

Our Thoughts on Large US Deficits and Their Impact on Bond Yields

Following Trump's victory, we assess the supply/demand picture for US debt, and what it means for yields going forward.

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As government deficits have risen, both in the US and globally, the impact of government borrowing on bond yields has become an increasingly important topic for investors. Since Trump's election win, we have seen even more interest in this question because the Trump administration is widely seen as likely to increase or maintain high fiscal deficits.

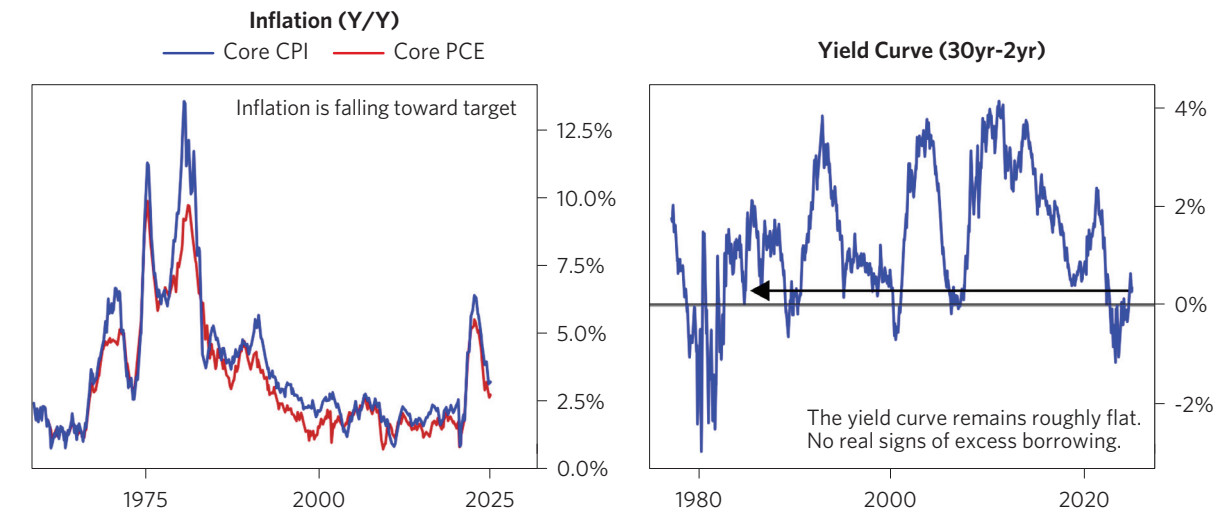
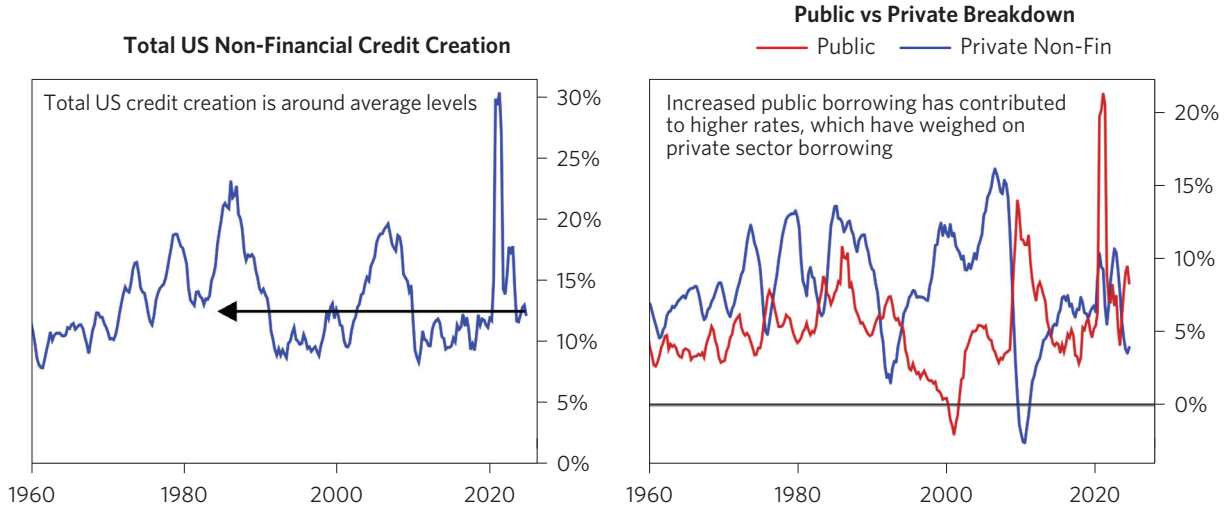
To assess the impact of large deficits on yields, it is important to look at the total debt in the economy, not just government debt. This is because public and private debt (both as an asset and as a source of spending) are reasonably fungible, so what matters for markets and the economy is how much collective new credit is being created, and the incentive and desire of investors to buy it.

