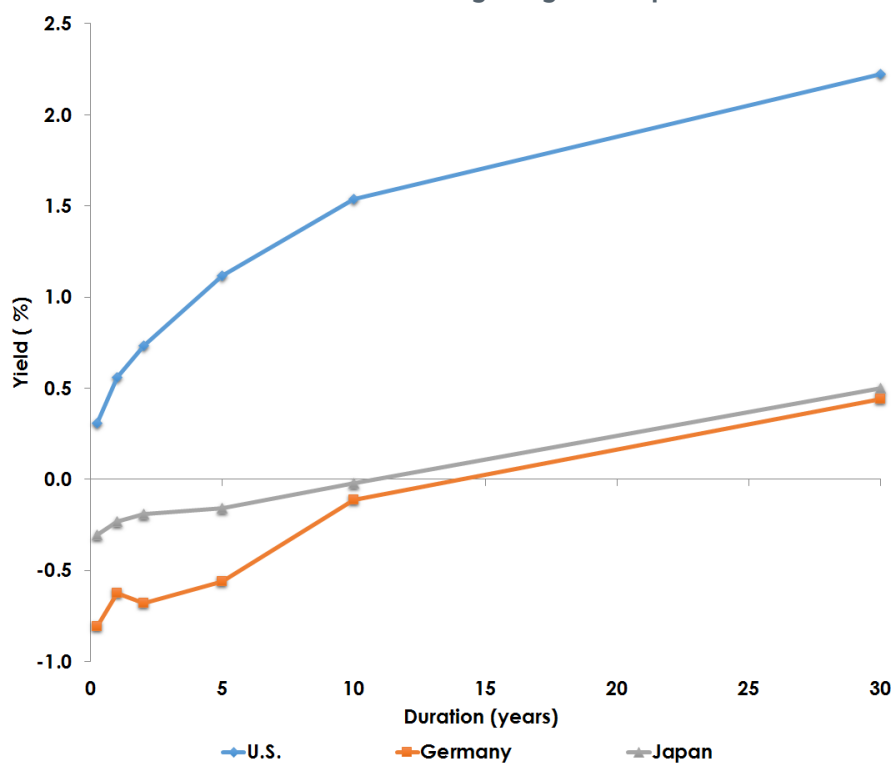


IS FOREIGN DEMAND FOR U.S. BONDS NEARING ITS LIMIT?

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To casual market observers, a rationale for why U.S. [interest rates](#) would remain contained (despite tightening by the Federal Reserve [Fed]) was simple: low rates around the world—especially in Europe and Japan, with negative rates—boost demand for higher-yielding U.S. bonds. While this narrative is compelling, the reality is more nuanced. Below, we outline why this flow of foreign buyers may slow and what impact this may have on the U.S. dollar and the U.S. bond market going forward. **Nominal Yields Are Just the Beginning: Developed Market Government [Yield Curves](#), as**



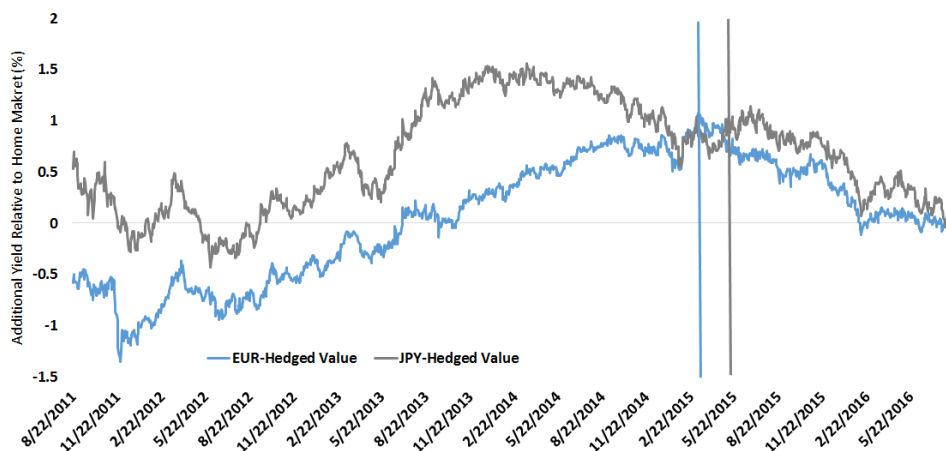
of 8/26/2016

Source: Bloomberg, as of 8/26/16. Past performance is not indicative of future results.

