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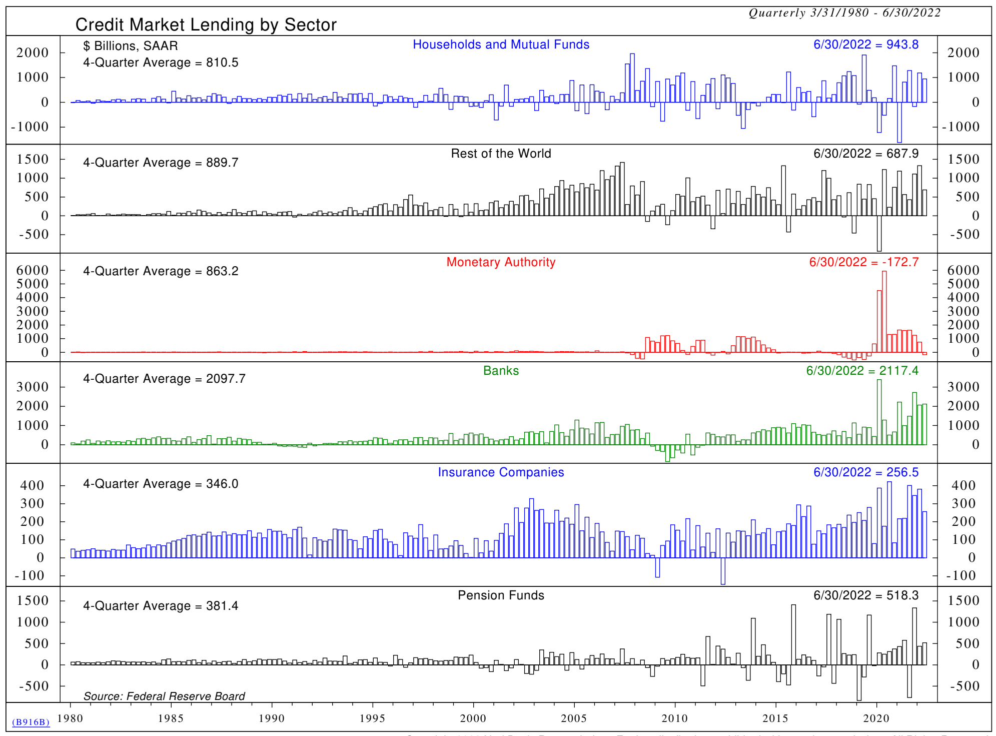
Who will buy U.S.-based bonds?

Key Takeaways

- Some of the biggest bond buyers have reversed course or are about to do so. That could make it difficult for bonds to break out of their current trading range.
- But the likelihood of recession and a potential Fed pivot could change the balance back toward bonds.
- Asset allocators will play a key role.

Former bond buyers are now turning sellers



One of the challenges for the U.S. bond market to break below its current range of 3.50% to 4.30% on the 10-year Treasury is where the money will come from. The biggest buyers of this debt have reversed course or are about to do so, as shown on the chart. Let's take a look at the major categories.

The Federal Reserve (i.e., the monetary authority) was the biggest buyer of U.S. debt during the pandemic. Over the two year period from March 2020 to March 2022, the Fed's securities holdings ballooned by $4.7 trillion. The Fed is currently reducing its holdings by roughly $80 billion per month. That won't change until the Fed cuts rates, which probably won't happen before the end of 2023.