In terms of how total borrowing flows through to rates, there is an economic pressure and a pressure created by supply and demand for debt. If there is too much borrowing and spending, leading to inflation, the central bank will raise rates, which in turn will curtail private sector borrowing. And if there is too much aggregate borrowing relative to demand, rates will rise as investors require a higher premium for lending out their marginal dollar. **If government spending gets high enough, it can lead to real debt problems and sharply higher bond yields** because a) the government doesn't really get squeezed out (at least not in a timely way) by higher borrowing costs and b) there are limits to how much private sector borrowing can decline to offset higher government borrowing.

That doesn't look like where we are now or where we are headed—markets look like they are reflecting more of a balanced supply/demand picture than an excess of borrowing, inclusive of public and private. **Some of the danger signs to watch for are rates rising led by the long end, total debt levels as a share of the economy rising, and currency weakness. The curve steepening driven by the long end is usually a sign you may have a problem finding buyers, and as you can see below, that is not the case today.**

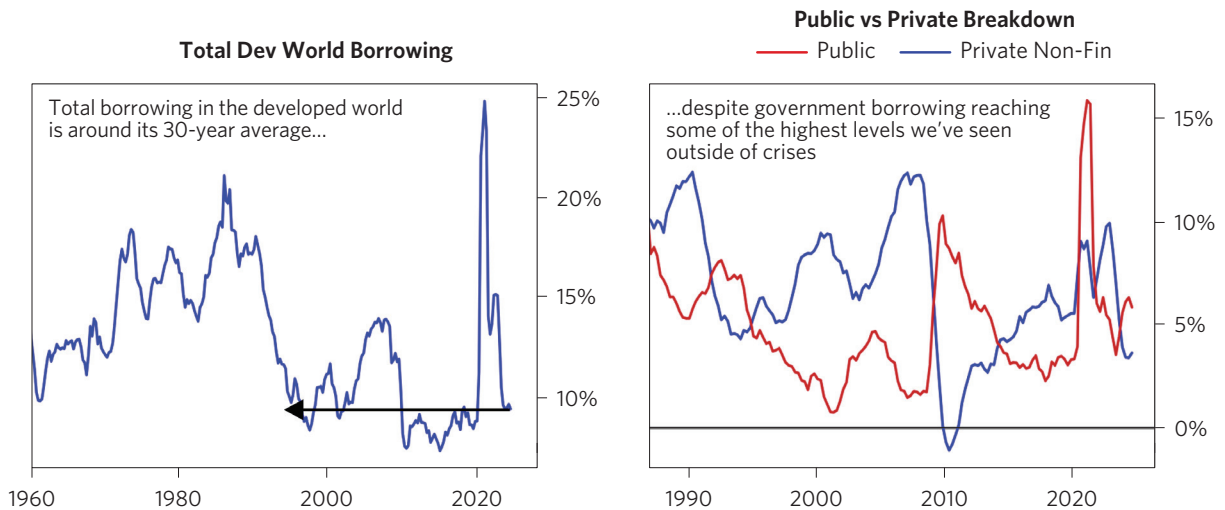
Before going into the details, the charts below highlight that, despite higher government deficits, total borrowing is about average. High public borrowing has contributed to the need for higher rates, which have depressed private sector borrowing. This return to normal levels of credit creation has helped gradually drive inflation down toward target. And in terms of supply and demand for debt, the risk premiums on the long end look about average, with no market signs that economic or debt limits are currently being hit. This contrasts with other times when abnormally high total borrowing has driven yields and risk premiums up (via higher supply, higher inflation, or both), such as during the 1980s, the GFC, or the height of COVID.

US Non-Financial Credit Creation (%GDP, 12mma)



As noted above, duration is one of the more globally fungible markets, so looking at the total borrowing across the developed world is relevant. There, total borrowing is roughly average for when the economy is healthy, while government borrowing is at highs normally only seen in recessions.

