

## Election Outcome: Riot Point Ahead For Treasurys?

The election outcome for the House is still up in the air as we go to press. But even if there is a clean sweep for the Republicans, our geopolitical expert, Dan Alamariu, argues that Trump's policy proposals will be heavily watered down after he takes office.

The outlook for the budget deficit will worsen relative to the CBO's baseline projection, although not as much as some currently fear. There will be some tariff increases, but not enough to "move the dial" on inflation. We will provide more details on these views in the coming days.

A key question is whether or not the bond market has fully digested the near-term implications of the election outcome. Also, what are the long-term implications for Treasurys of a sustained period of large budget deficits?

The violent Treasury selloff in the month before the election was reminiscent of the aftermath of the 2016 Presidential election ([Table 1](#), [Charts 1A](#) and [1B](#)). A key difference is that a sharp bear-steepening occurred *after* the election in 2016 because Trump's victory was a surprise. This time, "Trump trades" were popular

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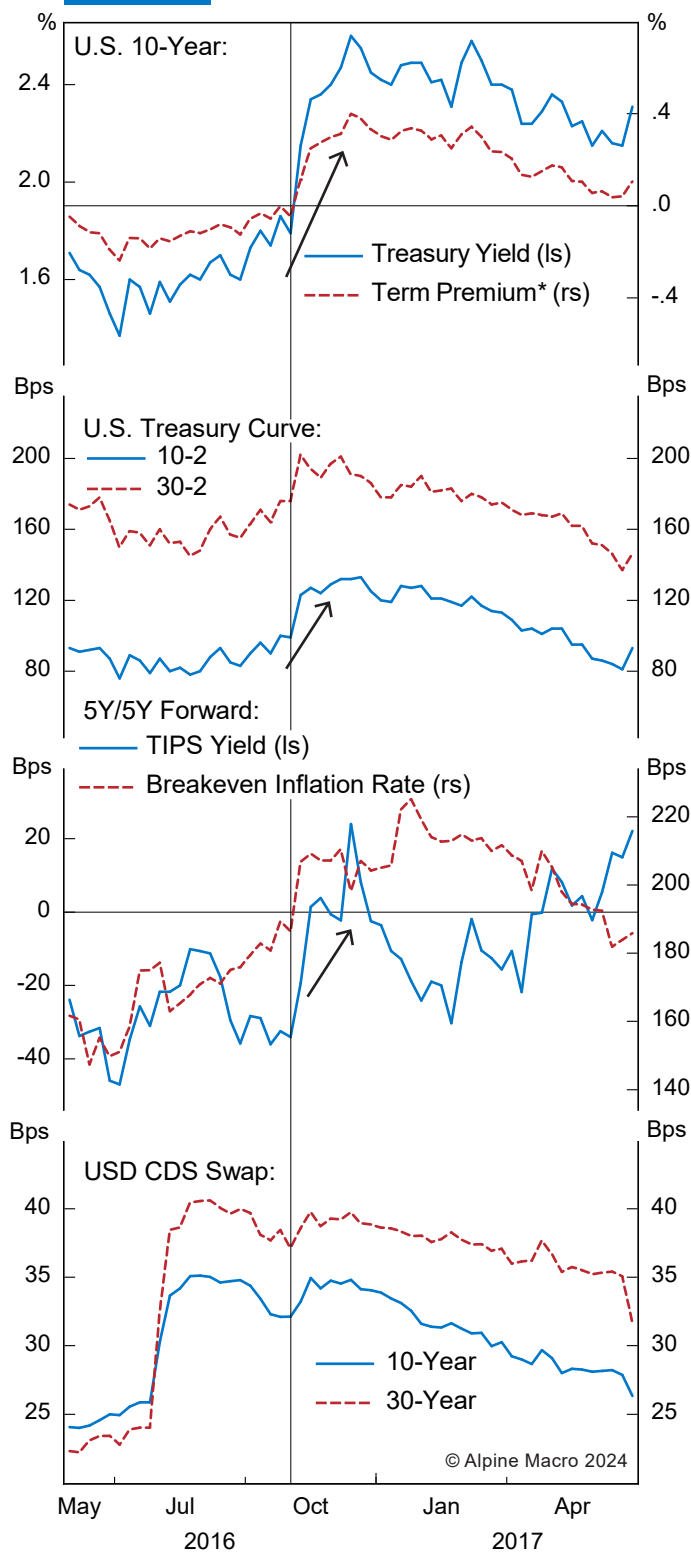
**Table 1** Bond Market Reaction To 2016 & 2024 Elections

