Instant Thoughts

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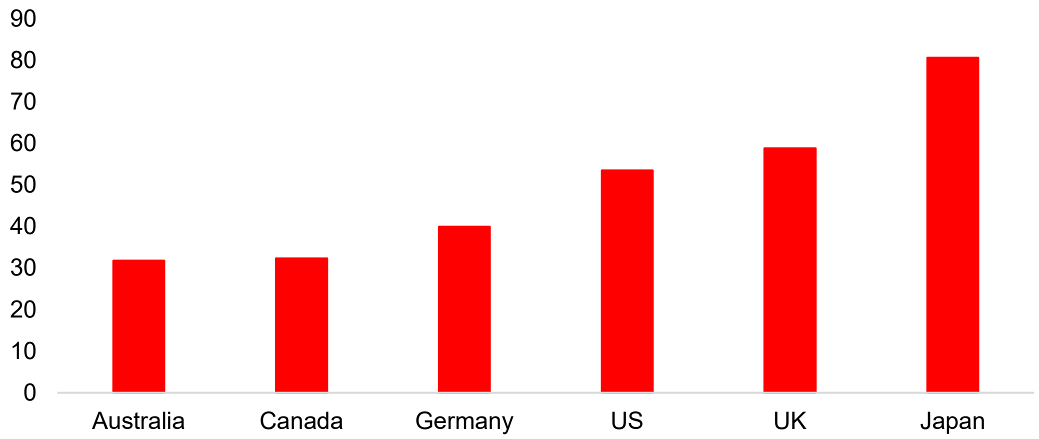
A Monetary Breather

- **Unlike QE, buying back longer-dated bonds and swapping them with shorter maturities is "reserve neutral". It is still desirable if they can remove duration risk from the primary dealers.**
- **Constraint can bite. The proposed buyback amounts to an inconsequential 0.2% of U.S. GDP. The first-order impact should not exceed a few basis points.**
- **Bessent can also fund the buybacks with foreign repo pool. His gambit can only be effective if foreign central bankers are willing to unwind their reverse repo positions, which we doubt.**
- **The Trump administration betrays its unapologetic willingness for sacrificing dollar strength to inflate away the debt.**

You may not be interested in the bond market, but the bond market is interested in you. As the pressure of renewed U.S.-Iran conflicts and budgetary frugality is rippling outward, the U.S. long-dated yields are now flirting with two-decade highs. That leaves U.S Treasury Secretary Bessent little choice but to swing into action, doubling long-end Treasury buyback last week.

Exhibit 1: Uptick in 10-year Government Yield (bp, year-to-date)



Source: Bloomberg, Shanghai Commercial Bank

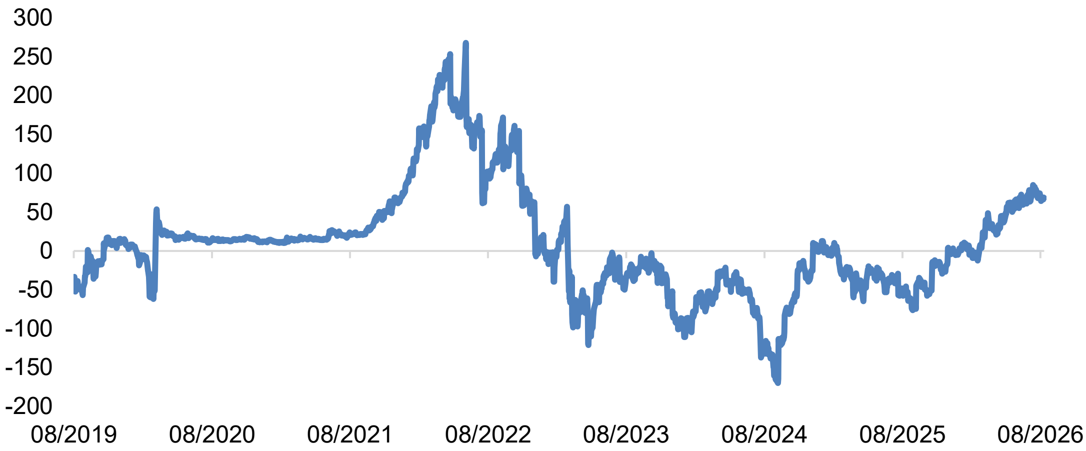
What comes after is far less certain. There are two ways for Bessent to deliver his gambit. First is to conduct an asset swap. While buying back longer-dated off-the-run Treasuries and swapping them with shorter maturities is "reserve neutral", it is still desirable if they can remove duration risk from the primary dealers. Constraints can bite, though. The proposed buyback amounts to US$64bn or an inconsequential 0.2% of U.S. GDP. Any way you slice it, they are bringing knife to a gunfight. The first-order impact should not exceed a few basis points.

Will it turn more like a cure than a circuit breaker?

Consider an alternative channel that Bessent can take advantage of: Buybacks funded with foreign repo pool (FIMA). If foreign central bankers decide to partake in Treasury-engineered buyback, the once-trapped overseas liquidity can recycle back into the banking system.

That's the trap Bessent faces: Treasury buyback can only be effective if foreign central bankers, nudged by Treasury's activism, are willing to unwind their reverse repo positions. Historically, superior return of bill or repos will have make the unwinding worthwhile. We nonetheless are skeptical if the rate gulf of 45bp, against the backdrop of a crushing debt load, is enticing enough (Exhibit 2). Cutting repo rate could incentivize foreign central banks to engage the bill market, but it will thwart the coordinated intervention with Bank of Japan. Above all, Bessent offers the same solution as the half-hearted buyback program in 2024 – plugging leaks rather than stopping the flood. Monetary alchemy without a broad fiscal overhaul would be a flash in the plan.

Exhibit 2: Rate Spread between U.S. 1-Month Bill and FIMA Repo Rate (bp)



Source: Bloomberg, Shanghai Commercial Bank

Treasury buybacks will provide a strong lower rate bound, not changing boldholders' tack anytime soon. Perhaps the more interesting chapter is beginning now, since the Trump administration betrays its unapologetic willingness for sacrificing dollar strength to inflate away the debt.

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