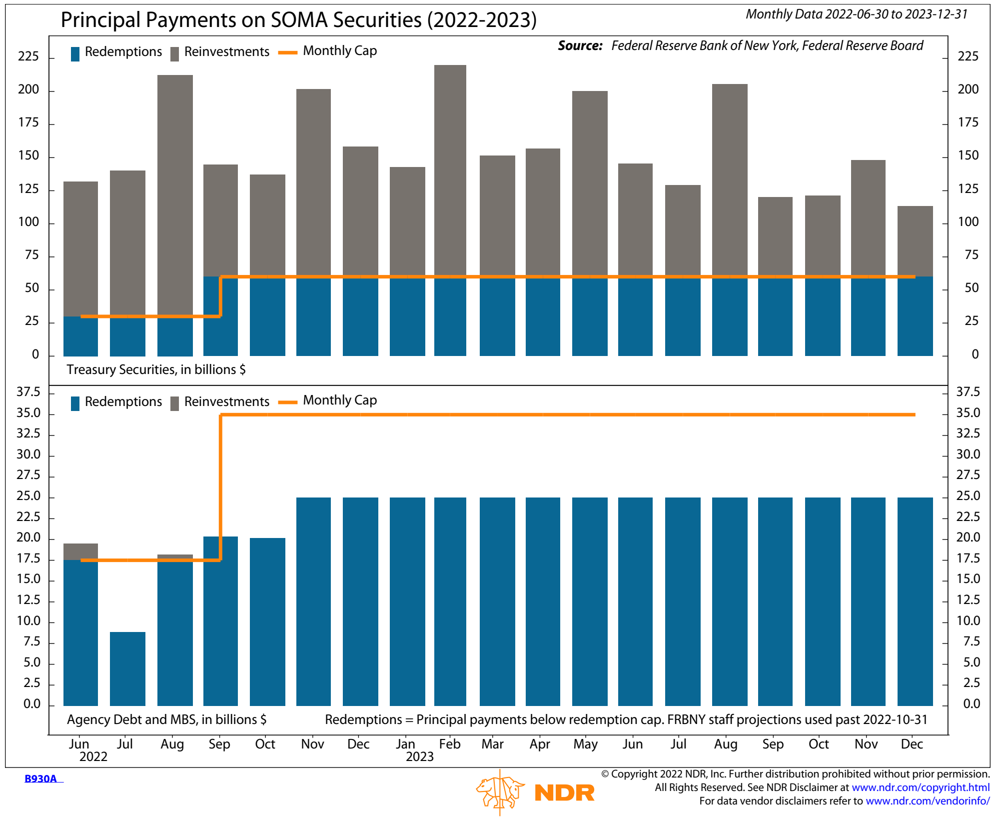
Commercial banks were also big buyers. During that same time, bank investments increased by $1.9 trillion. But since then investments have fallen by over $300 billion, although some of that is due to lower bond valuations. As banks continue to tighten lending standards and terms and the economy likely enters recession, loan demand will slow. At that point banks could return to the bond market.

Overseas investors have been steady buyers of U.S. debt, particularly in the first three quarters of the year when the dollar went on a tear. If we have seen the peak in the U.S. dollar (NDR is currently bearish on the buck), flows into U.S. debt could dry up.

Households and funds have also been respectable buyers of debt. But inflows to bond mutual funds and ETFs have turned from positive to negative for most of this year. Some money currently sitting in equities and cash could move into bonds next year.