	10/31/2016 (%)	12/12/2016 (%)	Change (bps)	2024 October Change* (bps)
U.S. 10-Year Yield	1.79	2.60	81	72
1-year short-term rate**	1.02	1.44	42	80
Term Premium	-0.23	0.31	54	35
Treasury Curve 10-2	99	132	33	4
Treasury Curve 30-2	176	191	15	-12
10-Year TIPS Yield	0.10	0.71	62	52
10-Year Breakeven Inflation Rate	1.69	1.88	19	20
5y/5y Forward TIPS Yield	-0.34	0.24	58	42
5y/5y Forward Breakeven Inflation Rate	1.86	1.98	12	2

\*Oct 1<sup>st</sup> 2024 - Nov 6<sup>th</sup> 2024

\*\*Eurodollars used for 2016 period, and SOFR for latest episode

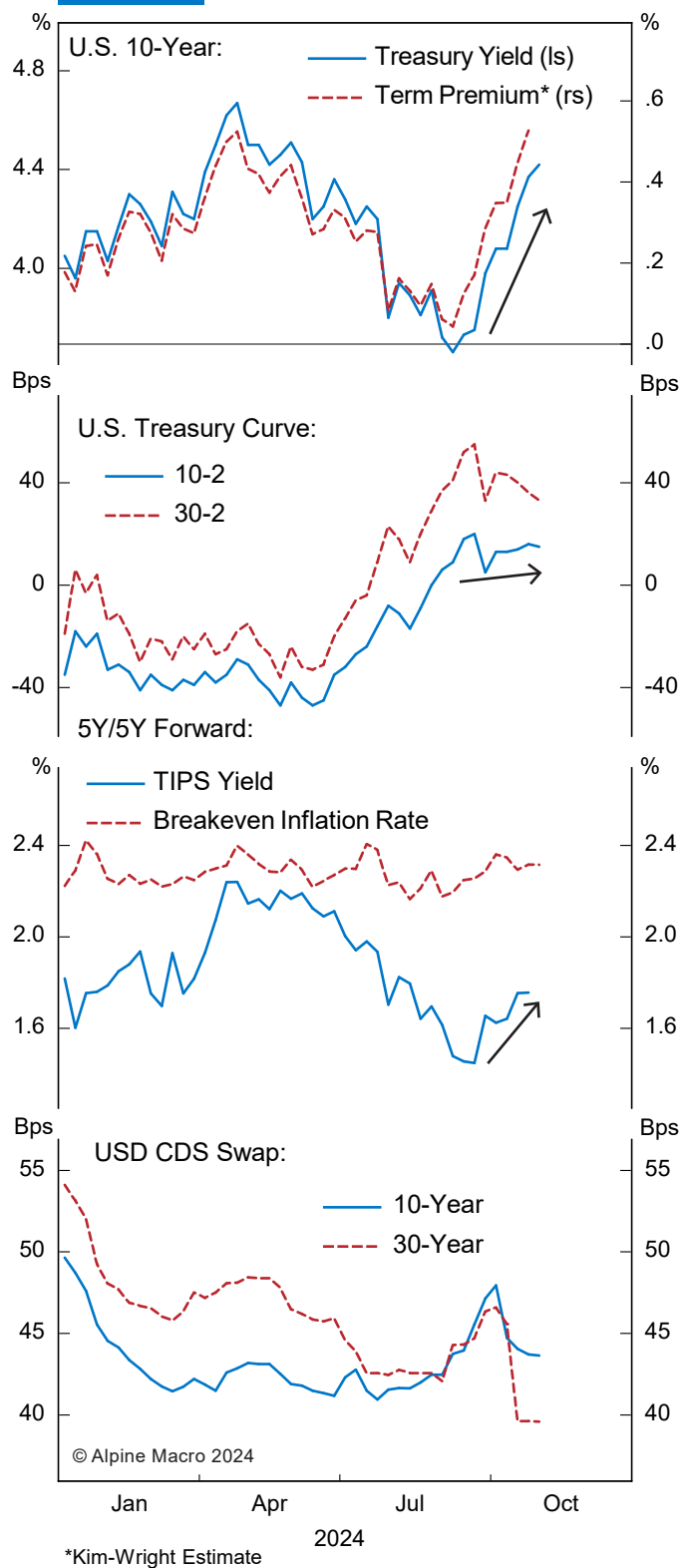
Chart 1A 2016 Election Selloff



\*Kim-Wright Estimate

Note: Vertical line denotes Nov 08, 2016 election

Chart 1B 2024 Election Selloff



\*Kim-Wright Estimate



in the lead-up to the election, so a lot of his policy agenda has already been discounted. Similar to 2016, most of the selloff in October was in the real component of yields rather than inflation expectations.

