Global Research Unlocked

Interrupting the cycle of high rates and higher deficits

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Rates Strategy
United States

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Key takeaways

- Our industry leading analysts join the podcast to discuss emerging risks, opportunities and growth themes in global markets
- Treasury demand from historical buyers has fallen and supply has risen on deficits and interest costs
- It's a combination that should keep 10Y yields relatively high, but a clear yield peak would help demand and interest costs

Heavy supply likely limits the downside in 10Y yields

Treasury bond yields are off recent highs but still up 40bps+ YTD and at the highest levels in 15 years. This is despite a decline in the inflation rate and an expectation from our Economics team that disinflation will continue. But bond yields are high not just because inflation is higher than recent trend, they're also high because of higher bond supply and less demand. Megan Swiber from Rates Strategy discusses the $8T of Treasuries that will need to be refinanced over the next year, the vicious cycle created by higher rates, but the reprieve we could get if rates and the economy cool off . . . assuming the cooling isn't of the deep freeze variety. *Global Research Unlocked can now be found on public podcast platforms, including Spotify, Apple Podcasts, Google Podcasts, and Amazon Music. These podcasts are first released to clients and then to the platforms.*

Refer to important disclosures on page 7 to 8.

Full Podcast Transcript

T.J. Thornton, Head of Product Marketing: Hello and welcome to Global Research Unlocked, where we discuss what's rising from growth industries to rising risks and opportunities in global markets. I'm T.J. Thornton, Head of Product Marketing at BofA Global Research, and we're recording this episode on Thursday, November 2, 2023.

Overall, the general lack of strong buying that we see here in the Treasury market really all comes back down to the conviction around rates being able to move lower, once that happens, demand can come back. I just don't think that happens until we see more of this turn in the US economy until we have more flight to quality flow from equity markets, riskier assets back into fixed income.

- Meghan Swiber, CFA

The US inflation rate has fallen significantly, and yet treasuries from the two year yield to the thirty year are close to the highest levels in 15 plus years. Strong US growth plays into this, but higher bond supply and less bond demand are important factors too. Today we're pleased to have Meghan Swiber, from US Rates Strategy, join us to discuss why Treasury demand has weakened, whether it's a given that supply will remain elevated, and whether this could all change as things tend to do in markets. So thanks Meghan for joining.

Meghan Swiber, US Rates Strategist: Thanks for having me, T.J.

T.J. Thornton: Okay. Meghan, the fact that so many homeowners locked in mortgages at low rates, that's been widely discussed. However, the US government did not do the same. Treasury will have to fund itself at these higher rates. How much government debt will be rolled over in the next few years?

Meghan Swiber: The short answer here is a lot. US Treasury really has two levers to finance itself. They have bills which are issued with less than one year of maturity, and they have coupon supply. Coupons are anything issued with a maturity of longer than one year and pay a coupon. In terms of what Treasury has to roll over in the next year, it's all of the bills that are currently outstanding and all of the coupons that are maturing and need to be reissued now, because the government is running a deficit, not a surplus. About 20% of what Treasury supply currently is in bills, so about $5 trillion and about 13% of Treasury's coupon supply, which is around $3 trillion. You're looking at about $8 trillion of supply that needs to be refinanced over the next year, and you have to add on top of that about $1.8 trillion for the deficit that we're expecting over the next fiscal year, so this gets you closer to $10 trillion. You can see here that the numbers become very large very quickly.

T.J. Thornton: What will that do to interest costs for the Treasury and what does it mean for US deficits?

Meghan Swiber: Interest rate costs are part of deficit spending itself. They're not the primary deficit that we think of, but it's still part of what Treasury has to go out and issue, now at these more elevated interest rate levels. It really becomes part of this spiral, where higher financing costs drive a higher deficit, which then in turn needs to be financed at higher interest rate levels. The other aspect of this is that it means that Treasury has to then go out and issue more supply. And when there's higher supply and generally stable demand, it means that rates are naturally then going to go even higher. And this only makes the problem worse, especially when we're thinking about the pass through to deficits and interest rate expenditures. This is just a compounding effect that we see.

T.J. Thornton: In the past there had been buyers sopping up some of the supply, but some of those buyers have been absent. Why is that?

