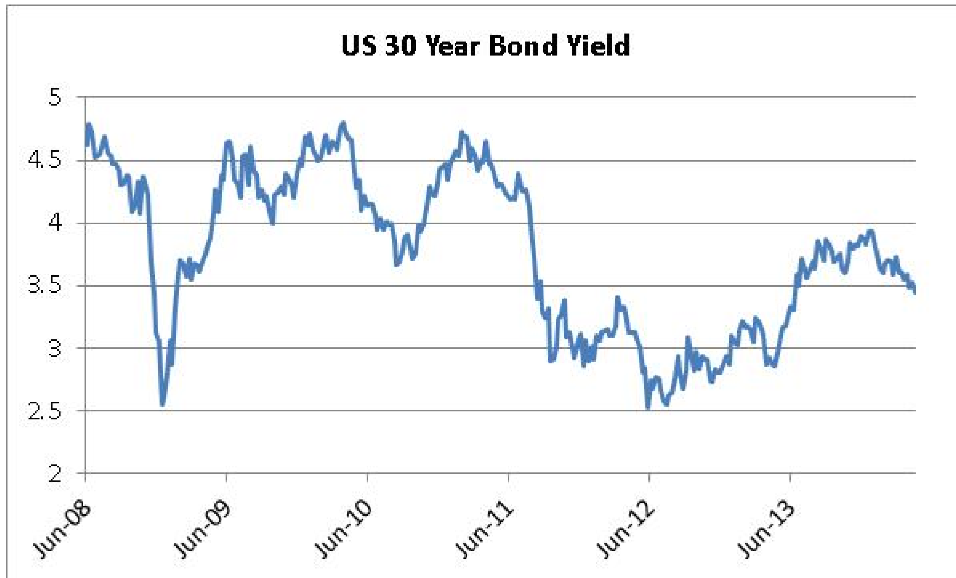
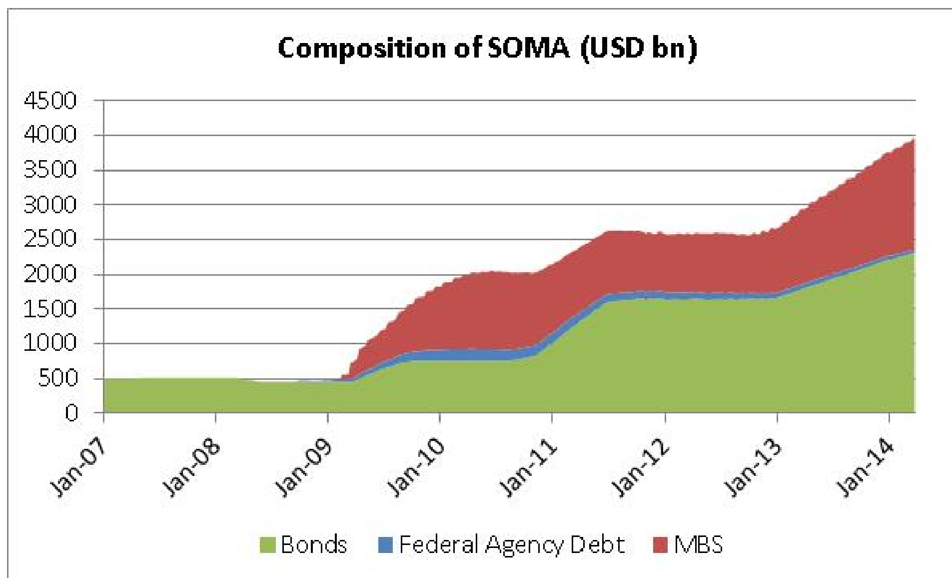
Since my original note in January of this year, US treasuries have performed particularly well, with the US 30 year seeing yields drop from nearly 4% to less than 3.5%.



Recent data has led me to believe that we are running the risk of a short squeeze in US treasuries. As pointed out in the previous note, US treasuries are very attractive to foreign buyers.

Furthermore, recent data from the Federal Reserve shows that the long dated treasury market is becoming less liquid. Since the financial crisis the Federal Reserve has increased its balance sheet substantially. As can be seen below, the Federal Reserve balance sheet is mainly made up of US Government Bonds and Mortgage Backed Securities (MBS).



The Federal Reserve Bank of New York carries out the purchases and places them in the System Open Market Account (SOMA). The annual report of the Federal Reserve Bank of New York was recently released and included a large amount of detail on these holdings.

