Treasury Market’s Long-Dormant Term Premium Is Finally Reviving
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By Liz Capo McCormick and Luke Kawa

(Bloomberg) -- The global bond rout that’s roiled markets to start 2018 could get more fuel as investors see mounting risks in owning longer-dated government debt.

The term premium, which measures the added compensation investors demand to hold longer maturities, has been surging in the Treasuries market. Strategists predicted that this long- dormant metric would revive once the Federal Reserve moved to unwind its balance sheet. Now it’s also getting a boost from signs that U.S. wages are heating up just as Treasury is increasing supply. Meanwhile, speculation is building that the European Central Bank will taper its debt-buying.

The upswing in the term premium, which has been below zero for almost a year, may exacerbate the selloff in Treasuries that drove 10-year yields to a four-year high this week before the stock-market swoon. It could also spell trouble for one of the bond market’s favorite trades in recent months -- the flattening yield curve.

“The supply-demand factors and inflation outlook signal that term premium should be rising,” said Francis Yared, a global rates strategist at Deutsche Bank AG. “It is highly correlated across jurisdictions because these tend to be more global than local factors.”

A rising term premium will continue to propel 10-year yields higher, according to Goldman Sachs Group Inc. The bank has estimated that each $100 billion drop in the Fed’s portfolio raises the 10-year term premium by two to three basis points.

That would amount to about 50 basis points if the balance sheet returns to pre-crisis levels.

Too Low

“We remain of the view that the U.S. term premium is still too low when conditioned against the macro outlook, and the uncertainty around it,” Francesco Garzarelli and his fellow strategists wrote in a note Tuesday. “We recommend preserving a short duration exposure and expect the rebuild of the term premium to lead to a steeper” U.S. yield curve.

Goldman Sachs issued a short recommendation for 10-year Treasuries in November, which the strategists maintain. The firm’s model for fair value -- given economic fundamental and the expected pace of Fed tightening -- has the note at 3.09 percent, compared with about 2.8 percent now.

The term premium is the extra compensation that buyers demand to hold longer-maturity debt instead of a succession of short-term securities year after year. A widely used valuation tool, it tumbled across world markets in the wake of the financial crisis as the Fed and its counterparts bought debt as part of stimulus measures.

The 10-year Treasury term premium is negative 0.29 percentage point, up from a record low of negative 0.84 percentage point in 2016. As the name implies, it’s normally positive.

Its increase in 2018 marks a departure from its typical downward trend during Fed tightening cycles. But much is different this time around -- namely, the central bank’s balance-sheet tapering.

Mortgage Pile-On

Adding to the case for a higher premium and steeper yields is that as the Fed unloads mortgage-backed securities, it may foster volatility because of how private owners hedge their mortgage assets.

Agency mortgage-backed securities generally have negative convexity: As yields rise, prepayments fall and the life of the bond lengthens. Owners tend to hedge against that risk by selling duration via Treasuries or swaps contracts while mortgage rates rise. This tends to bolster the momentum of a prevailing trend upward in long-term yields (as well as the term premium).

It may already be taking place, said Priya Misra, head of global rate strategy at TD Securities.

"The sharp rise in rates could exacerbate fears of convexity hedging, which typically hits the 10-year part of the curve," she wrote in a note last week. "We expect more dynamic hedging behavior, which should exacerbate the selloff if rates continue to rise."

To contact the reporters on this story:
Liz Capo McCormick in New York at emccormick7@bloomberg.net; Luke Kawa in New York at lkawa@bloomberg.net To contact the editors responsible for this story:
Benjamin Purvis at bpurvis@bloomberg.net; Jeremy Herron at jherron8@bloomberg.net Mark Tannenbaum, Vivien Lou Chen