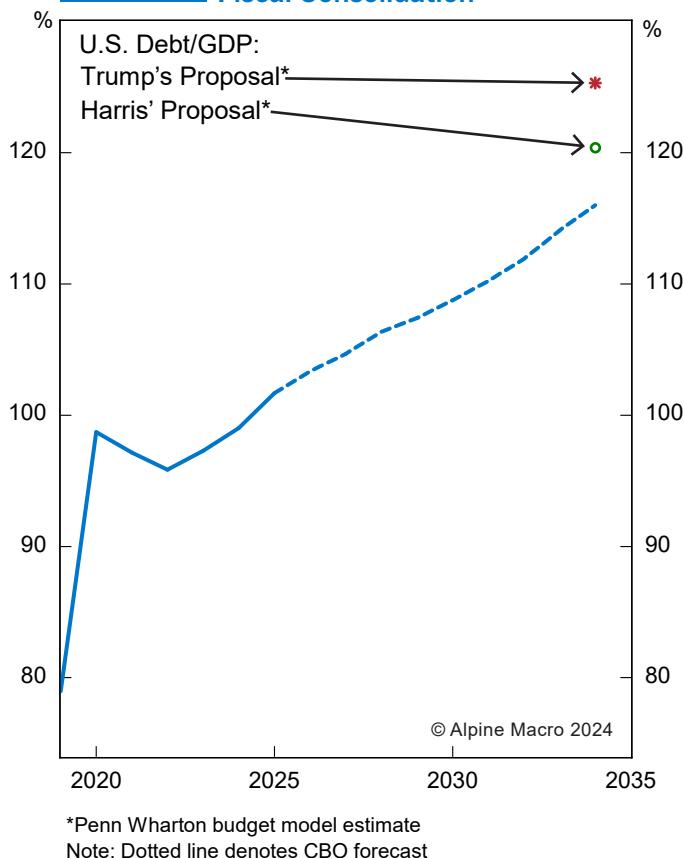
It is difficult to separate the impact of recent positive economic surprises from the effects of growing investor angst over U.S. fiscal policy. That said, stronger growth usually generates bear-flattening curve shifts. The fact that October's selloff reflected a more-or-less parallel shift of the coupon curve suggests that investors appear to have become more concerned about unsustainable budget deficits, which weighed on the back end of the curve. The market has revised up its estimate of where real rates will settle in the long run by a little more than 40 basis points since early October, based on the 5-year/5-year forward TIPS yield (Table 1).

Many investors are posing the question: when will the U.S. suffer a “Lizz Truss” moment?

There are good reasons to be concerned about the long-term viability of U.S. fiscal policy. The worrying outlook for the federal debt/GDP ratio is well known, so we will not review it in detail here. Under current law, the CBO forecast projects that the debt/GDP ratio will climb from 99% this year to 116% in a decade, and to 166% over the next 30 years. This is driven by the demographic “time bomb” and soaring interest payments.

What is particularly alarming is that few seem to care. Neither party has the stomach to undertake the painful policy steps necessary to put the federal finances on a sustainable footing. Indeed, both

**Chart 2** Neither Party Plans Fiscal Consolidation



Harris and Trump campaigned on platforms that would boost the structural budget deficit.

The Penn Wharton Budget Model suggests that Trump's campaign policy proposals would add 9.3 percentage points to the debt/GDP ratio by 2034 if fully implemented (Chart 2). These proposals will be significantly watered down. But the point is that there is no prospect of fiscal consolidation on the horizon. Ultimately, it will likely require a riot point to force a change in voter and political attitudes.

## Warning Signs For A Fiscal Tipping Point

A warning bell does not ring when government debt or deficits reach certain key thresholds. In 2010,



**Box 1: Traditional Signs Of An Approaching Debt Crisis**

- Government deficits absorb a rising share of net private savings, leaving little for new investment.
- Interest payments account for an increasingly large share of government revenues, squeezing out discretionary spending and requiring tough budget action merely to stop the deficit from rising.
- The average interest rate on government debt persistently exceeds nominal GDP growth.
- The government exhausts its ability to raise tax burdens.
- Traditional sources of debt-finance dry up, requiring alternative funding strategies.
- Fears of inflation and/or default lead to a rising risk premium on interest rates and a falling exchange rate.
- Political shifts occur as governments get blamed for eroding living standards, high taxes, and continued pressure to cut spending.



academics Reinhart and Rogoff made the case that economic growth potential tends to fall significantly once the government debt/GDP ratio surpasses 90%.<sup>1</sup> Much slower growth could then contribute to a financial crisis. However, their report methodology was heavily criticized in academic circles.