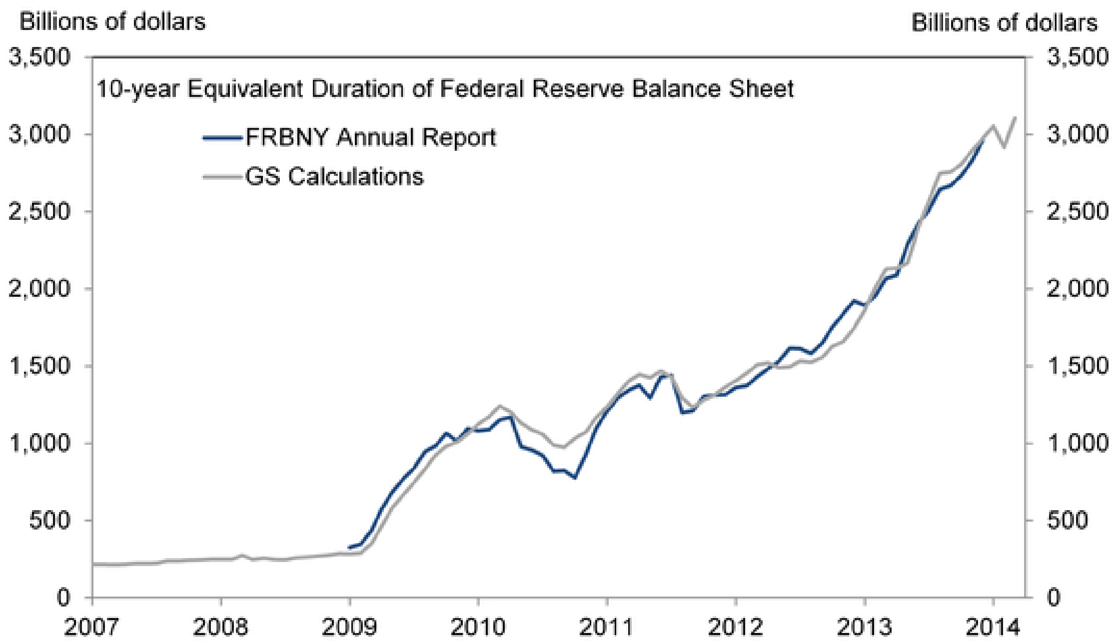
Some interesting statistics from the Annual Report include the following:

- SOMA holds 19% of all Treasuries.
- The duration of the SOMA treasury portfolio is more than twice that of the outstanding treasuries not owned by SOMA.
- SOMA holds 45% of all 10 to 30 year Treasuries
- SOMA holds 28% of fixed rate agency MBS

Another interesting statistic from the annual report is that the average duration of the SOMA holdings of MBS rose from around 1.5 years to nearly 6 years. This is due to a significant decline in refinancing as mortgage rates have risen.

The report highlights that this extension of duration is intentional as the Federal Reserve wishes to remove interest rate risk from the bond market.

The increased duration of MBS leads to one of the most intriguing charts of the annual report. The SOMA portfolio is broken down in to 10 year treasury equivalents. In September of 2012, the Federal Reserve owned USD 840bn of MBS, but in ten year treasury equivalents, this was a holding of less than USD 100bn. By the end of 2013, MBS holdings were USD 1,500bn, but in 10 year equivalents this had become USD 1,000bn in holdings. In other words the rise in rates caused by tapering has led to the Federal Reserve increasing the duration of its portfolio. Adjusting for this increase in duration, the Federal Reserve has become a much bigger player in long dated bonds. I am unable to paste the Federal Reserve graph of this, but I can paste a graph taken from Goldman Sachs research. The original source is here :
http://www.newyorkfed.org/markets/omo/omo2013.pdf



Source: Federal Reserve Bank of New York. Goldman Sachs Global Investment Research.

