ACG Atlanta Consulting Group

ACG Insights: Treasury Market Dilemma with Deficits

Executive Summary

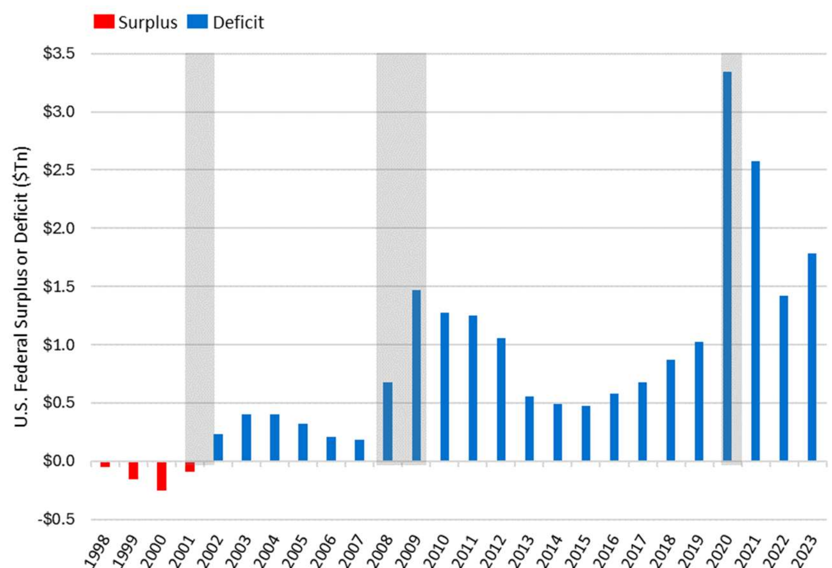
- **In tandem with annual fiscal deficits, there has been a rise in Treasury issuance**
- **Despite the vast size and stability of the Treasury market, there are concerns regarding how the Treasury market will respond to prolonged debt growth and a transitioning investor base**
- **Weak Treasury auctions, potential downgrades in U.S. debt ratings, and the return of term premium are all things to watch as the situation is unlikely to change in the near future**

Background:

Apart from a few years in the late 90's and early 2000's, the U.S. government has consistently operated at a deficit, where spending exceeds revenues from taxes. Federal or fiscal deficits are not categorically negative and are quite common globally. Nevertheless, the Treasury Department needs to borrow money by issuing Treasurys to bridge the gap between spending and revenues.

Historically, national debt tends to decline during times of prosperity, but the post-pandemic era has proven to be an exception with issuance rising to meet growing entitlement spending (Social Security, Medicare, etc.), pandemic related stimulus, and rising interest payments (Exhibit 2). Some investors are worried about the sustainability of federal debt outpacing economic growth, and the impact on interest rates and the treasury market.

Exhibit 1: Annual Deficits are Common and Have Grown[1]

