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Fixed Income— US Debt Dynamics 11/3/2023

Since the summer we have been recommending high quality core bonds (which includes short-dated US Treasuries). Although down the past few days, interest rates have risen throughout the year and weighed on bond market returns. Rates have risen this year for a host of reasons:

Yields are determined by three primary factors- policy rate (real economic growth and inflation), supply vs. demand (liquidity), and term premium. Generally it is the first factor that is most important.

Policy Rate

Over the past year and half, the Federal Reserve has been very aggressive in raising rates to cool off inflation. Aggressive policy has been a major reason yields rose through August after the FOMC raised rates 25 bps at the July meeting. During that time the Fed raised rates over 500 bps and headline inflation has fallen significantly. As a result, the Fed’s rate tightening might be nearing an end as they paused at the September and October meetings. However, interest rates are likely to remain higher for longer due the stubbornness of core inflation which is above the Fed’s long term target.

In addition to Fed policy, the third quarter saw economic data come in better than expected. Solid economic numbers helped support rates, in our view. US September composite PMI moved up to 50.0 led by an improvement in services PMI. US industrial production rose by 0.3% in September. Moreover, retail sales were also favorable led by strong household consumption. As a result, US GDP rose 4.9% annualized in the third quarter, the fastest pace since 2021. It is a strong acceleration from the second quarter’s 2.1% pace.

The UST 10 year has tracked economic growth fairly well through September, as expected. The chart to the right shows how UST 10 year yields tracked economic growth.

Source: Strategas, October 2023

However, the economy has recently started to see some signs of weakness. Manufacturing activity in the U.S. contracted more than expected in October. The ISM manufacturing index declined to 46.7—in contraction territory. The slowdown is reflected in the Atlanta Fed GDP Tracker, which provides a useful pulse of economic growth.

The Treasury Department forecasted that the pace of growth likely will tumble to 0.7% in the fourth quarter and just 1% for the full year in 2024. The Federal Reserve's Statement of Economic Projection in September put expected GDP growth at 1.5% in 2024. As a result, US Treasury yields should have fallen.

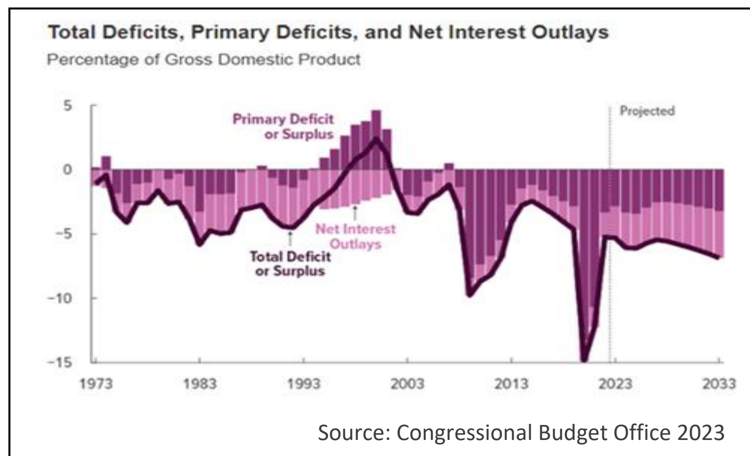
But in October the UST 10 year yields appears to have diverged from the Fed's growth tracker, as seen in the above chart. Moreover, due to the higher geopolitical risk in the third quarter, one would have expected US yields to have fallen. Historically when geopolitical rises US Treasury markets would have rallied due to flight to safety resulting in falling yields. Instead yields rose throughout the month.

We suspect that the cause of higher yields was related to US political and debt dynamics, particularly Treasury liquidity. Leadership issues in the US House of Representatives throughout October could have soured sentiment. But the major factor, in our opinion, is supply-demand imbalance in the Treasury market that has been occurring. US debt dynamics have pushed up yields and will impact the bond markets for a foreseeable future. In the next section we will provide an overview of the US debt factors that will continue to affect yields.

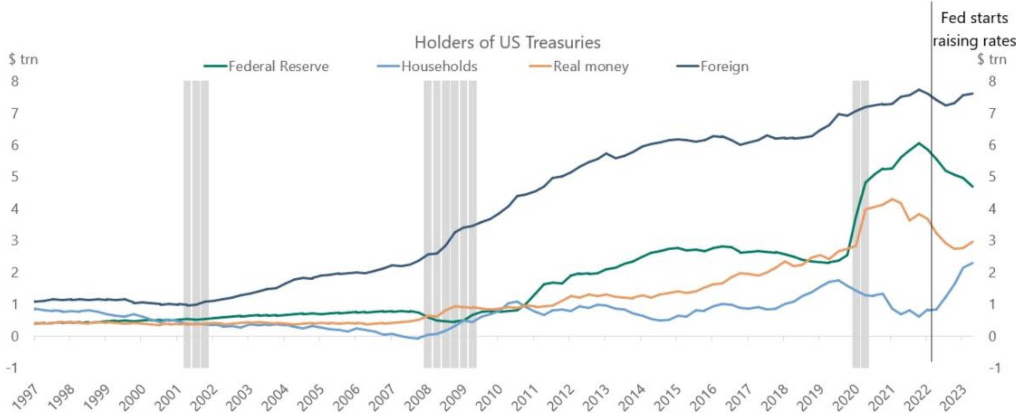
Treasury Bond Supply vs Demand

Like any traded asset, price is where supply and demand clears. The same occurs in the Treasury market. Treasury yields are largely determined at auctions where buyers (investors) and sellers (US Treasury) interact. This is where the US deficit is funded.