While there is no warning bell, there are a number of red flags that fiscal trends are entering dangerous territory. The relevance of the various flags will be different for each country, reflecting the depth and structure of the financial system, the soundness of the economy, the dependence on foreign capital, and the asset preferences of domestic investors. Some key signs of building fiscal stress are given in **Box 1**.

None of the factors in **Box 1** appear to be a threat at the moment for the U.S. Moreover, comparisons

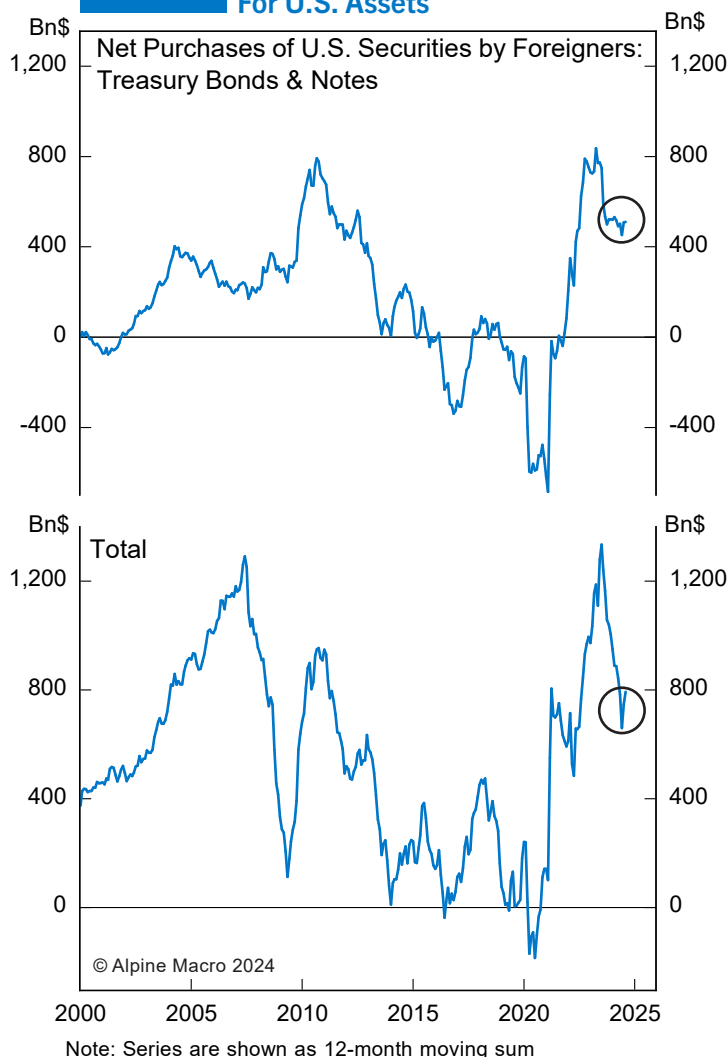
with other countries that have hit the debt wall in the past are not that helpful because the U.S. is a special case. It has a huge economy and has political and military clout. The dollar is the world's reserve currency and America is able to borrow in its own currency. This suggests that the U.S. will be able to "get away" with its borrowing habit for longer than other countries that hit the debt wall in the past.

The situation is quite different from what happened in the U.K. gilt market in 2022. There has been no sudden loss of confidence in Treasurys. In fact, it has been just the opposite as higher yields are attracting foreign investors. The U.S. dollar has strengthened on the back of strong inflows into U.S. securities, including Treasurys (**Chart 3**). There is no buyers' strike evident in bid-cover ratios at recent Treasury auctions or in longer-term Treasury CDS spreads (**Chart 1B**, bottom panel).

<sup>1</sup> Growth In A Time of Debt. Carmen M. Reinhart and Kenneth S. Rogoff. American Economic Review, Papers and Proceedings 100 (May 2010).



