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Before the Boat Sails: The Case for Long-Duration US Treasuries

Understanding Bond Dynamics

Investors often turn to bonds for their stability and capital protection, however, it's worth noting that bonds prices can move sharply in response to interest rate changes. The relationship between bond price and its yield is crucial to understand this dynamic.

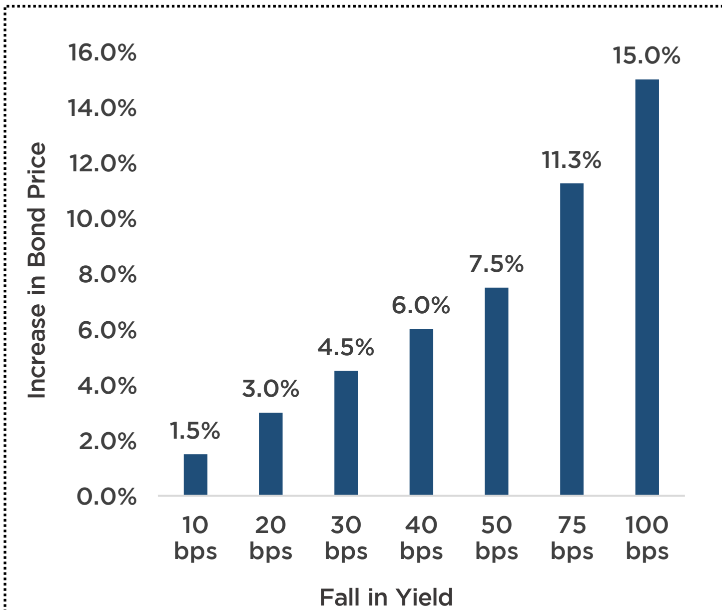
- When interest rate (or bond yield) falls, bond price rises and vice versa.
- Bonds with longer duration exhibit more significant changes in price in response to fluctuations in interest rates. This is measured by modified duration (MD) which represents the change in bond price with change in bond yield.

$$\%\text{ change in bond price} = -(\%\text{ change in yield}) \times (\text{MD})$$

At 5% coupon rate and yield, MD of 10yr bond is ~8 and that of 30yr bond is ~15. This means that a 1% fall in yield leads to approx. 8% capital gain for 10yr bond and 15% capital gain for 30yr bond.

Probable bond price change in US 30yr G-sec with fall in yields

Considering the modified duration of 15 for 30yr bond, below is the scenario analysis of probable change in bond price in US 30yr G-sec with different levels of fall in yield.



Source: Internal calculations based on bond dynamics
Note: Changes in bond price shown above are absolute; accrual gain/coupon income has not been considered
Disclaimer: Above calculations are shown for illustration purpose only. Actual changes in bond prices will be subject to market risks and volatility. Past performance is not an indication of future returns.

Did You Know?

- Modified duration (MD) is inversely proportional to coupon rate and yield.
- For same maturity bonds, those with lower coupon rates/yields—such as US bonds—exhibit higher MD than higher-yielding counterparts like Indian bonds.

	Yield	MD
US 30yr G-sec	5%	15
India 30yr G-sec	7%	12

This structural difference means that US bonds are more responsive to shifts in interest rates, making them optimal for duration or interest rate strategies. Conversely, Indian bonds, with higher yields and relatively lower duration, are better suited to accrual-based approaches, where steady income is prioritized over interest rate strategies.

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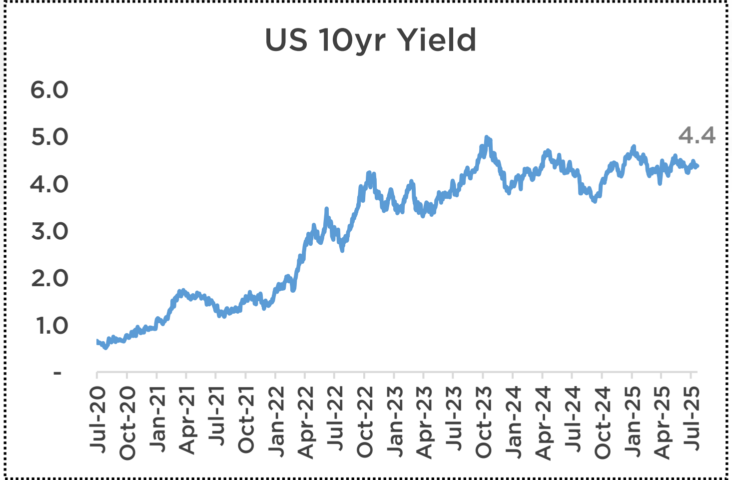
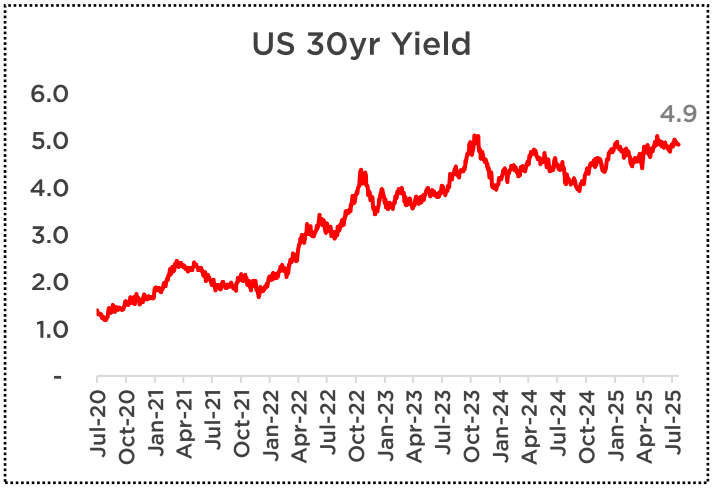
US Treasury Yields Trend