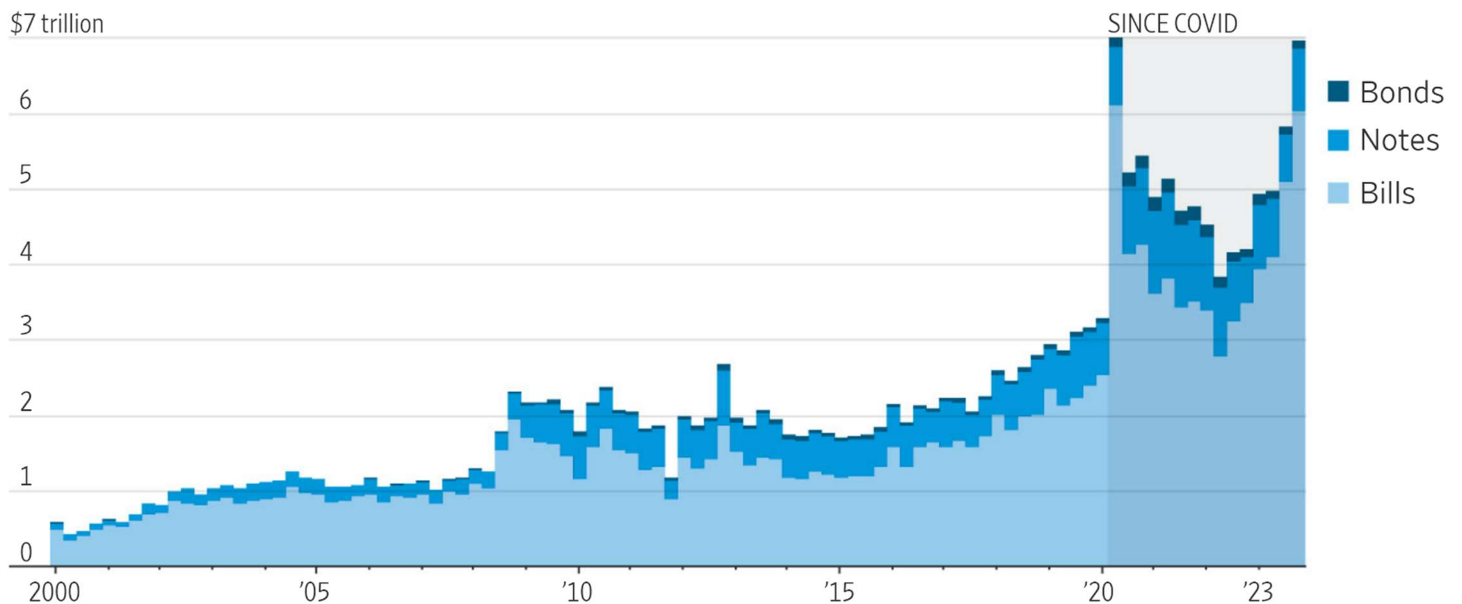


[1] Source: Federal Reserve Economic Data

How Treasurys are Sold

The method of issuing Treasurys to investors is worth noting, as the competitive auction process sets the yield for new issues. The Treasury Department announces their borrowing plans in advance of conducting maturity specific bond auctions, offering any and all participants the opportunity to invest in reliable coupon payments with the security of a government guarantee. “Primary dealers” are one of the key participants. These select banks are required to bid at Treasury auctions and often buy more bonds when demand is weak. “When-issued” or advanced trading among primary dealers helps set expectations for the new bond’s yield.

Exhibit 2: Gross Issuance of U.S. Treasurys, Quarterly[2]



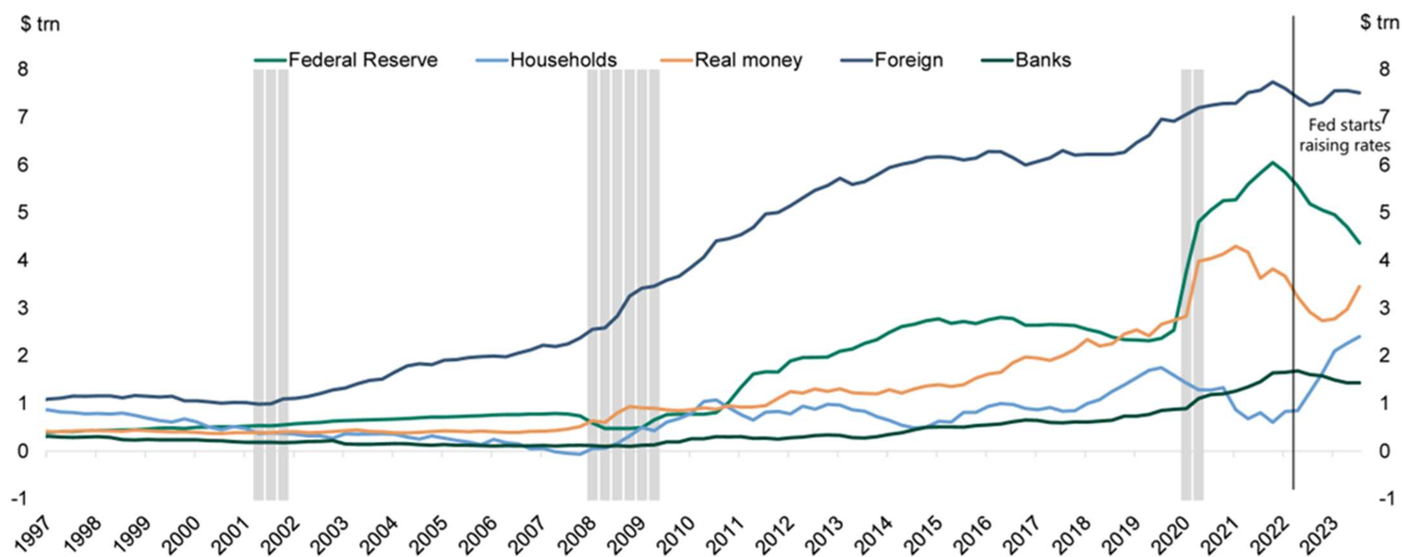
Potential investors submit bids specifying the quantity they wish to purchase and the price (yield) they are willing to accept. The Treasury then accepts bids starting from the lowest yield, the least costly to the government, until the total amount offered is reached. All bidders receive the same highest rate needed to complete the auction.

Investor Base for U.S. Treasurys

The auction process illustrates how investor sentiment of Treasurys in relation to other assets significantly influences interest rates and, ultimately, the cost of financing the government. For safety and security, investors may be willing to accept a lower yield, but they might demand a higher yield if more attractive options are available. It is interesting that since the Federal Reserve (Fed) started raising rates, there has been a change in incremental buyers from those indifferent to yield (central banks including the Fed) to yield-sensitive investors like households and asset managers (Exhibit 3). If the Fed decides to lower rates as expected later this year, one important consideration is whether there will be sufficient aggregate demand for the lower yielding bonds to keep up with the increasing issuance of Treasury securities. If the Fed were to resume Treasury purchases, also known as quantitative easing, it would undoubtedly raise concerns about inflation.

