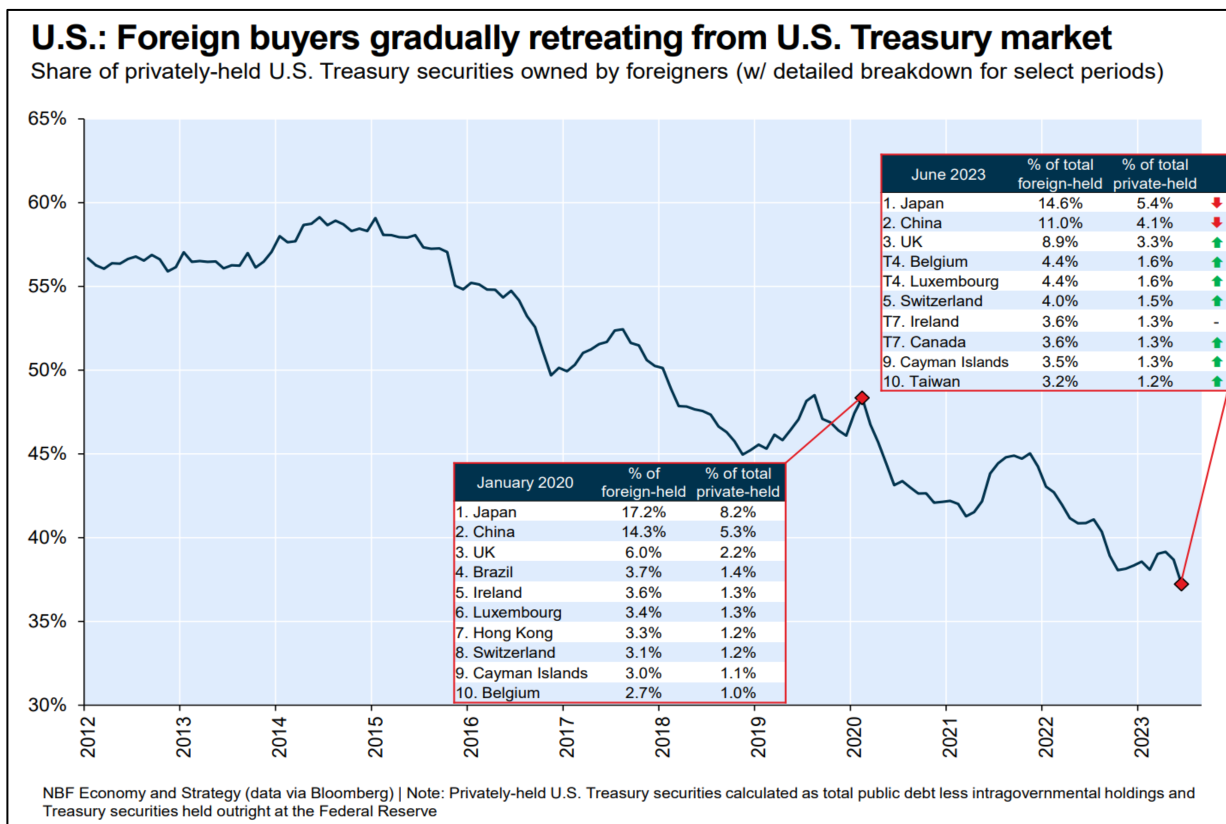
What Determines Long-Term Interest Rates?

September 9, 2023

Short-term interest rates are determined by central bank policy. For example, the Bank of Canada sets its overnight rate (rate commercial banks are charged to borrow from the Bank of Canada) at the level it believes will maintain inflation within its stated band of 1 to 3%. If inflation is higher than central banks desire, they increase the overnight rate to slow the economy. If inflation is lower than they want, they decrease the overnight rate to stimulate the economy.

What isn't as well understood is how longer-term interest rates are set. For example, what determines the rate you are charged for a 5-year mortgage? Longer-term interest rates are determined by the bond market with the US bond market being the world's largest and most influential. The simplest way to understand long-term interest rates is they are determined by the rate which balances supply and demand for government bonds. For example, the US 30-year interest rate fluctuates daily based on the price of the US 30-year bond. As the price of the US 30-year bond moves higher, 30-year interest rates decrease and vice versa. If demand for 30-year bonds is higher than supply, the price of the bond must move higher to balance supply and demand. Conversely, if supply for the 30-year bond is higher than demand, the price of the bond moves lower. As shown in this week's chart, foreign buyers of US bonds are buying less than they have at any point over the past decade. The largest foreign buyers of US bonds are Japan and China which have both decreased their purchases in recent years.