Historically the US deficit has averaged 3% of GDP in normal times (i.e. peacetime with no recessions). It rose significantly during COVID. According to the non-partisan Congressional Budget Office, that annual deficit is expected to increase to approximately 7% annually for the next decade as interest expense rises. **As a result, we believe the supply of bonds will rise**.



Source: Congressional Budget Office 2023



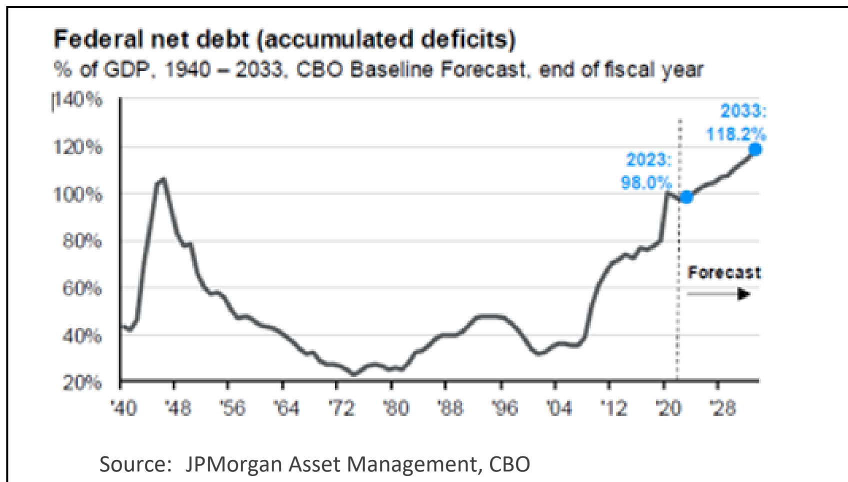
A major problem is that the two largest investor groups have pulled back. Foreign investors (esp. Japanese and Chinese investors) have slowed purchases, and the Federal Reserve has been selling $60 bn/ month of its holdings as part of Quantitative Tightening.

Source: FFUNDS, Haver, Apollo Chief Economist

More buyers are needed this decade to fund the larger deficits. Higher rates are needed to coax them to buy more, and as result, rates will stay high. With 2023 deficit higher at approximately $2 trillion, supply-demand appears to have been a major cause of the yield rise. **We believe this is likely to be the case going forward.**

US debt (held by the public) is nearly 100% and expected to rise throughout the decade. It means more buyers are needed. The debt trajectory is also likely to sharpen the political debate.

In the first half of this year we faced the risk of the debt ceiling not being raised, potentially causing a debt default. This type of political gridlock might be a more frequent event, in our view.

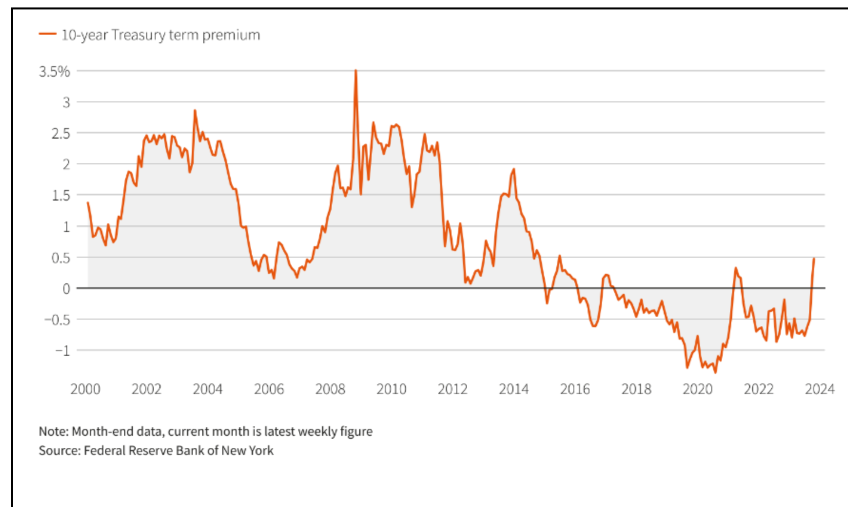


Source: JPMorgan Asset Management, CBO

<u>Term Premium</u>

The US is not at risk of defaulting on its debt. The country is very wealthy and has the ability to meet its debt obligations. However, the *willingness* to repay due to political polarization could cause interest rates to become more volatile.

As a result, <u>investors will need to be compensated for the higher risk through a higher term premium</u>. The term premium spiked in 2013 when political risk rose. It has also risen this year. Going forward the term premium might continue to rise.



Beyond politics, there is an economic impact. The larger the debt burden combined with higher interest rates, the more funds are directed to the payment of interest rather than productive growth investment. The crowding out of investment could lower future US economic growth.

Implications for Investing

So what does this actually mean for investing? The effect on markets is likely to be secularly higher bond yields, higher volatility, lower growth and a weaker US dollar. Its impact to investments is broad:

- Bond yields are likely to be higher than otherwise due to both the need to find new buyers and reflect the higher term premium. It makes the yields of shorter duration core fixed bonds more attractive.
- In addition to higher yields, higher volatility should increase the discount rate for all risk assets.
- US equities should face increased headwinds due to both a higher discount rate and lower corporate earnings. Higher interest rates reduce corporate earnings and lower economic growth causes revenues to slow. This will be a challenge for equity returns given the current high valuations.
- Higher volatility makes macro hedge fund strategies attractive.
- A weaker US Dollar should help boost returns for unhedged foreign assets.
- A weaker dollar should also benefit gold.

Conclusion

Despite the debt dynamics we continue to be optimistic on the outlook for core fixed income- yields are attractive and up significantly over the past year, performs well after the Fed ends rate hiking cycle, not exposed to reinvestment risk to the extent of short-dated treasury bills, provides a counter-balance to equities and we believe it is attractively valued compared to equities.

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