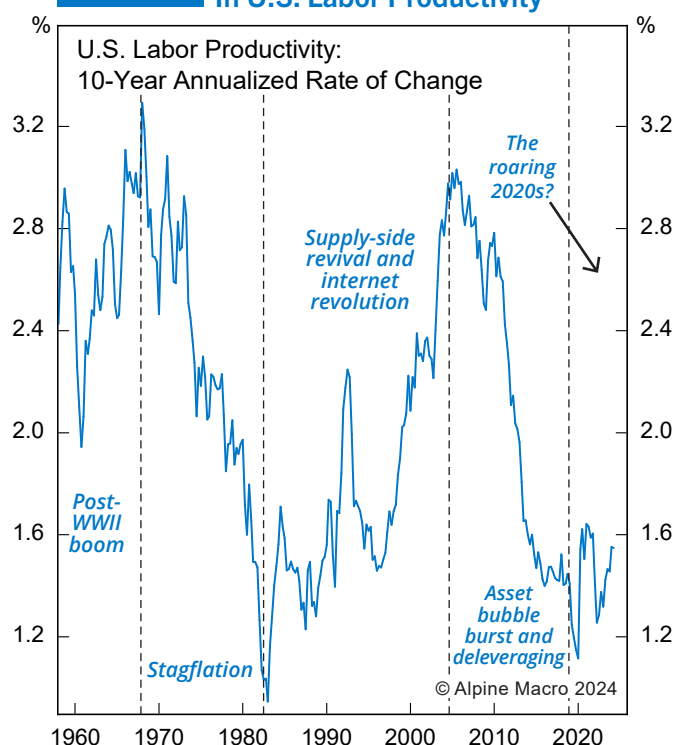
**Chart 3** No Loss Of Foreign Demand For U.S. Assets



## Productivity Echoes Of The 1990s

The productivity backdrop also helps. Alpine Macro's *Global Strategy* service compares the current U.S. situation with the second half of the 1990s.<sup>2</sup> That period was characterized by robust productivity growth and persistent disinflation. There was a massive investment boom in technology-related equipment as the internet proliferated. This is akin to AI today (Chart 4). Deregulation under the Trump Administration could add to the acceleration in output-per-worker.

**Chart 4** Secular Trends In U.S. Labor Productivity



A robust productivity tailwind raises expected returns in U.S. assets, attracting foreign investment. Faster GDP growth also lifts government tax revenues. This reduces the risk that the “twin deficits” issue will spark a flight away from Treasuries.

That said, we do not wish to sound complacent. Financial markets are fickle and it is not always clear why investors suddenly flip from acceptance to panic about a particular fiscal state of affairs.

## The Costs

Even if the U.S. is not near a fiscal tipping point, this does not mean that massive debt accumulation is costless. Some of the main negative consequences are presented in Box 2.

<sup>2</sup> Alpine Macro *Global Strategy, Outlook For H2 2024* “Redux Of The Late 1990s” (July 8, 2024).



**Box 2: The Costs Of Fiscal Profligacy**

- **Interest Costs:** Spending more than 6% of GDP on servicing the federal government's debt load by 2054 would not be a total disaster. Nonetheless, it does reduce the tax dollars available to fund entitlements or investing in infrastructure. Interest on the public debt is projected to exceed spending on Social Security by 2054.
- **Counter-Cyclical Fiscal Policy:** Lawmakers would have less flexibility to use tax and spending policies to respond to unexpected events, such as natural disasters, pandemics or recessions.
- **National Savings and Foreign IOUs:** Because government borrowing reduces national savings, then either private capital spending must assume a smaller share of the economy or the U.S. must borrow more from abroad. Most likely it will be a combination of both. A larger budget deficit implies a larger current account deficit and a faster accumulation of foreign IOUs.
- **Crowding Out:** If global savings are not in plentiful supply, then the additional U.S. debt issuance could place upward pressure on domestic interest rates and thereby "crowd out" business capital spending. This effect is slow-moving, but it could trim the nation's capital stock over time, leading to lower growth in productivity and living standards than would otherwise be the case in the long run.

The last consequence in **Box 2** could prove to be the most important over the long haul.

Economic theory suggests that government borrowing competes for the economy's available savings. This means that an increase in the budget deficit must "crowd out" consumer spending and/or business capital spending. Somewhat higher interest rates are required to encourage consumers and businesses to spend less/save more than they otherwise would.

Crowding-out is not one-for-one because the U.S. can borrow from abroad, tapping foreign savings to fund the budget deficit. However, the crowding-out effect could be more onerous to the extent that all of the major economies are running larger budget deficits and are thus draining the global pool of savings available to the private sector.

A recent long-term study by the Congressional Budget Office<sup>3</sup> estimated that every 1 percentage point rise in the *expected* U.S. debt/GDP ratio over the subsequent 5 years boosts the 10-year Treasury yield by 2-3 basis points. Their work was conducted based on *expected* levels of debt/GDP because the bond market is forward looking, and thus reacts immediately to changes in expected fiscal policy.