June 2023	% of total foreign-held	% of total private-held	
1. Japan	14.6%	5.4%	↓
2. China	11.0%	4.1%	↓
3. UK	8.9%	3.3%	↑
T4. Belgium	4.4%	1.6%	↑
T4. Luxembourg	4.4%	1.6%	↑
5. Switzerland	4.0%	1.5%	↑
T7. Ireland	3.6%	1.3%	-
T7. Canada	3.6%	1.3%	↑
9. Cayman Islands	3.5%	1.3%	↑
10. Taiwan	3.2%	1.2%	↑

January 2020	% of foreign-held	% of total private-held
1. Japan	17.2%	8.2%
2. China	14.3%	5.3%
3. UK	6.0%	2.2%
4. Brazil	3.7%	1.4%
5. Ireland	3.6%	1.3%
6. Luxembourg	3.4%	1.3%
7. Hong Kong	3.3%	1.2%
8. Switzerland	3.1%	1.2%
9. Cayman Islands	3.0%	1.1%
10. Belgium	2.7%	1.0%

You may have noticed a recent increase in longer-term interest rates both in Canada and the US. The reason for this move can be attributed to an increase in supply and a decrease in demand for US bonds. The largest buyer of US bonds has been the Federal Reserve through Quantitative Easing (“QE”). As I’ve written about previously, the Federal Reserve has reversed course from QE and is now selling bonds through what is known as Quantitative Tightening (“QT”). This means the largest buyer of US bonds has become a seller. In addition to losing the largest buyer for US bonds, the second and third largest buyers (Japan and China) are buying less because they are buying bonds denominated in their own currency to help support their economies.

Decreased demand for US bonds is occurring while the supply is increasing. The reason for an increase in supply is record deficits and the recent increase in the debt ceiling. Once the debt ceiling in the US was increased, the US Treasury began increasing the amount of bonds they sell to pay for record deficits. In simple terms, the US is borrowing more money than ever. Decreased demand and increased supply is driving bond prices lower and interest rates higher. Long-term interest rates could move even higher if the current trends of increasing supply and decreasing demand for US bonds persists.

Blaine Kunz, B.Mgmt., CIM
Senior Wealth Advisor &
Portfolio Manager
Tel.: 403 488-4681
blaine.kunz@bnc.ca

Eric Van Enk, B.Comm., B.A., CFA
Wealth Advisor &
Associate Portfolio Manager
Tel.: 403 488-4685
eric.vanenk@bnc.ca

National Bank Financial – Wealth Management
102 - 505 1st St. SE,
Medicine Hat Alberta T1A 0A9

National Bank Financial - Wealth Management (NBFWM) is a division of National Bank Financial Inc. (NBF), as well as a trademark owned by National Bank of Canada (NBC) that is used under license by NBF. *NBF is a member of the Canadian Investment Regulatory Organization (CIRO) and the Canadian Investor Protection Fund (CIPF), and is a wholly owned subsidiary of NBC, a public company listed on the Toronto Stock Exchange (TSX: NA). The information contained herein has been prepared by Eric Van Enk, Associate Portfolio Manager and Wealth Advisor at NBF. I have prepared this article to the best of my judgment and professional experience to give you my thoughts on various financial aspects and considerations. The opinions expressed herein, which represent my informed opinions rather than research analyses, may not reflect the views of NBF. The opinions expressed are based on my analysis and interpretation of historical data. Values and returns will fluctuate, and past performance is not necessarily a guarantee of future performance. The particulars contained herein were obtained from sources I believe to be reliable but are not guaranteed by me and may be incomplete. The opinions expressed are based upon my analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein. The securities or sectors mentioned herein are not suitable for all types of investors. Please consult your wealth advisor to verify whether the securities or sectors suit your investor's profile as well as to obtain complete information, including the main risk factors, regarding those securities or sectors.*