Meghan Swiber: Yeah, I think T.J., the simple answer here too is just that there's a lack of directional conviction in rates, specifically they're moving lower. It's hard for the market to have a belief in rates falling; when we look at Q3 GDP, which is still showing a US economy accelerating, despite the fact that the Fed's delivered over 500 basis points in hikes. In order to buy rates further out the curve, investors need to have a belief that rates are going to go down because they're susceptible to more of that duration risk, which means that when rates move higher, losses can just be magnified, if you're buying, for example, a 30 year part of the curve versus a two or five year part of the curve. When we think about this from just a different investor class perspective, banks were really very strong buyers when supply levels were similarly elevated to what we're expecting to see over the next couple of fiscal years. But banks can't buy because they still see losses on their own securities portfolios and are instead looking to hold on to liquidity. Pensions, which have the potential to de-risk here, given the fact that they're very well funded at the moment aren't moving out of these riskier assets like equities EM (Emerging Markets) into fixed income because recently we've had the equity market perform well when rates have gone higher. They're really waiting until the last minute to de-risk portfolios and buy duration. They need conviction that the Fed's final hike is in and that the direction of rates is going to be moving lower. And then finally, our FX and rate sentiment survey that we run here at Bank of America, which surveys global benchmark investors, shows us that many folks who manage to a benchmark portfolio have already been overweight duration in the US for the entirety of the year. But in general, they don't have the appetite to come back in and re-add to those duration positions without this conviction around where the direction of rates is going to be near term. Overall, the general lack of strong buying that we see here in the Treasury market really all comes back down to the conviction around rates being able to move lower, once that happens, demand can come back. I just don't think that that happens until we see more of this turn in the US economy until we have more flight to quality flow from equity markets, riskier assets back into fixed income.

T.J. Thornton: Got it. Okay. And I know that others have also talked about foreign buyers, especially China, Japan and even out of the Middle East, the petrodollars being less present, in terms of buying, but I guess one, is that true? And then secondly is the fact that rates may go down more elsewhere? I mean, you've got the European economy rolling over. Could that ultimately help US Treasury buying because US then starts to look like a bit of an outlier in terms of rates being as high as they are?

Meghan Swiber: As you mentioned, foreign demand is a very big component of the equation here. What we actually see when we look at Treasury's own data on this is that foreign private demand, demand from investors who are buying Treasury securities because of the outlook for US rates or as a compliment to other assets that they're holding in their portfolios has actually been pretty strong this past year. But what we've seen this more persistent selling from is the foreign official sector. Those accounts that manage their own currency are selling Treasury securities to access more dollar liquidity and then sell those dollars to buy back and support and prop up their own currency. Now this comparison that you're making here, T.J., when we look at Treasury yields and we compare them to other yield curves, like JGB (Japanese Government Bond) is one could make the very clear argument that wow, treasuries yield much higher than what you're getting in some of these other regions. And that is true, but investors who are buying Treasury securities and who hold other currencies like the yen, they're typically buying duration on an FX hedged basis. So if we actually look at the pickup that a JGB investor could earn buying treasuries and apply this FX hedge, they're actually incredibly unattractive. And that really comes down to the fact that interest rate differentials at the front end of the curve, between the Treasury market and JGBs for example, is very wide. You're paying up to hedge this FX exposure between dollar and yen. The one way that this gets fixed is if we are looking at a steeper yield curve in the US versus some of these other regions, where investors are able to earn more further out the curve versus what they're paying for on an FX hedge basis.

T.J. Thornton: Got it. The rates team is looking for a steeper curve though, is that right?

Meghan Swiber: Yes. That is what we're expecting, and in part one of the drivers of this steeper curve is the demand picture that investors are going to have to demand more to be compensated for owning and taking on more duration risk.

T.J. Thornton: Got it. Okay. We talked about deficits, obviously that is a big driver of the supply picture, but what happens to Federal deficits if we do see a recession next year? That's not our econ team's base case, but it certainly could happen and it's a concern that many have. And then also, do you think outcomes of next year's elections could have much of an impact on these deficit numbers?

Meghan Swiber: Recessions tend to see deficits move higher. You'll see likely more spending stem from the primary deficit. Probably we'll see the government need to spend more and we'll see less in terms of tax receipts, if we're looking at a recession. However, one thing that we would also likely see in a recession are lower interest rates, lower borrowing costs. If we're looking at more of this recession harder landing scenario, while it means likely a higher primary deficit, it takes the 'wind out of the sails' a bit in terms of what the government's going to have to be issuing at and may maybe some of this offset that we would see as well. T.J., what we could see from the government, in terms of getting any revisions lower in the deficit, our economists think that there's relatively limited potential for the deficit to be cut meaningfully from the government's perspective. We're looking now at when we're thinking about the deadline of November 17th, we're looking at the appropriations plan for the next fiscal year of spending. Annual appropriations are really shrinking as a share of total outlays, mandatory outlays, which includes entitlement spending, like Social Security and Medicare are really viewed as untouchable by many politicians. And similarly, tax increases are really also not palatable from their perspective as well. When we think about this interest rate cost part of the equation, it's really just a function of prior deficits and market rates. One option that Congress does face at the end of fiscal year 2025 is the decision around Trump tax cuts. If Congress is serious about correcting the trajectory of the debt to GDP ratio, which we're concerned about, it would not extend these increases. But this is still not going to be enough to really correct the current trajectory. It would just be the first real test of Congress's resolve around the increasingly unsustainable fiscal path.