What about the post-GFC period? A huge escalation in global public debt coincided with a downward trend in real interest rates for about a decade. The CBO accounted for this period by including Fed

3 The Effect of Government Debt on Interest Rates. Congressional Budget Office. Working Paper 2019-01. March 2019.





holdings of Treasuries in the regression analysis. The impact of quantitative easing was found to more than offset the crowding-out effect of rising government debt during that period. In fact, one could argue that larger budget deficits were required to offset “excess” savings in the U.S. private sector after the GFC, suggesting that there was no crowding-out of private spending occurring.

This might help to explain why JGB yields have been so low despite a massive and sustained Japanese budget deficit. Government dissaving was required to offset private sector retrenchment. Moreover, it may also be important that virtually all of Japan’s government borrowing is domestically financed.

In contrast, about one-third of Treasuries are held abroad and it appears that the “excess saving/insufficient demand” story in the U.S. private sector is now in the rearview mirror.

The CBO baseline projection for the debt/GDP ratio under current law sees it rise from 99% this year to 166% by 2054. Using the mid-point of the CBO’s 2-3 basis point estimate, this implies a rise in the equilibrium 10-year bond yield of almost 170 basis points. The fiscal outcome will likely be worse to the extent that the Trump Administration is able to extend the 2017 tax cuts and implement additional tax reductions in other areas.

This estimate must be taken with a grain of salt. Much depends on potential shifts in global private desired savings and investment in the coming decades, which are difficult to predict. But the lack of political will to impose austerity in the major countries suggests that the path of least resistance is up for equilibrium interest rates as governments absorb a larger share of the global savings pie.

## What About The Yield Curve Slope?

The CBO estimates show that the crowding-out effect on the short-end of the curve is roughly the same as on the long end, implying no impact on the slope of the curve from debt accumulation.

The CBO concludes that *“...changes in debt are associated with shifts, as opposed to rotations, in the yield curve...changes in debt affect the long-run neutral rate of interest rather than the spread between short and long-term rates.”*

We believe that there are other factors at work besides fiscal policy that are pushing up the equilibrium rate of interest (R-star). A recent *Special Report* from Alpine Macro’s *Global Strategy Service* estimates that nominal R-star today has moved up to around 3.75% due to several structural shifts, including the higher sustained rate of productivity growth discussed above (please see the *Special Report* for more details).<sup>4</sup>

The crowding-out effects of escalating government debt likely add to upward pressure on equilibrium interest rates, although this is a slow-moving process.

While crowding-out may not affect the slope of the curve, there are reasons to believe that the negative term premium era has come to an end. The **Appendix** on page 10 highlights why we believe the term premium is transitioning back into positive territory.

## Some Thoughts On The Endgame

We do not believe the U.S. is close to any tipping point. Nonetheless, investors are wondering whether the government will eventually resort to financial repression and/or inflate away the value of the debt.

<sup>4</sup> Alpine Macro *Global Strategy* “Why R\* May Have Risen” (October 21, 2024).



A future government may try these approaches, but they are unlikely to work.

After WWII, many heavily indebted countries capped government bond yields and/or placed regulatory limits on deposit rates and savings bonds. The U.S. called it Regulation Q. This financial repression prevented interest rates on public debt from rising to levels commensurate with inflation, limiting government interest payments.

However, governments could not simultaneously control interest rates and inflation. In the U.S., inflation was both high and volatile, reaching a second post-war peak of 21% in 1947 (Chart 5). While the inflation surge helped to erode the real value of government debt, it became publicly unacceptable. The tension culminated in the Treasury-Fed Accord of 1951, which separated the management of government bonds from monetary policy. Short- and long-term rates then shifted higher.

