Why International Investors Aren't Buying U.S. Debt

Rising hedging costs are reducing demand from international investors for Treasurys
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- ***The Wall Street Journal***

The rise in Treasury yields should make U.S. debt more attractive to international investors still struggling with low returns at home—yet few are buying.
The rising costs of currency hedges means it often isn't worth it.

Yields on 10-year U.S. government bonds have jumped to 2.9% from 2.1% a year ago, nearing levels last seen in early 2014. In Europe, a 10-year German bund yields 0.68%, while in Japan the same maturity returns 0.05%. Yields move inversely to prices.
Last year, buying Treasurys and swapping the proceeds back into euros provided European investors with a higher return than buying German sovereign bonds. Now, hedging costs have increased so much that this trade is no longer profitable.
That could sap an important source of demand for U.S. Treasurys. It's also making it more expensive for foreign investors to buy U.S. corporate debt.
"We've been very wary about what optically appears like a very wide difference [in yields] between Europe and the U.S., because of funding and hedging costs," said Charlie Diebel, a London-based fund manager at Aviva Investors, who is now looking to buy in other bond markets like Canada.

The European Central Bank estimates that since 2015, eurozone investors have accounted for more than half of foreign purchases of U.S. debt securities. But in 2017, eurozone investors were consistent net sellers of Treasurys, according to official U.S. data.
International investors usually hedge their holdings of foreign bonds using derivatives, which allow them to borrow a foreign currency in exchange for their own, and lock in a future rate at which they will reverse the transaction.

On the surface, there is still a case for buying Treasurys and hedging the currency risk. Buying a 10-year Treasury and buying a hedge in euros for that same maturity will still earn an investor a small pickup of around 0.1 percentage point over what they would get buying a German bund. A year ago, the reward was similar.
But the problem for the Treasury market is that few big investors hedge it for anywhere near that time, analysts say.
"Most investors prefer to roll over three-month currency hedges because it's a more liquid market," said Chris Iggo, chief fixed-income investment officer at AXA Investment Managers.

Holding long-term Treasurys and hedging the currency risk for three months means taking a hit every time the Federal Reserve nudges up short-term borrowing costs, which it has done three times over the past year.

The greenback has also just become harder to source for investors using currency derivatives, as rules designed to make finance safer have made banks more reluctant to lend dollars in the short term. Adding to this, the Fed is now sucking dollars out of the financial system as it rolls back its monetary stimulus, making the currency even scarcer.

A year ago, investors were getting around 0.5 percentage point extra for buying a 10-year Treasury and hedging the currency risk every three months, instead of purchasing a German bund, according to The Wall Street Journal's calculations. They are now losing 0.5 percentage point—a multiyear low.

Yields on long-term bonds like the 10-year Treasury will have to go up much more if they are to attract fresh overseas buyers, Mr. Iggo said.
Typically, government debt trades in line with where investors believe central banks will set interest rates in the future. Investors currently think borrowing costs will be increased to cool burgeoning inflation pressures, with new Fed Chairman Jerome Powell cementing that belief on Tuesday.

But Fed data suggests that rate expectations account for only a third of the selloff in 10-year Treasurys this year. The rest of the selling has been influenced by a rise in that bond's "term premium," the extra compensation investors get for holding longer-term debt—which is more sensitive to a fall in demand.

The rising cost of currency hedges is also affecting U.S. corporate bonds, investors say, making them less attractive compared with their euro-denominated counterparts. Over the past month, yields on corporate debt have risen further in the U.S. than Europe, according to indexes complied by Bank of America Merrill Lynch.

Japanese investors can still get a 0.3-percentage-point pickup over their own debt by buying Treasurys with three-month currency hedges. But Commerzbank analysts noted that they will find much better opportunities in Europe, where they now get an extra 0.8 percentage point to hold bunds and swap the proceeds back into yen every three months.

Since 2014, Japanese asset managers have been steadily reducing their holdings of U.S. debt, data from Japan's Investment Trusts Association shows, and that trend continued into last year.

To be sure, for those investors who want to accumulate dollars outright—like developing-world central banks—the rise in Treasury yields is still a boon. And others are now foregoing hedging altogether, which could help a beleaguered dollar.

"For the first time any of us can recall we have interest from an Asian entity to buy unhedged U.S. credit," said Bob Michele, JPMorgan Asset Management's global head of fixed income.

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Appeared in the March 1, 2018, print edition as 'Foreign Investors Eschew U.S. Debt