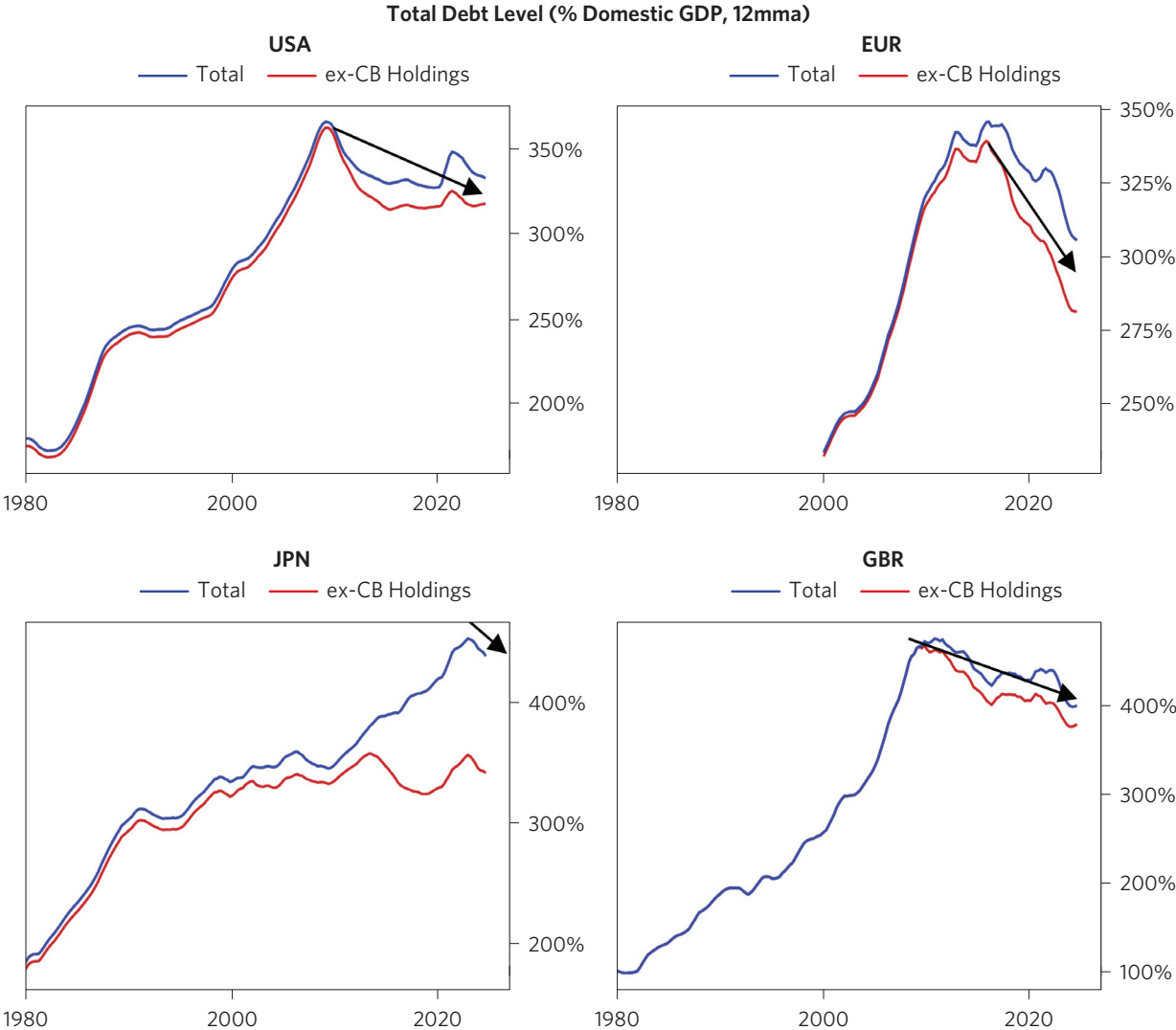
Developed World Borrowing (% DW GDP)



On a Level Basis, Total Debt in the Developed World, Even in the US, Is Flat or Falling

These borrowing levels are instructive as to why risk premiums on borrowing are not currently high. As the charts below show, across many developed world economies, total debts relative to GDP are falling rather than rising. And notably, the amount of debt that needed to be taken down (exclusive of central bank purchases) has come down—though more recently, central bank selling adds a bit. Pressure is put on markets and economies when debt and spending rise faster than what the economy can produce. Across much of the developed world, debt levels peaked in the global financial crisis, a crisis brought on by too much private sector borrowing relative to what the economy could handle. There was, of course, a massive increase in money and credit in response to COVID that pushed the level of debt higher in the short term, but more recently, the path of stability/lower debts has resumed.