T.J. Thornton: Okay. Treasury refunding the announcement recently came out. What did you learn from that announcement? Clearly seems to have had a pretty big impact on the rates market.

Meghan Swiber: Yeah, T.J., so we learned that Treasury in short is rate sensitive. We were expecting Treasury to deliver another round of supply increases very similar to what they delivered in August, and recall this decision in August was one of several factors that kicked off a very notable sell off at the back end of the curve. And what we think is going on here is that this move higher in rates has spooked Treasury. They took it as a sign of relatively limited demand that we're speaking of at the back end of the curve, and they recalibrated by increasing issuance more at the front end of the curve where demand is stronger. And this reduces risks here around how high back end yields can get and has been really a key source of the bull flattening of the curve that we're seeing both yesterday and today, where longer dated rates are moving lower. Now that the market knows the Treasury is interest rate sensitive, is very cognizant of the supply demand imbalance, there's limit to how cheap we can really see the long end get, just purely from the supply demand perspective.

T.J. Thornton: Okay, so Meghan, we're talking about the absence of buyers of treasuries. One former very large buyer of treasuries, who's not in the market buying right now and is actually winding down their holdings - is the Fed. Could they step back in and start buying, given that we do seem to lack buyers and given where rates are?

Meghan Swiber: They certainly could T.J. and the Fed does have the ammo. They have it on their balance sheet to go out and do that. But what would drive them to do that is likely seeing more market functioning issues. Issues where you have really no end buyer source, where you have rates gapping higher without a buyer to take the other side, and that will likely come if the market's feeling the pressure of oversupply. Treasury's actions this week actually reduce the likelihood we think that this happens because Treasury is being more proactive. It's trying to manage its issuance, find the right balance of supply versus what they're viewing as demand. While the Fed certainly could do that, it would probably take more of this buyer strike, where the market is more oversupplied for this to happen, and we just see lower risks that this happens near term. What we're more worried about right now and how the Fed could have to end QT sooner is more about banks, more about the funding risk that we see. Banks right now are bidding up and trying to hoard as much liquidity as they possibly can, and this is sending an important signal that banks are already feeling reserve scarcity. While the Fed is using a lot of the old rules of thumb that they had in mind back in 2019 to manage and think about where reserve scarcity is, banks are telling us this time that that may be different, and in our view that's the risk to them having to end QT sooner.

T.J. Thornton: Got it. Okay. And last question. Inflation has come down significantly, depends on the measure you look at, but I think three month annualized core inflation is down to around 2.8%, which is not that far from the Fed's target. If this continues to decelerate, do you think the narrative around rates changes? Because real rates would then be even higher, the Fed would probably have more ability to cut rates, if inflation was deemed to be more or less totally under control and could the start to look past deficits again, changing the rates picture?

Meghan Swiber: Well, the Fed is really trying to determine if this is just a sweet spot for inflation right now and whether or not this disinflation that we've been seeing over the past several months can continue. And while we have seen really good progress here, T.J., and you pointed this out, it's come with very little pain on the labor market and very few signs that the US economy is meaningfully slowing down. The question that the Fed is asking themselves is can we have this immaculate disinflation with very few signs that the economy is cooling in a manner that's consistent with the disinflation that we're seeing? What the Fed is doing here is looking at the constellation of data around inflation to tell whether or not that's the case. And we think that they really can't deliver on these cuts regardless of where inflation is coming in without that certainty that the risks around inflation are more evenly distributed or skewed to the downside. What the Fed needs to see happen first is it's more cooling in consumption, more cooling and spending and likely see the labor market get back into this better balance. Because in the Fed's heart of hearts, I don't think that they believe in this immaculate disinflation story that we're seeing so far. In order to have that conviction that inflation is back down at 2% and going to stay there, they need to see things like the labor market come back into this better balance before they have the green light to go ahead and cut rates.

T.J. Thornton: Alright, Meghan well thanks very much for joining today and I think I'm only going to minimally have to refer back to my college econ textbooks because I think you did a pretty good job making that clear.

Meghan Swiber: Anytime T.J. and you guys all know where to find me if I can help.

T.J. Thornton: Okay, thanks. The current situation in the Treasury market is a bit concerning because we have short-term treasuries coming due and resulting in more supply, high deficits leading to more Treasury supply and because of high rates, there's more supply that has to come to fund these interest costs. And if there's a recession, deficits probably rise even more. It's a bit of a vicious cycle, but one positive is that, if the economy does slow and rates fall, interest expense becomes a bit less of a problem. And regardless of what happens with 2024 elections, there's not much hope for significantly smaller deficits because so much spending is mandatory. Try cutting Medicare and Social Security, for example. Rates will remain structurally higher in all likelihood. That said, we should see more buyers of long rates once it seems that rates have stopped marching higher. And with the refunding news, the Treasury has also shown that they're sensitive to these high long rates. Thanks for joining.

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