[2] Source: SIFMA, WSJ https://www.wsj.com/finance/the-27-trillion-treasury-market-is-only-getting-bigger-a9a9d170

Exhibit 3: Holders of U.S. Treasuries[3]



What to Watch: Treasury Auctions, U.S. Credit Ratings, and the Return of Term Premium

Auction results provide indicators of Treasury demand such as the quantity purchased by primary dealers, the Bid-to-Cover Ratio[4], and the yield in comparison to what was expected. When a significant portion of the offering is purchased by primary dealers, the bid-to-cover ratio is low, and/or the yield is higher than anticipated, it is indicative of a weak auction. A failure to complete a Treasury bond issuance is improbable, but a lackluster auction would signal that buyers demand higher yields.

Exhibit 4: Rating Agency Opinion[5]

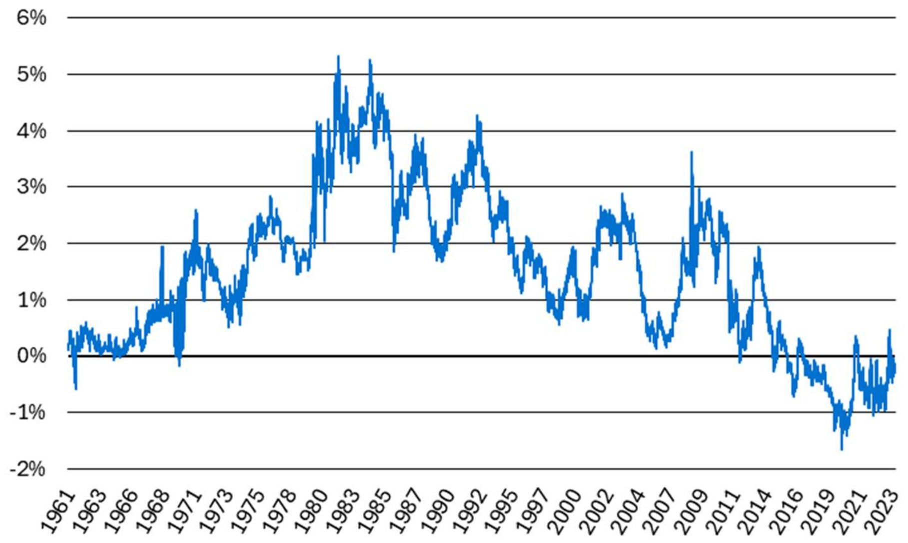
Rating Agency	U.S. Debt Credit Rating
Moody's	Aaa
Fitch	AA+
Standard & Poor's	AA+

With the full faith and credit of the U.S. government, Treasurys are considered "risk-free" from a credit worthiness perspective. However, ratings agencies are still tasked with providing an evaluation of how likely the debt is to be repaid in the form of a credit rating. These ratings generally range from a high of AAA to D, with ratings below BBB- considered "noninvestment grade" or "junk." The U.S. government currently has the highest rating from Moody's but was downgraded to AA+ by Fitch in 2023 and Standard & Poor's in 2011. The growth in spending and consequent debt burden, as well as the debt limit standoffs that have eroded confidence in the likelihood of structural reforms, were cited in both downgrades. Additional downgrades are possible should the fiscal deterioration continue.

Being compensated for taking on greater risk is a paradigm in investing. Extending the maturity of bonds you buy comes with a higher level of uncertainty, which should factor into the compensation you receive. Term premium refers to this extra compensation needed for assuming the risk of potential interest rate fluctuations throughout the life of a long-term bond relative to a short-term bond. Historically, the average 10-Year term premium for Treasurys is 1.5%, but the term premium has been negative in recent years (Exhibit 5).

[3] Source: FFUNDS, Haver, Apollo. "Real money" includes U.S. pensions, U.S. insurance companies, and U.S. asset managers
[4] Dollar amount of bids received divided by the amount sold
[5] Source: Moody's, Fitch, and Standard & Poor's as of 12/31/2023

Exhibit 5: 10-Year Term Premium[6]



Considering the present fiscal situation, it is possible we will see Fed rate cuts coupled with a rise in long-term yields as the term premium makes a resurgence. A return to the term premium levels seen in the early 2000s would have significant implications for various asset classes, extending beyond Treasuries.

Conclusion

It is difficult to say that growing debt and fiscal deficits do not matter, but it has been a slow-moving issue for multiple decades. Based on indications from both presumptive presidential nominees, it seems highly unlikely that any significant changes will be made to reduce deficits soon. Yet, as of right now, markets do not appear to be worried. The advantages of the U.S. dollar's status as the world's reserve currency and the widespread appeal of the large and liquid Treasury market cannot be denied. During the Great Financial Crisis, which originated primarily in the United States, Treasury securities remained in high demand and are expected to remain so in the foreseeable future.

[6] Source: Federal Reserve Bank of New York as of 3/22/2024

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