Bond Market Frets Over Treasury Supply

By Stephen Slifer *Thu, Mar 1, 2018*

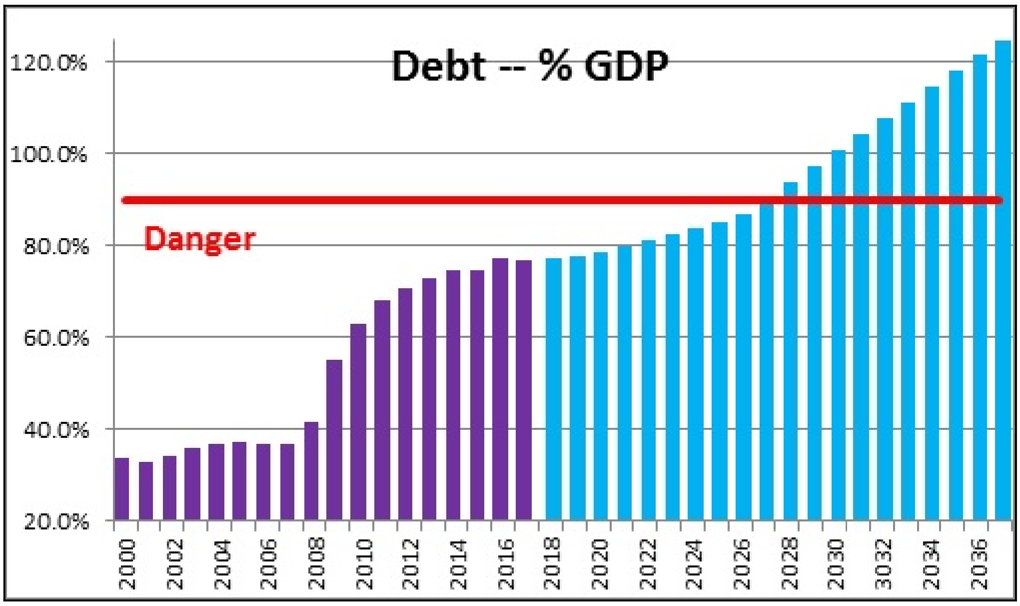
'Without wanting to be unduly alarmist, the U.S. has a debt problem,' writes our guest columnist regarding the roots of recent market volatility. 'And that is not going to change under this president. Any effort to reign in government spending is years down the road.'

Inflation fears sent the stock market into a tizzy in late January and early February. Those same fears rattled the bond market and boosted long-term interest rates. However, the fear of a sharp pickup in the inflation rate seems to have subsided and the stock market has recovered about half of what it lost. A rising inflation rate troubles the bond market as well, but its attention recently has shifted to larger budget deficits and increased Treasury supply in the years ahead. As a result, bond yields have jumped 0.5% since the end of last year.

Economists have been talking about escalating budget deficits for ages but, until now, the bond market has largely shrugged off any such concern. Politicians occasionally express some alarm, but they have been unwilling to do anything. Are rising bond yields an indication that budget deficits finally matter? Will our politicians in Washington be willing to do something? Our conclusion is that we are years away from any serious budget reform.

In late January the fear was that the economy was overheating, inflation was going to climb appreciably, and the Fed would be forced to raise rates more quickly than had been anticipated. The stock market swooned and registered its first “correction” in a couple of years. As is often the case the stock market overreacted. It still believes the economy has gathered momentum, inflation is headed higher, and the Fed may raise four times this year rather than three, but it now expects the interest rate ascent over time to be more gradual. As a result, the S&P 500 index has recovered about half of its earlier loss.

The bond market has not been so lucky. Bond yields have jumped 0.5% since the end of last year from 2.4% to 2.9%. While we thought that bond yields would rise in 2018, the runup has occurred much more quickly than we had anticipated. So, what’s bugging the bond market? Is it inflation, or is something else to blame? Our conclusion is that inflation has played a small role, but the bond market’s greatest fear currently is Treasury supply.



Long-term interest rates are closely tied to expectations of inflation. The measure of inflationary expectations we like the best is the implied inflation rate from the bond market. The Treasury has a nominal rate on the 10year note. It also has an inflationadjusted rate on the 10year note. The difference between the two represents an implied 10year inflation rate. It has risen in recent months but, at 2.1%, it can hardly be called troublesome and would not bother the Fed in the slightest.

First, tax cuts. The Congressional Budget Office initially estimated that they would add $1.5 trillion to budget deficits and debt outstanding during the next 10 years. Even if it tried to estimate the "dynamic" effects of the budget buts – i.e., tax cuts will stimulate GDP growth, generate more tax revenue, and partially offset some of the loss of tax revenue caused by the lower rates — the CBO still estimated that the deficit would increase by $1.0 trillion. While that estimate is still too high, the important point is that the recently enacted tax legislation will almost certainly boost budget deficits relative to the forecasts shown above – which were already problematical.

Second, President Trump and Congress agreed on a 20182019 budget deal which will increase both defense and nondefense spending. That additional spending will boost budget deficits for the next couple of years by an additional $300600 billion. No wonder the bond market is spooked. There is no longer any pretense of fiscal restraint.

Budget deficits matter because they add to the debt outstanding. If the government runs a $1.0 trillion budget deficit, the Treasury is forced to issue an additional $1.0 trillion of debt to finance that deficit. Debt as a percent of GDP today is 77%. It is expected to increase to 86% by 2026 and continue climbing to 125% of GDP within 20 years. And remember, these numbers were done prior to the tax cuts and prior to the increases in spending agreed upon over the next two years. They will go higher. Economists tend to believe that a debt to GDP ratio in excess of 90% can create problems.

Why? First, the ratings agencies may (once again) choose to downgrade Treasury debt which would increase the Treasury’s cost of borrowing. Second, the Fed will be reducing its holdings of U.S. Treasury bonds in the years ahead as it tries to shrink its balance sheet to a more sustainable level. Third, China and other foreign governments may be less willing to hold U.S. debt. They collectively own $6.3 trillion (or 42%) of the $14.8 billion such debt outstanding.

Foreign central banks cannot significantly reduce their holdings of U.S. Treasury debt because no other sovereign market is big enough to allow that to happen in any size. But they could at the margin cut back on their willingness to own U.S. Treasury debt and substitute euro or yendenominated debt instead. With Treasury debt poised to escalate any such marginal cutback would be bad news.

For purposes of comparison, the debt to GDP ratio for Greece is currently 180%. Prior to the recession the debt/GDP ratio in Greece was 103%. The recession boosted its budget deficits, triggered a crisis, and Greece had to be bailed out by its European Union partners. A recession in the U.S. at some point, which is inevitable, would exacerbate its debt woes. The U.S. may not be Greece, but there are lessons to be learned. Countries that do not prudently manage their government spending typically experience an unhappy ending.

Without wanting to be unduly alarmist, the U.S. has a problem. And the saddest part is that nobody in Washington seems willing to do anything about it. Because entitlement spending represents two-thirds of all government spending, the above situation is not going to be resolved without cutbacks in Social Security, Medicare, Medicaid, veterans’ benefits, and welfare benefits. And that is not going to change under this president. Any effort to reign in government spending is years down the road.