In a prior post

on emerging markets, we explained how [yield is just a starting point for foreign currency denominated fixed income](#). While yields abroad may appear compelling, currency risk has the potential to have a much more significant impact on total return. Above, we compare the U.S. [Treasury yield](#) curve versus Japanese and German government debt. Today, government bond yields in Japan and Europe are negative through 10-year [maturities](#).¹ While U.S. yields remain low by historical standards, they appear extremely generous compared to Europe and Japan. In fact, the [U.S. 10-Year bond](#) offers a 163 [basis points \(bps\)](#) pickup in yield over the [German 10-year](#) and a 162-bps pickup against the [Japanese 10-year](#). However, nominal yields are just a starting point. In order for foreign investors to take advantage of this income premium, they must expose themselves to U.S. dollar risk (and [volatility](#)). For this reason, a simple comparison between foreign interest rates and the U.S. can often be misleading, in our view. **U.S. 10-Year: Back to Reality** So how does the U.S. 10-Year compare to Japanese and German debt if investors [hedged](#) their positions back into euros or yen? As we

show in the chart below², a once-profitable trade may be reaching its limit. To calculate the potential advantage for European and Japanese investors to buy U.S. Treasuries, we compare the yield on their local debt versus the yield on a U.S. 10-Year Treasury that's combined with a [cross-currency basis swap](#). **Swapped Yield Comparison for European and Japanese Investors Yield Advantage: EUR & JPY-Hedged U.S. 10-Year Treasury**



Source: Bloomberg, as of 8/26/16. Past performance is not indicative of future results.

In this hypothetical, foreign investors are not exposed to foreign currency risk and minimal relative [interest rate risk](#). Five years ago, when European short-term interest rates were higher than U.S. rates, German investors would have sacrificed income by investing in U.S. Treasuries and hedging back into euros. However, after the so-called "taper-tantrum" in May 2013, investors in Germany and Japan could capture a reasonable pickup in yield by owning U.S. debt and hedging. With central banks abroad embarking on asset purchases and U.S. investors decreasing positions in U.S. fixed income investments in anticipation of a Fed [rate hike](#), the relative advantage continued to grow. In a separate but seemingly related phenomenon, the value of the U.S. dollar continued to appreciate against the Japanese yen and euro over this period because of rising rate differentials. By owning U.S. debt [unhedged](#), Japanese and European investors were potentially able to boost total returns by collecting higher income and gaining from U.S. dollar strength. Interestingly, the chart above also highlights the point at which the U.S. dollar peaked versus both the yen and the euro. Subsequently, the advantage of owning U.S. fixed income investments relative to domestic markets begins to decline. It is likely that investors who had previously owned U.S. fixed income unhedged began to hedge their U.S. dollars back to the Japanese yen and euros. As a result, demand for hedging these positions started to rise, thus negating the advantage of [swapping](#) U.S. debt. At the same time, [short-term U.S. interest rates began to rise as a result of money market reform](#), which added further pressure to this trade. The dollar weakened because foreign investors sold U.S. dollars and bought their local currency. **U.S. Yield Advantage Dissipates** Today, the advantage of owning U.S. debt on a currency-hedged basis is virtually nonexistent. Put another way, the potential arbitrage for foreign investors is gone, which could dampen U.S. fixed income flows. As a result, U.S. rates may increasingly be determined by domestic factors such as Fed policy and the outlook for [inflation](#) vs. global demand. Additionally, with the potential for risk-free return diminished for foreign investors, some may be more willing to take on currency risk to boost returns. Should these current hedges roll off, we may be poised to enter another period of U.S. dollar strength, especially as the Fed hikes interest rates and raises the costs to hedge U.S. dollars further.

¹Source: Bloomberg, as of 8/26/16. ²The yield series below are calculated by combining the 10-year U.S. Treasury yield + ([Foreign 3m LIBOR](#) - [U.S. 3m LIBOR](#)) + Foreign 10-year basis swap compared to the local bond yield.

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DEFINITIONS

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Maturity : The amount of time until a loan is repaid.

10-year government bond : a debt instrument backed by a government guarantee with an original maturity of 10 years.

Basis point : 1/100th of 1 percent.

German 10-year bund : a debt instrument issued by the German government with an original maturity of 10 years.

Japanese Government Bond (JGB) : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Cross-Currency basis swap : an agreement whereby two parties can agree to exchange a series of cash-flows on a periodic basis at an agreed upon exchange rate.

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Unhedged : Strategy that includes the performance of both the underlying asset as well as the currency in which it is denominated. The performance of the currency can either help or hurt the total return experienced.

Swap : A swap is an agreement between two parties to exchange payments based on a reference asset, which may be a currency or interest rate but also may be a single asset, a pool of assets or an index of assets.

Inflation : Characterized by rising price levels.

Foreign 3m LIBOR : the average 3-month rate that major banks offer to lend to one another for short-term unsecured funds in a particular currency in London. LIBOR refers to the London Interbank Offered Rate.

U.S. 3m LIBOR : the average 3-month rate that major banks offer to lend to one another for short-term unsecured funds in U.S. dollars in London. LIBOR refers to the London Interbank Offered Rate.