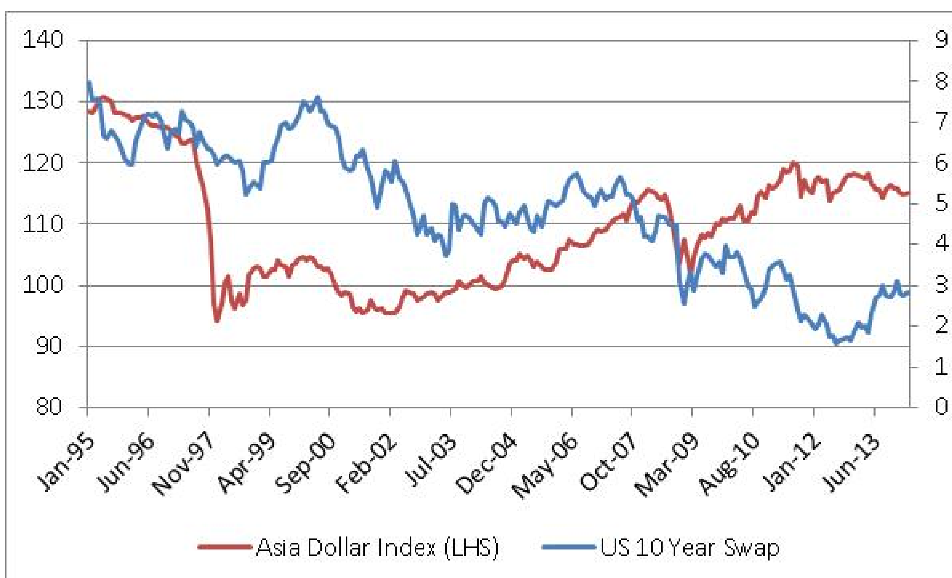
While it is possible that the Federal Reserve may sell bonds, they have so far expressed the view that they would rather let their bond holdings fall naturally as they mature.

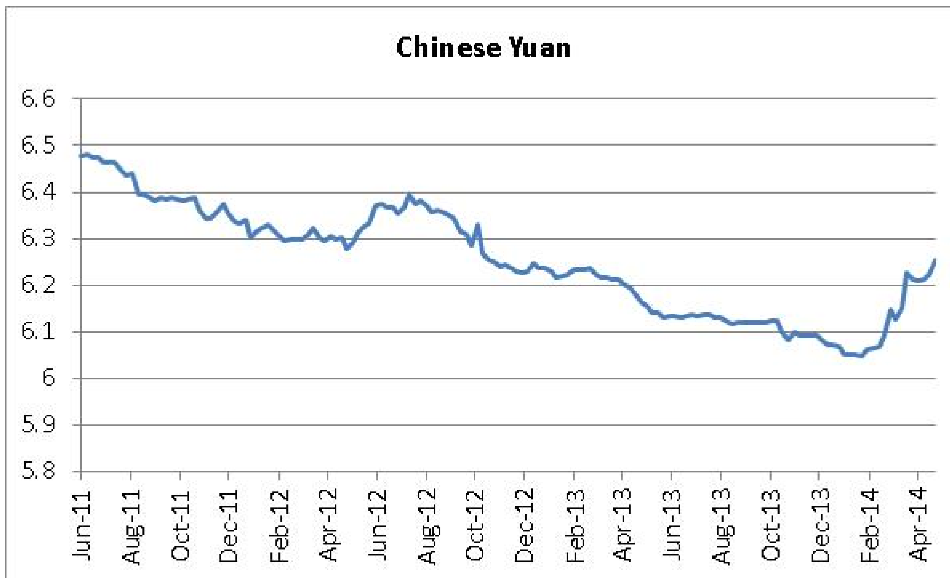
I have also been intrigued to find out that investors have become very keen on "strategic bond funds" as highlighted in this FT article - http://www.ft.com/cms/s/0/458b9916-c935-11e3-bba1-00144feabdc0.html#axzz30C7Ue3Fs

One of these funds, the Goldman Sachs Strategic Income Fund has grown assets from USD 2.5bn in 2012 to USD 20bn as of today. https://assetmanagement.gs.com/content/gsam/us/en/advisors/fund-center/fund-finder/gs-strategic-income-fund.html

As pointed out in its monthly update, this fund has an average duration of -4.41, its lowest level ever. I also note that Bill Gross is bearish on duration in his credit fund. These investors' bearish views are based on a bullish view on the US economy, and inflation forcing the Federal Reserve to raise rates.

However, looking outside of the US there are signs that deflation pressures in the global economic system are building. In particular, I observe that US bonds do well when Asian currencies are weak.





The Asian currency index in the first chart has usually moved with the US stock market, as Asian currencies are generally seen to rally with strong markets. However for the last four years they have been range bound. As we are now beginning to see weakness in the Chinese Yuan, we could potentially begin to see much more weakness in Asian currencies. As the top chart shows, periods of very weak Asian currencies, such as 1997 and 2008, have tended to coincide with falls in US bond yields.

Given that the Federal Reserve owns a huge chunk of long dated bonds, many large US bond funds are either underweight or even making negative bets, that US bonds have higher yields than either bunds or JGBs its seems to me that the long dated US treasuries are very well supported. Should we get devaluations from Asia, the potential for a significant rally in US bonds is very high.

Information

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