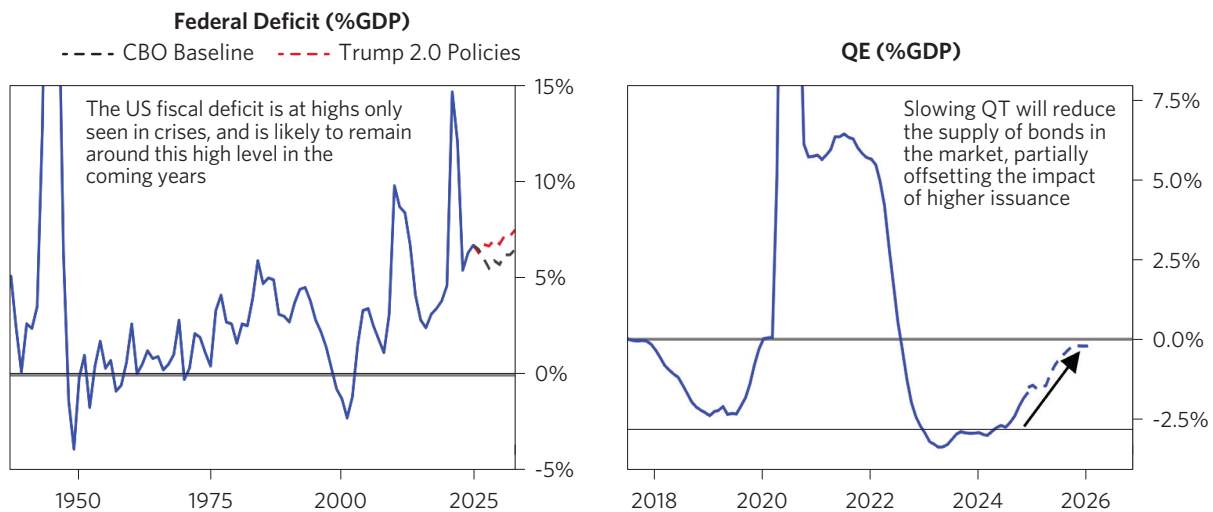
Today, as we showed above, the picture is flipped, with much more public sector borrowing than private. This equilibrium is not a problem as it relates to markets but has led, and may continue to lead, to political issues the longer the private sector is priced out of debt markets by the public sector. There seems to be more concern today about how much borrowing is too much for the public sector when, in aggregate, the overall borrowing relative to the size of the economy is declining across the developed world.



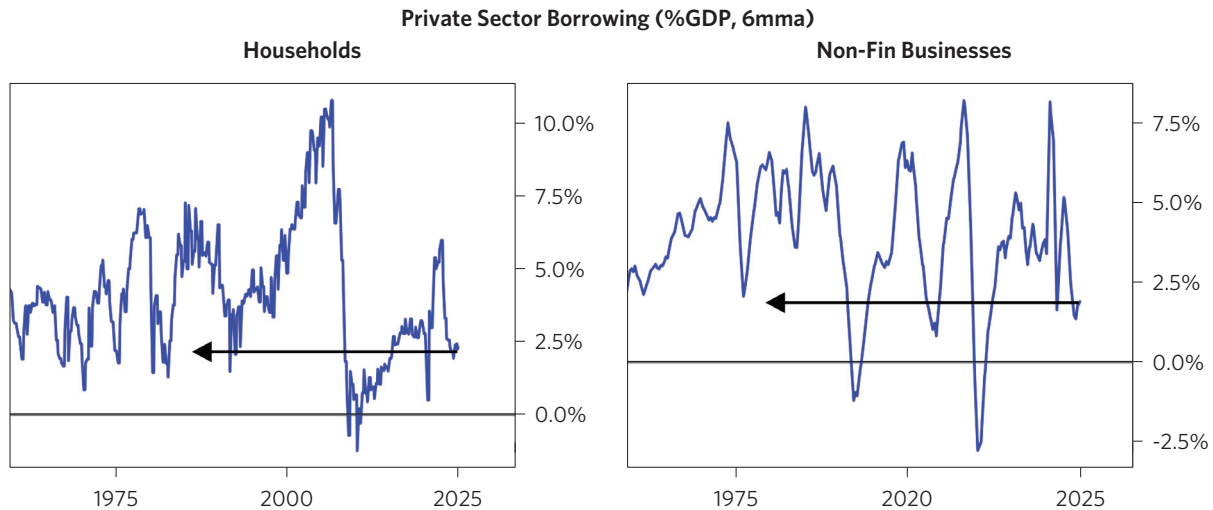
The Base Case for Supply Is More of the Same: High Fiscal Deficits and Low Private Borrowing