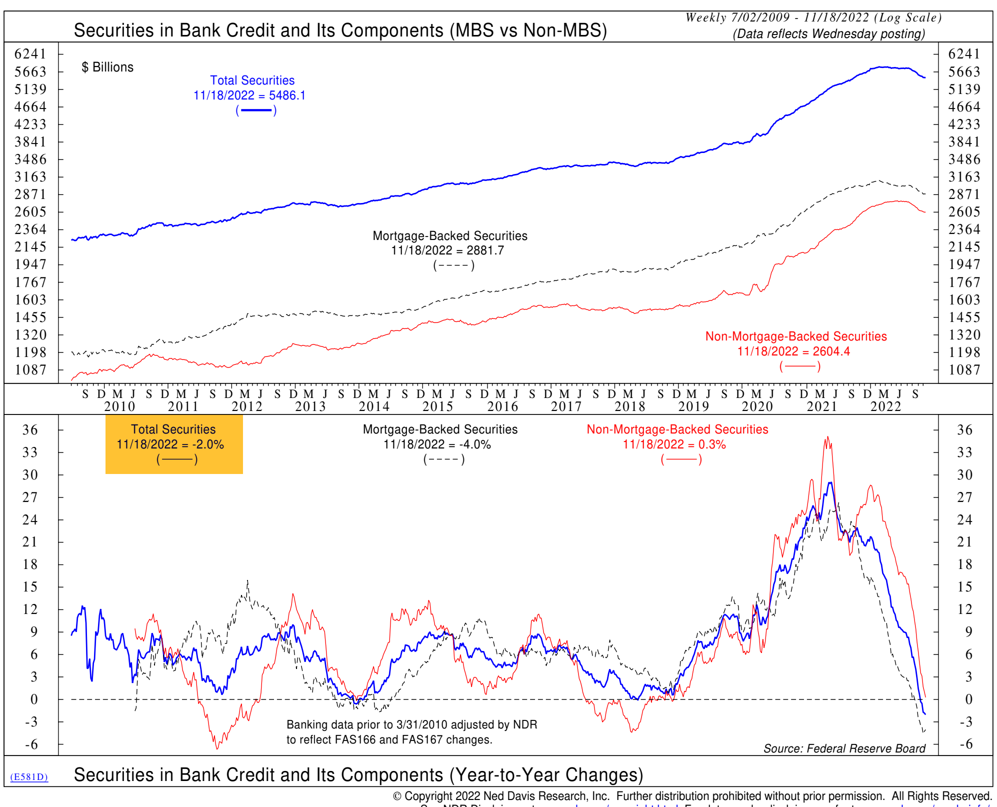
Insurance companies and pension funds should continue to be reliable buyers of bonds, but they aren't big enough to make up for the other buyers.

Fed shedding about $80 billion per month



What could really turn the tide toward bonds prior to the Fed cutting rates is a resumption of the equity bear market due to shrinking margins and lower earnings on growing recession fears. That shift from equities to fixed income is what could really propel bonds out of their current range.

Value of bank securities lower than a year ago



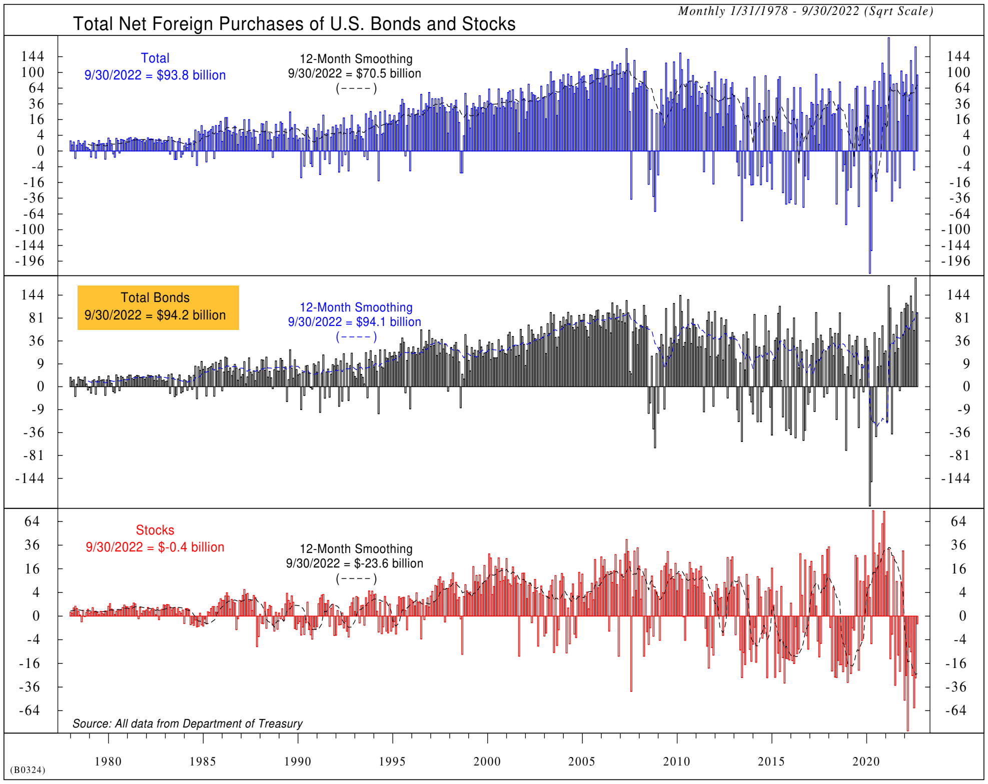
With loan demand from businesses, households, and real estate soaring at double-digit rates in recent weeks, banks have been less interested in buying bonds, and have seen the value of their holdings tumble like everyone else. When loan demand slows and the Fed pauses, banks will likely return to the bond market.