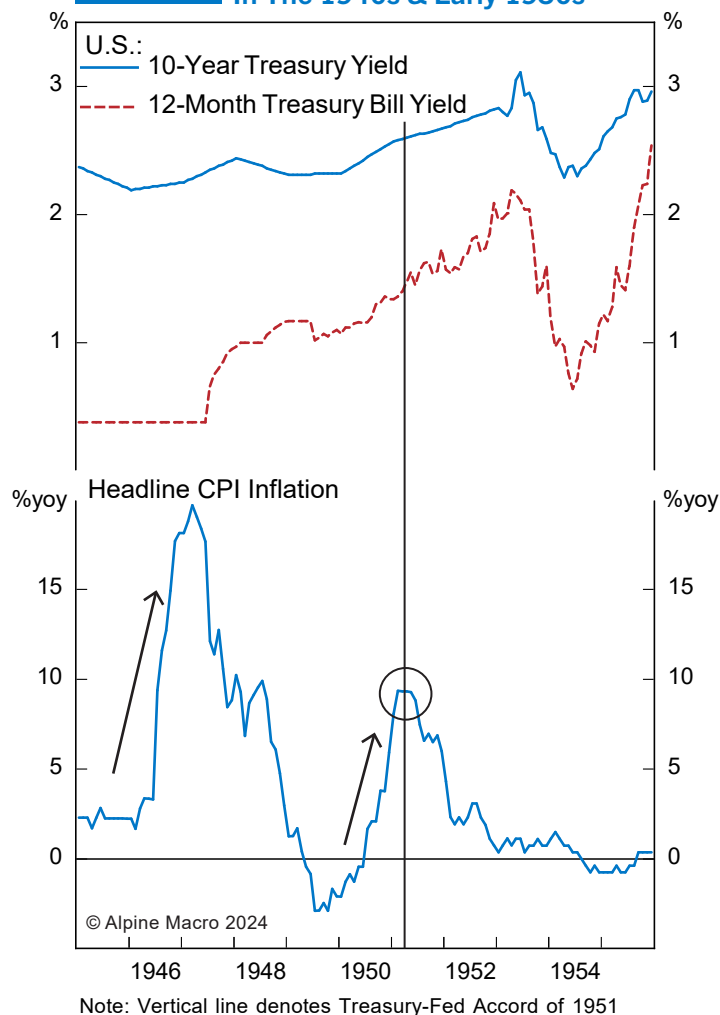
During a speech at the 2023 Jackson Hole meeting of central bankers, Barry Eichengreen argued that it would be impossible to repeat these policies today.<sup>5</sup>

History shows that inflating away the debt requires financial repression and restricted international capital flows at the same time. Otherwise, government bond yields would simply rise along with inflation (or perhaps even faster than inflation). Only unanticipated (surprise) inflation would work but, even then, investors would quickly catch on.

The public is much more financially savvy today and is unlikely to accept deliberately sustained high inflation and capped deposit rates at a low level.

<sup>5</sup> *Living with High Public Debt*. Serkan Arslanalp and Barry Eichengreen. August 2023.

**Chart 5** High Inflation Became Unacceptable In The 1940s & Early 1950s



Eichengreen argues that countries that have successfully reduced their debt ratios since the early 1800s mostly did it the hard way; they ran primary budget surpluses for decades.

## Conclusions

The key points of this report are as follows:

- The projected path for the U.S. federal debt/GDP ratio will almost certainly deteriorate from an already unsustainable baseline trajectory.





- We do not believe the situation has reached a tipping point, due to a productivity tailwind and special status that the U.S. enjoys in the global economy.
- The U.S. is not facing a “Liz Truss” moment anytime soon, although there are consequences from running sustained large budget deficits. This includes the crowding-out effect, which will place upward pressure on the equilibrium interest rate (R-star) over time.
- Crowding-out, by itself, does not appear to affect the equilibrium slope of the curve. However, fiscal uncertainty, along with other factors, mean that the term premium is transitioning back into positive territory on a structural basis.
- Inflating away the value of the debt is not really an option in a modern, open economy.

Keep in mind that structural factors shift slowly over time and can easily be dominated in the short-term by cyclical forces that affect the Treasury yield curve. Changes in the near-term Fed outlook will remain a key driver.

Fiscal stimulus will not occur before the second half of 2025. In the meantime, the Fed will remain “data dependent” and will not try to lean against any forthcoming fiscal expansion in advance by limiting rate cuts that policymakers feel are necessary.

If economic growth holds up and inflation moves down to the 2% target as we expect, then the Fed will drop the fed funds rate to neutral over the next year. We believe that R-star is around 3.75%. The market currently expects the Fed to cut the funds rate by 100 basis points, bringing it exactly into line

with our estimate of the neutral rate. Assuming a 50 basis-point term premium, this implies that the equilibrium 10-year Treasury yield is around 4.25%. Again, this estimate is not far from the current level.

The implication is that we do not see a compelling case to be long or short duration at the moment. However, our bias is to believe that inflation could eventually undershoot the Fed’s target. This would allow the FOMC to cut by more than 100 basis points and trigger a bond rally that moves beyond the forward curve.