Starting with supply, as we showed above, the total borrowing that needs to be taken down is not all that high relative to normal. In the US, with the new administration likely pushing to extend the Trump tax cuts but not expand government spending much beyond the level it is today, public sector issuance is likely to remain roughly constant if not rise a bit to somewhere in the range of 7–8% of GDP. And in terms of the total supply of Treasury debt that needs to be taken down, less quantitative tightening from the Fed is likely to be an offset to marginally higher deficits. However, in aggregate, this remains a high level of government borrowing, which is being cleared by higher yields that have kept down private sector borrowing.

If the Trump administration really pushes to the point where the private sector can't be depressed enough to offset the higher deficit, then we will start to get problems. But we do see constraints on fiscal spending—inflation remains a constraint on policy makers, particularly after the impact it had on the last campaign. And there is not much appetite, even from Republicans, for much higher deficits. The chart below is meant to illustrate the range of outcomes in the next few years rather than our estimate of what will occur. The black line in the left-hand chart below shows what the baseline of current law would produce if the current tax regime were not rolled, and the red line is what President Trump's proposals would look like if they were enacted in reasonably full measure.



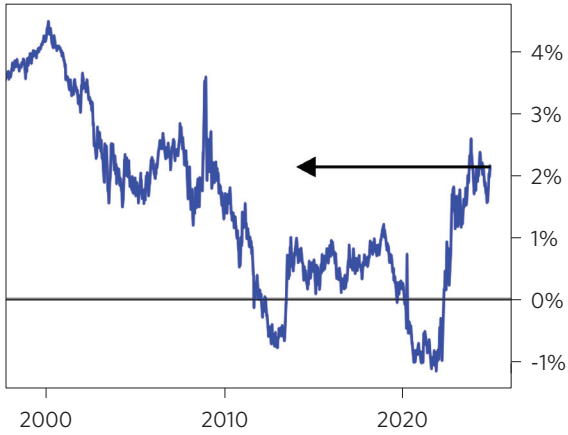
Private sector borrowing has been depressed by much higher yields, but it saw a small pickup with the drop in yields earlier this year. That looks to be turning as yields have risen. Depressed private sector borrowing has been an important part of getting to equilibrium, but now that it is already at low levels, it is unlikely to fall a lot further. The current level of private sector borrowing has not been lower than it is today, with the exception of pretty severe downturns.



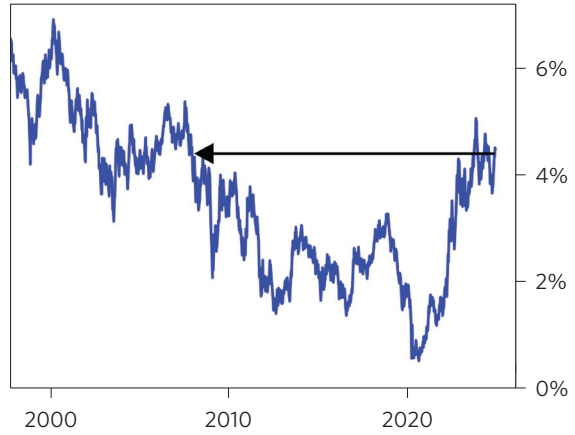
The Incentive to Buy Bonds Has Improved, Supporting Demand, Particularly from Real Money Investors