Please see important disclosures at the end of this report.

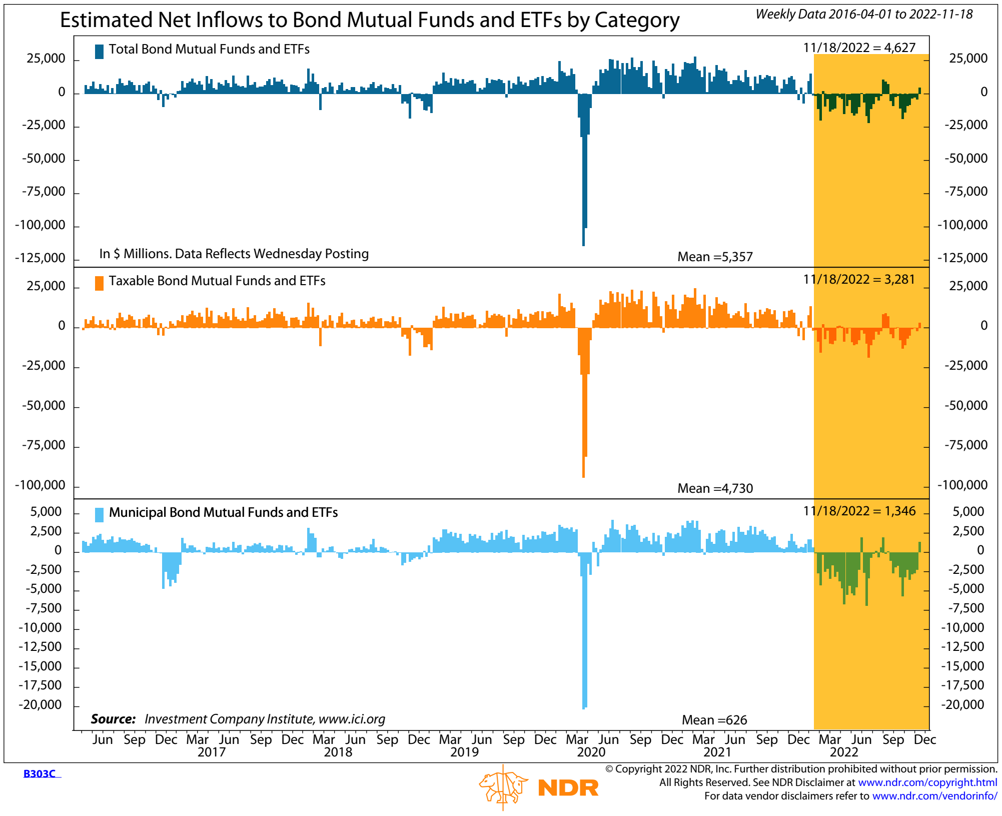
One way to take advantage of the strong U.S. dollar in the first three quarters of the year was to invest in unhedged U.S. dollar denominated debt. But with the dollar peaking, those inflows could disappear.

And with dollar hedging costs high, it makes more sense for European and Japanese investors to stay home.

Overseas buying may dry up



Net outflows from households for most of the year



As the Fed continues to raise rates, cash (T-bills and money funds) becomes more attractive. In fact, assets at retail money funds have hit a record high. That money may stay locked up until investors sense the Fed will reverse course on its monetary policy.