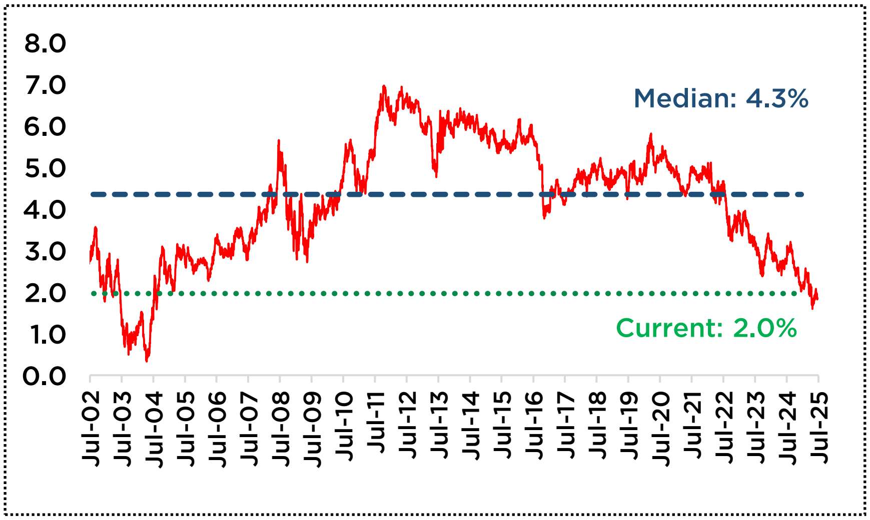
Source: Bloomberg

US Yields have been elevated recently on account of:

- Sticky inflation and relatively strong economic data in US
- Hawkish Fed monetary policy outlook
- Large US government borrowings and increased treasury supply
- Reduced foreign demand for US treasuries
- Global trade policy uncertainty and geopolitical factors

What could bring down US yields from current levels

India 10yr vs. US 10yr G-sec Yield Spread (%)



Source: Bloomberg

- With the India–US 10-year bond yield spread currently near 200 bps (well below its median spread of 430 bps over last two decades) there is a potential for mean reversion.
- If the spread moves back toward its historical range, the adjustment is most likely to play out through a fall in US yields rather than a rise in Indian yields.

- US Fed Rate Cuts – Fed has maintained its policy rate at 4.25-4.5% since Dec'24 and is widely expected to cut rates soon. As per CME FedWatch tool, market is factoring ~50 bps cut in Fed Funds rate in CY25. Cut in policy rates could lead to a fall in government bond yields.
- Economic Slowdown or Recession – IMF had lowered US economic growth forecast to 1.8% in Apr'25 from their earlier estimate of 2.7% in Jan'25. In a slowing economy with a softening labor market and business sentiment, demand for risk-free assets like government bonds could increase.
- US Inflation Easing Towards the Fed's Target – Currently CPI inflation in US is 2.7% (Jun'25). While not yet at the 2% Fed's target, steady disinflation could relieve pressure on the Fed to maintain tight monetary policy, a trend that could lower yields.
- Potential for Geopolitical or Financial Shocks - New trade tariffs, global political events, or financial market volatility can provoke a "flight to safety," causing investors rush into Treasuries, leading to fall in yields.
- Moderation in Treasury Supply and Yield Curve Control Hints - While large-scale government borrowing has contributed to high yields, any signals of fiscal improvement or Fed intervention can shift demand in favor of Treasuries, capping or reducing yields.

Key Risks of Investments in US Treasuries

- Interest Rate Risk - Higher duration bonds are much more sensitive to changes in interest rates. Any adverse movement in bond yields or interest rates could lead to capital loss.
- Currency Risk – For an Indian resident investing in US treasuries, all returns are denominated in US dollars. If INR depreciates against USD, Indian investor can gain additional return on currency conversion. However, in case INR appreciates vs. USD, overall INR returns may reduce.

Investment Avenues in US Treasuries for Indian Investors

Indian investors can open international brokerage accounts under the RBI's Liberalized Remittance Scheme (LRS), which allows investments of up to $250,000 per individual per financial year in foreign assets. Through these accounts, investors can buy US Treasury ETFs. Purchasing direct bonds is also an option but it can be cumbersome as bonds could have high investment limits, low liquidity and involve higher transaction charges vs. ETFs. Some of the ETFs are listed below:

- UTHY (US Treasury 30 Year Bond ETF): Invests in US Treasury bonds with a 30-year maturity.
- UTWY (US Treasury 20 Year Bond ETF): Invests in US Treasury bonds with a 20-year maturity.
- UTEN (US Treasury 10 Year Note ETF): Invests in US Treasury bonds with a 10-year maturity.

Above ETFs are domiciled in US and pay regular payouts on monthly/quarterly basis. These payouts are subject to tax and required to be manually reinvested.

Note: Investors considering US Treasuries should exercise caution regarding taxation and regulatory requirements. Returns from overseas investments, including US Treasuries, are subject to Indian tax laws and US withholding tax on interest or dividends. Additionally, all foreign investments must comply with the RBI's guidelines, which imposes annual caps and reporting obligations. Investors should stay updated on any changes in RBI rules, ensure proper tax filings, and verify that chosen investment platforms meet regulatory guidelines to avoid compliance issues and unforeseen tax liabilities.

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