On the demand side, the incentive to buy bonds is higher than it has been. We see the appetite for bonds as supported by our view that unlevered investors generally remain under-allocated to bonds relative to longer-term targets, and bonds are more diversifying for an equity-heavy portfolio at these higher yields. The yield for unlevered investors, both real and nominal, is much higher than it has been for many years. At the same time, as US equity markets have risen, earnings yields have fallen to the point that they are now roughly equal to bond yields. Real yields are now at 2% in the US—a level that, before late last year, hadn't been seen since the mid-2000s—and high relative to much of the rest of the developed world. US nominal yields are at levels where the yield is attractive and diversifying relative to stocks in any growth slowdown. Though the yield curve, which matters for levered investors, is relatively flat, it is steepening and may steepen further if the Fed continues to ease. Banks have not been buying many bonds and are likely to step in more if the curve steepens and/or regulations are eased to enable more lending.

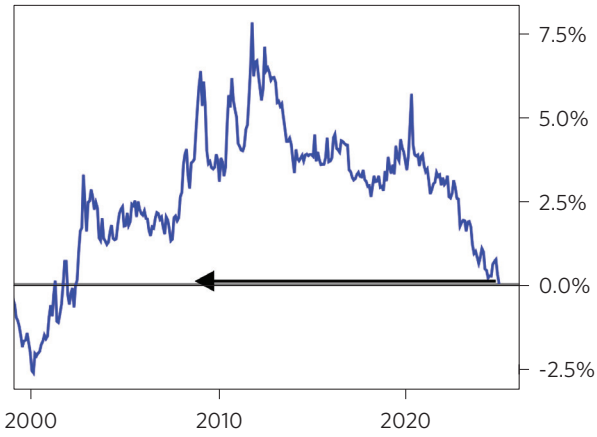
USA Real Long Rate



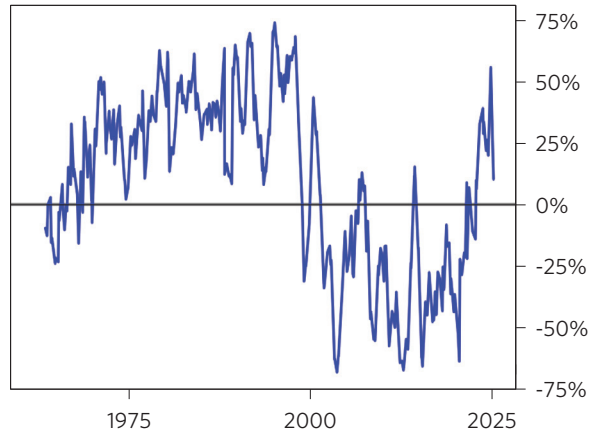
USA Nominal 10yr Yields



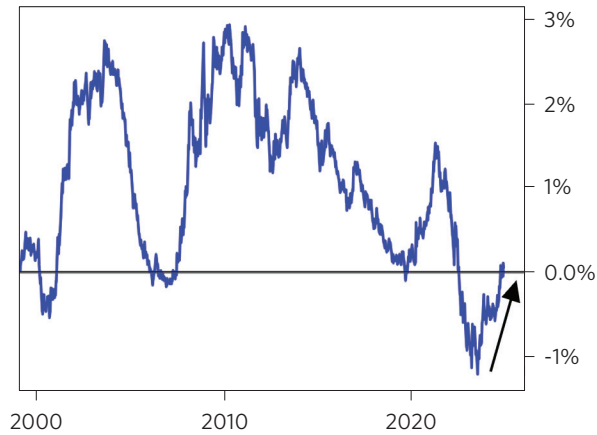
Earnings Yield vs Bond Yield



Stock/Bond 1yr Rolling Correl



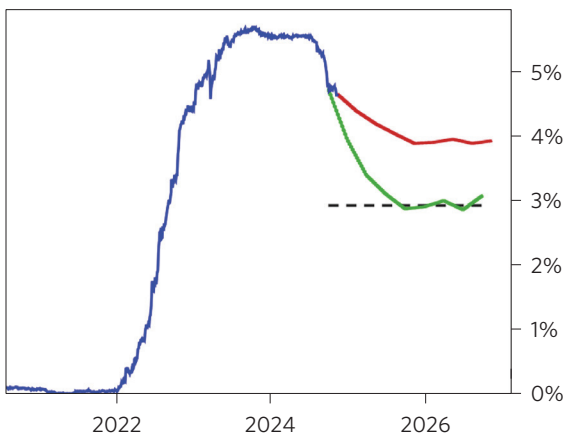
Yield Curve (10yr-2yr)