What may have more impact is a shift by allocators from equities to fixed income on recession fears, as bonds usually rally during recessions. Until then, bonds will likely be stuck in a range.

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NDR HOUSE VIEWS (Updated November 17, 2022)

For global asset allocation, NDR recommends marketweight allocation to stocks, bonds, and cash. We are in line with our Global Balanced Account Model estimate.

Equity Allocation

U.S. | We have a modest underweight to stocks in our asset allocation recommendation but are neutral on an absolute basis. The hawkish Fed has overwhelmed the positive tape development in the summer, but sentiment is extremely pessimistic. We favor small-caps over large-caps and Value over Growth.

INTERNATIONAL | We are overweight Europe ex. U.K. and marketweight on all other regions.

Macro

ECONOMY | The global economy is in a sustained slowdown due to waning monetary and fiscal support, stubbornly high inflation, and rising geopolitical risk. While the slowdown remains moderate, the risk of severe recession increases in 2023. Global inflation pressures are easing but will remain historically elevated in the foreseeable future.

FIXED INCOME | We raised our bond exposure to 100% of benchmark duration and are neutral on the yield curve. We are overweight Treasurys, MBS, and CMBS and underweight high yield and TIPS. We are marketweight everything else.

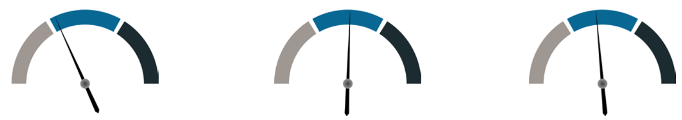
GOLD | We are currently neutral but will be watching our Gold Watch Report for a bullish signal for a potential upgrade.

DOLLAR | We are bearish due to worsening momentum and model readings.

Economic Summary

November 28, 2022

Near term activity: ● Accelerating ● Neutral ● Decelerating



Global Economy (2.9%) | U.S. Economy (1.5%-2.0%) | U.S. Inflation (4.0%-4.5%)

Economic gauges reflect changes in near-term economic activity. Numbers in parenthesis refer to NDR 2022 forecasts.

Global Asset Allocation

● Overweight ● Marketweight ● Underweight

- ●
- ● Stocks (55%) | Bonds (35%) | Cash (10%)
- ●

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Equities — Regional Relative Allocation

- ● Europe ex. U.K. (14%)
- ● U.S. (61%) | Emerging Markets (11%) | Japan (5%) | U.K. (4%) | Pacific ex. Japan (2%) | Canada (3%)
- ●

Benchmark – U.S. (61.5%), Europe ex. U.K. (12%), Emerging Markets (11.2%), Japan (5.5%), U.K. (3.8%), Pacific ex. Japan (3%), Canada (3.1%)

Global Bond Allocation

- ● Japan (19%)
- ● U.S. (55%) | Europe (25%)
- ● U.K. (1%)

Benchmark: U.S. (57%), Europe (25%), Japan (15%), U.K. (4%)

U.S. Allocation

- ● Cash (15%) | Small-Cap | Value
- ● Bonds (35%) | Mid-Cap
- ● Stocks (50%) | Large-Cap | Growth

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Sectors

- ● Health Care (17%) | Energy (5%) | Materials (4%)
- ● Consumer Discretionary (8%)

Benchmark: Technology (27.4%), Health Care (13.8%), Financials (10.7%), Communication Services (9.3%), Consumer Discretionary (12.1%), Consumer Staples (7.0%), Industrials (7.9%), Energy (4.0%), Utilities (2.7%), Real Estate (2.7%), Materials (2.5%)

U.S. Bonds — 100% of Benchmark Duration

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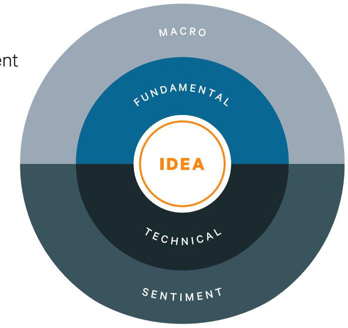

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