

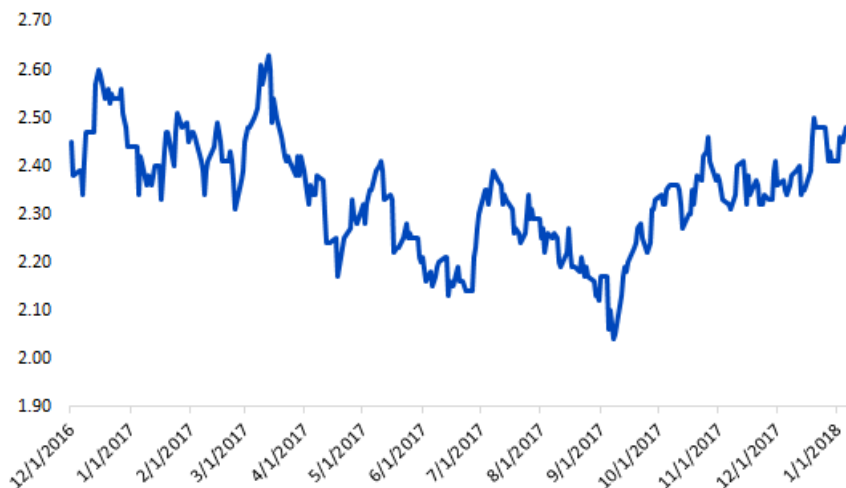
U.S. TREASURIES: STARTING OFF ON THE WRONG FOOT

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There is no doubt 2018 has gotten off to a far different start for the [U.S. Treasury \(UST\)](#) market as compared to the last few years. Indeed, from 2014 through 2017, the [UST 10-Year note](#) rallied in the first month or so in each year, but thus far in 2018, just the opposite has occurred. Remember, what happens in January does not necessarily dictate the trend for the remaining 11 months of the year, but given the movement of the last week or so in 10-Year Treasury yields, some perspective is needed.

Interestingly, the rise in government [bond yields](#) has not been isolated to the U.S., as essentially all of the [G7](#) nations have seen increases. As of this writing, 10-year government yields have risen, on average, by roughly 15 to 30 [basis points \(bps\)](#) from their mid-December low-water marks. For the record, the UST 10-Year increase is pegged at about 20 bps and was quickly approaching the 2.60% level at one point, the highest reading since March.

U.S. 10-Year Treasury Yield



Source: Bloomberg as of 1/10/18. Past performance is not indicative of future results.

The early 2018 uptick in the [UST 10-Year yield](#) had really nothing to do with the fundamentals, namely economic data or a shift in the [Federal Reserve \(Fed\)](#) policy outlook. Rather, the catalyst was coming from offshore. One of the key influences to watch for in the 2018 U.S. rate outlook will be other central bank policy actions, specifically from the European Central Bank (ECB) and the Bank of Japan (BOJ). This is precisely what caught investors off guard to begin the new year.

First up, in Japan, the BOJ surprisingly announced it was dialing back on its longer-dated securities [buyback](#) program, and that was followed by reports ECB officials have been contemplating the notion of tweaking their policy guidance, with an eye on their quantitative easing program. As a reminder, the current ECB QE program was adjusted in October, when the amount of purchases was reduced to €30 billion and extended through September of this year. Obviously, the actual policy outcomes are of vital importance, but one could make the case that “how we get there?” is equally important. How the ECB and others communicate their intentions is very important to the bond market. The Fed has given investors an example of success (last year’s [balance sheet](#) normalization plan) and an example of failure (the [taper tantrum](#)).

Now, let’s throw China into the mix. At around the same time the aforementioned news was coming out, reports that China was considering either slowing or halting its purchases of Treasuries was “hitting the tape.” How serious should investors take such headlines? China has been cutting back its purchases of Treasuries for a while now. To provide some perspective, through October (latest data available), China’s holdings were pegged at 18.7% of the foreign total amount versus a peak of 28% in 2011. For the record, the percentage got down to as low as 17.6% in November 2016 (for those interested, the next report comes out later today). In addition, following the UST 10-Year sell-off in response to this headline, China’s State Administration of Foreign Exchange (SAFE) put out a statement saying this news report “might have cited wrong sources or may be fake news.”

Conclusion

Now that you’ve digested all that, what’s the bottom line here? Investors will need to watch foreign central bank developments closely. While any potential further news regarding China’s purchases will no doubt bear scrutiny, how the ECB prepares the markets for its September end date and how the BOJ communicates any modifications to its buying program will probably move to center stage.

Want some good news? If you follow technical analysis, the backup in the UST 10-Year yield placed it right back up to the “oversold” line when looking at the relative strength index chart. Over the last year or so, each time that has happened, the 10-Year then rallied. Interestingly, last week’s UST 10-Year note auction was met with stellar demand, no doubt a result of the yield increase. On that front, perhaps, some things never change. Stay tuned.

Unless otherwise noted, data source is Bloomberg as of January 10, 2018.

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DEFINITIONS

Treasury: Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

U.S. 10 Year Treasury Note: A debt obligation issued by the United States government that matures in 10 years.

Bond yield: Refers to the interest received from a bond and is usually expressed annually as a percentage based on its current market value.

G7: The Group of 7 is a group consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

Basis point: 1/100th of 1 percent.

10-year government bond yield: Yields on the 10 year government debt security.

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Buyback: When a company uses its own cash to purchase its own outstanding shares; may positively impact the share price.

Balance sheet: refers to the cash and cash equivalents part of the Current Assets on a firm's balance sheet and cash available for purchasing new position.

Taper tantrum: a period in which global interest rates rose dramatically in 2013 as a response to a shift in monetary policy by the Federal Reserve.