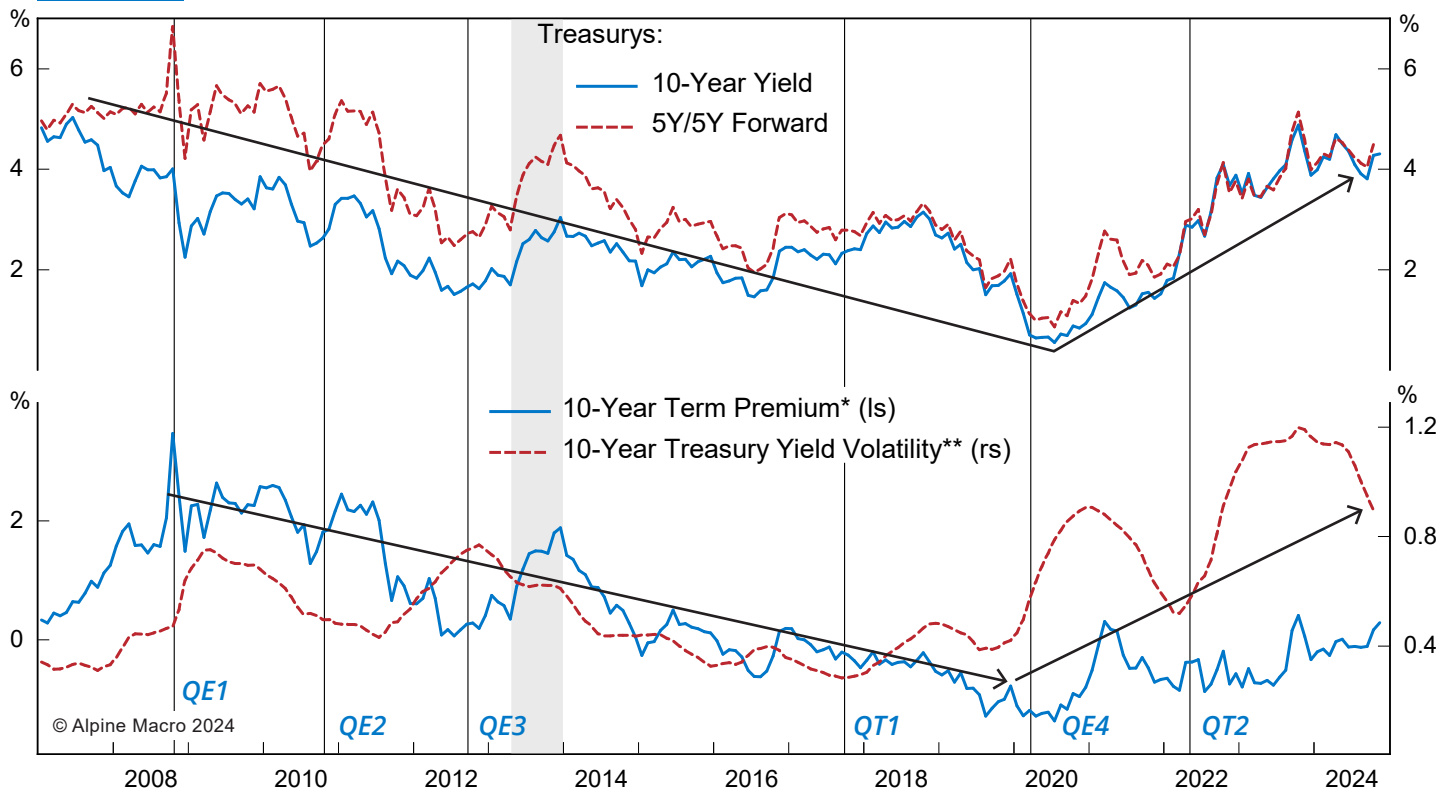
**Bottom Line:** We remain at benchmark on duration for now, but would consider going long if the bond selloff proceeds much further or inflation begins to surprise to the downside.

We will discuss the implications for fixed-income allocation in the next report.

**Mark McClellan**

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**Chart A1** QT And Lack Of Forward Guidance Steepen The Curve

\*Source: New York Fed

\*\*Shown as 3-year moving standard deviation

Note: Vertical lines denote the start of each Fed quantitative easing or tightening period; shaded area denotes the taper tantrum period

## Appendix

### A Mean Reversion of the Term Premium

In theory, this premium is driven by macro and bond volatility.

After the GFC, Fed asset purchases tended to flatten the yield curve over time by withdrawing duration and depressing bond volatility (Chart A1).

QT has the opposite structural effect of steepening the curve. The addition of duration to the market and the removal of strong forward guidance should exert upward pressure on the term premium over time. Indeed, massive policy stimulus to fight the effects of the pandemic appear to mark a structural break in the slope of the curve.

Continuing large budget deficits could also augment macro and bond volatility, thereby boosting the term premium.

That said, we do not expect a major rise in the equilibrium level of the term premium as long as the U.S. returns to a world characterized by low and stable inflation. Our best guess is that the term premium will fluctuate around an equilibrium level that is low, but positive, in the coming years. A 2/10 yield slope of around 50 basis points seems reasonable, although it is hard to be precise.





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