Bond market pricing looks consistent with pretty high and stable government borrowing, pretty low and stable private sector borrowing, and not much pressure on risk premiums. Market pricing of the Fed's terminal rate has come in substantially over the past six weeks, and the Fed is no longer priced to bring rates down to its definition of neutral. With yields near cyclical highs and markets discounting that the terminal policy rate will remain in restrictive territory, markets are signaling that the economy is strong and the Fed doesn't need to generate a credit response. Most of the sell-off in long rates since September has come through real yields, while 10-year breakevens have remained relatively stable (ticking up only modestly). Breakeven inflation remaining around target is consistent with markets pricing a continually subdued private sector. Though markets are discounting some bounce in near-term inflation, much of that can be chalked up to the Trump administration's tariffs rather than markets discounting a sustainably higher level of inflation.

USA Nominal Short Rate

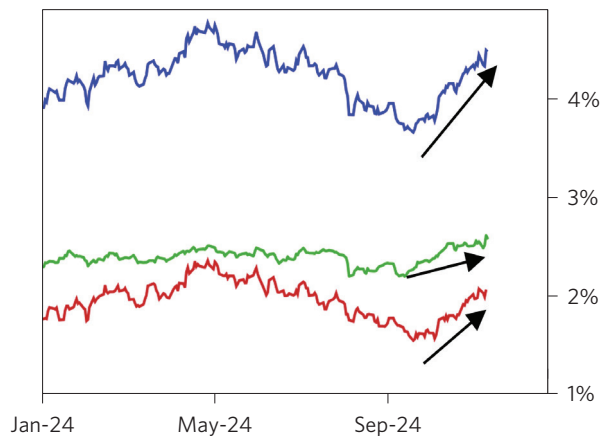
— Disc Today — Disc as of 9/24
 - - - Fed's Long-Run Neutral Rate Projection



Markets are no longer discounting that the Fed will cut interest rates to neutral

USA Nominal Yield Attribution

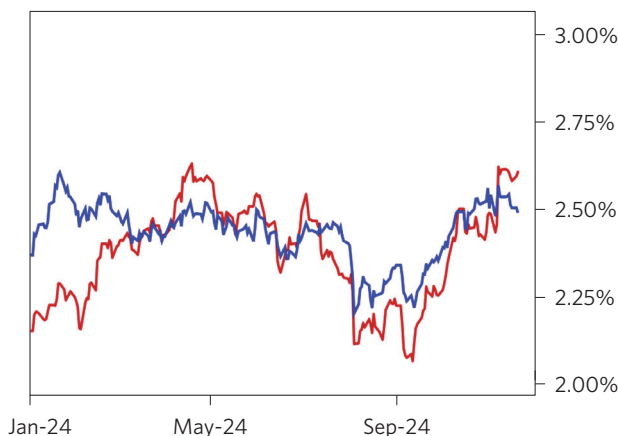
— Nom Yield — Real Yield — BEI



Most of the recent sell-off in long rates has been driven by real yields, while 10-year breakevens have been relatively stable

BEI Pricing

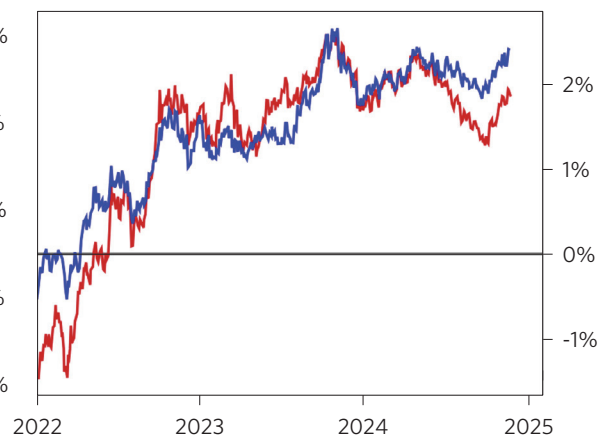
— 5yr, 5 Years Fwd — 3yr



Markets are pricing a moderate bounce in inflation in the near term (as tariffs flow through), while longer-term expectations remain more anchored

Real Yields

— 5yr, 5 Years Fwd — 5yr



Longer-term real yields remain at cyclical highs, signaling that the economy is strong and the Fed does not need to engineer a credit response

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