BONDS REMAINS ELEVATED



Source: LPL Research, FactSet 07/24/17

Past performance is no guarantee of future results.

HEDGING COSTS

The figure above clearly shows the value of Treasuries relative to other developed nations, but yield isn't the only factor that foreign investors have to consider when investing in the U.S. When a foreign investor purchases a Treasury security, they have to make the purchase in U.S. dollars. If the dollar depreciates relative to the investor's home currency, the investor receives less of the local currency back for each dollar, reducing total return. Given that exchange rates can be volatile, a depreciating dollar could wipe out a significant portion (or all) of any advantage the investor would see from investing in the U.S., especially with interest rates at low absolute levels.

For this reason, many foreign investors choose to hedge their dollar-denominated investments by

using currency futures. To do this, an investor would purchase dollars at the current exchange rate (known as the "spot rate"), and simultaneously sell their local currency forward to lock in a given exchange rate over a selected period, helping to reduce the risk of unforeseen currency swings. However, a currency hedge involves a cost and this cost can fluctuate over time due to a variety of factors.*

Figure 2 shows the relative value of Treasuries including hedging costs for Japanese investors. Last summer, falling Treasury yields and increasing hedging costs meant that Treasuries were less attractive to Japanese investors. Though hedging costs haven't changed much since that time, rising U.S. yields have made the trade more attractive.

*Futures and forward trading is speculative, includes a high degree of risk, and may not be suitable for all investors. The fast price swings in currencies can result in significant volatility in an investor's holdings.

2 TREASURY YIELDS REMAIN ATTRACTIVE FOR JAPANESE INVESTORS, EVEN AFTER ACCOUNTING FOR HEDGING COSTS



Source: LPL Research, Bloomberg 07/24/17

Past performance is no guarantee of future results.

Hedge-adjusted yield is calculated by taking the annualized percentage difference between the current exchange rate and the 3-month forward prices of Japanese yen, and the U.S. dollar currency pair, added to the 10-year Treasury yield.

CHECKING THE DATA

Even after adjusting for hedging costs, other financial and non-financial sources of risk can have an impact on foreign demand for Treasuries as well. For this reason, it is also important to look at data sources that show actual purchases or holdings of Treasury securities by foreign investors, such as Treasury auction results and the monthly Treasury International Capital (TIC) System report, to gauge whether perceived value is translating to actual demand.

The data on both of these fronts continue to support the idea that foreign demand remains strong. Indirect bidders, which include foreign investors, continue to be a factor in recent Treasury auctions as shown in [Figure 3](#). Purchases from indirect bidders have been 60%

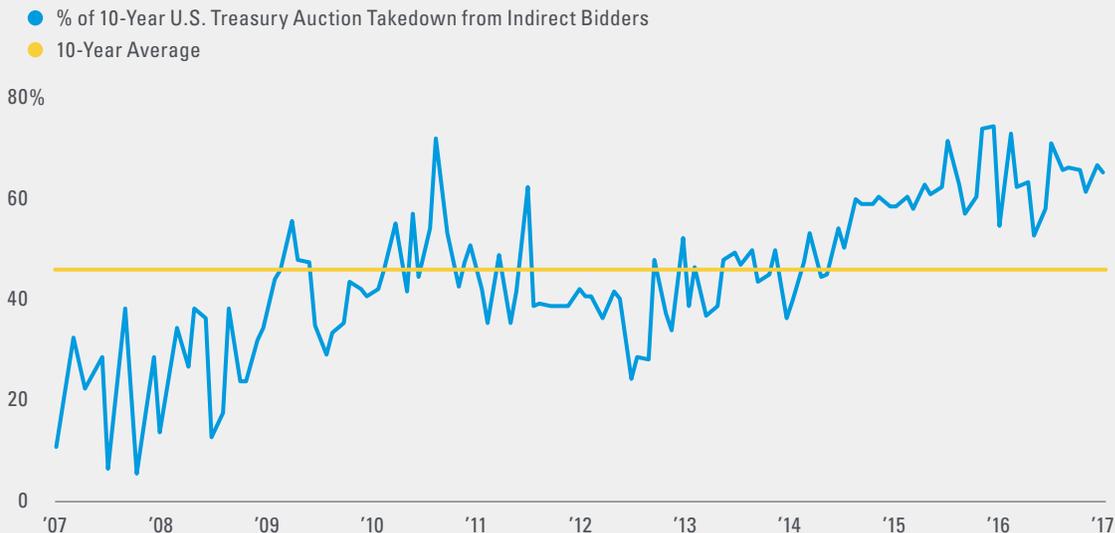
or higher for each of the 10-year Treasury auctions held in 2017, compared to an average of 45% over the past 10 years.

TIC data are delayed by a couple of months, but the latest release in July (which captures May results) shows that foreign nations continue to be large holders of Treasuries. Total foreign holdings increased by \$50 billion from April to May 2017, approximately \$10 billion of which was from China, which has seen Treasury holdings increase in the last four consecutive reports.

CONCLUSION

Though U.S. yields have fallen year to date, and yields in many other developed nations have risen slightly, the yield advantage that U.S. Treasuries hold relative to foreign bonds remains large. We believe

3 AUCTION DEMAND FROM FOREIGN INVESTORS REMAINS ABOVE AVERAGE



Source: LPL Research, Bloomberg 07/24/17

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An indirect bidder purchases Treasury securities at auction through an intermediary, such as a dealer or bank. Indirect bidders include foreign and international monetary authorities, but can also include domestic money managers.

foreign yields, which remain at low absolute levels, may continue to exert downward pressure on U.S. yields in 2017, helping to offset the potential for a significant move higher in rates driven by Federal Reserve policy, continued economic growth, and the potential for pro-growth initiatives such as tax cuts (see this week's [Weekly Market Commentary](#)). Given these factors, we continue to believe our expectation for the 10-year Treasury yield to end 2017 within the 2.25% and 2.75% range, with the potential for 3% if meaningful fiscal stimulus is enacted, remains reasonable.* ■

*We expect the 10-year Treasury yield to end 2017 in its current range of 2.25–2.75%, with a potential for 3%. Scenario analysis based on this potential interest rate range and the duration of the index indicates low- to mid-single-digit returns for the Bloomberg Barclays Aggregate Bond Index.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

International debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets. Futures and forward trading is speculative, includes a high degree of risk, and may not be suitable for all investors. The fast price swings in currencies can result in significant volatility in an investor's holdings.

DEFINITION

Treasury International Capital (TIC) is select groups of capital which are monitored with regards to their international movement. Treasury international capital is used as an economic indicator that tracks the flow of Treasury and agency securities, as well as corporate bonds and equities, into and out of the United States. TIC data is important to investors, especially with the increasing amount of foreign participation in the U.S. financial markets.

This research material has been prepared by LPL Financial LLC.

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