OPINION PIECE

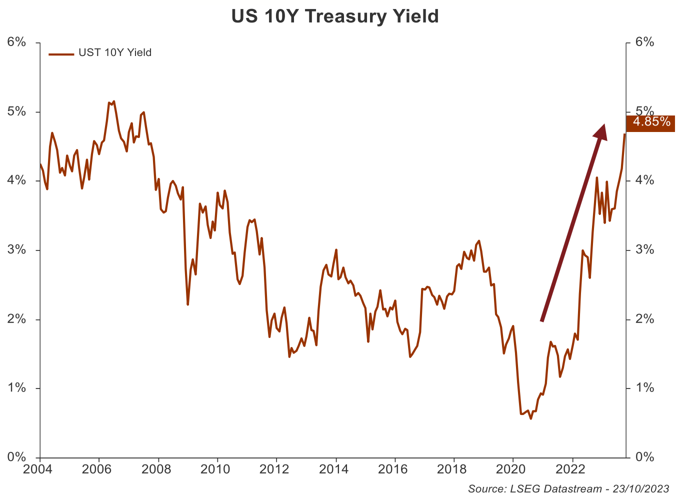
WILL RISING RATES & FED ‘INDEPENDENCE’ COLLIDE?

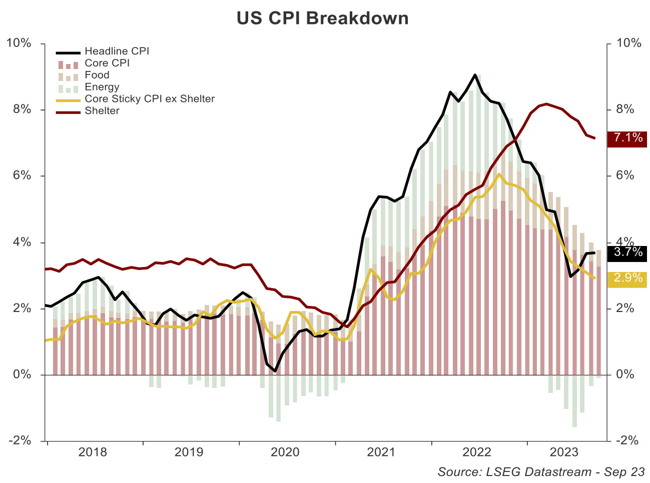
THE KEY ISSUE – SURGING US LONG BOND YIELDS

We’ve been thinking a lot about the elephant in the room for investment markets - surging US long bond yields. It is the one issue that seems to be dominating all others and sucking the life blood out of equity markets (and hurting bond investors for a second year running)!

Again, we would emphasize that we think it is the *rate of change that matters more than the absolute level* – and the disorderly sell off in yields has weighed heavily on indices since the end of July after a period of relative calm.

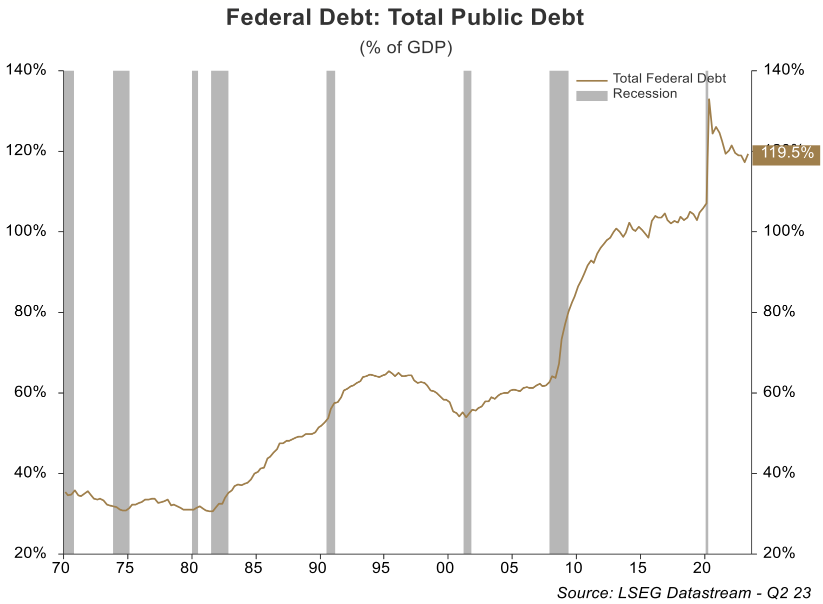
At the time of writing, the 10-year treasury bond is yielding 4.8% after having made a new high of just over 5% in the past few days.





It is worth delving into some macro numbers to contextualise the US fiscal situation, which we believe is the key driver of the current sell-off in rates. Inflation, while still not at the Fed’s 2% target , has moderated meaningfully from a Year-on-Year high of 8.9% in June 2022 to 3.7% based on the September 2023 data and is likely the smaller issue at hand right now.

US federal debt to GDP at 120% is the highest level since WW2, albeit off its pandemic peak (due to the denominator benefiting from high inflation over the past two years). See chart below.



At the beginning of the pandemic a high debt burden wasn't as big an issue, because the Treasury was able to issue paper at very low interest rates. However, with market interest rates across the US curve approaching 5%, it starts to become a real discussion point and a potential concern.

To illustrate the point, the US government's finances look broadly like this:

- **Federal debt of $33.5 trillion,** up from $31 trillion at the end of 2022. It is important to note that this 'headline' figure includes non-marketable debt held by governmental agencies themselves (e.g. social security). For a true reflection of the external debt burden, one needs to look at the marketable debt as at end 2022, this debt balance amounted to ~$24 trillion.
- **Revenue YTD (i.e. tax receipts) of $4.44 trillion**
- **Expenditure Fiscal Year 2023 of $6.13 trillion**
- **Of which ~$659bn is net interest on debt**[1]

So, the government is running a deficit of $1.7 trillion, or c.6% of GDP.

Now, the $659bn interest number is what is notable – this ***implies an average coupon of 2.7%***[2] ***on the debt obligations outstanding***, which would make sense considering where interest rates have been in recent years. Simplistically, if all the debt was repriced to market rates today, it would mean an extra $550bn+ in annual interest expenses on externally held, marketable debt, or:

- An *additional* **2% budget deficit as a percentage of GDP**.
- An **incremental absorption of ~12% of the government's (current) revenue**.

This is of course a theoretical construct to illustrate the long-term effects of the dramatic repricing of the cost of money, fortunately interest expenses don't shift upward in lockstep with market rates due to staggered maturities of debt. The point we're trying to make is that the US government likely cannot afford to have interest rates stay

[1] Federal Spending | U.S. Treasury Fiscal Data

[2] https://research.stlouisfed.org/publications/economic-synopses/2023/06/02/assessing-the-costs-of-rolling-over-government-debt

here if it wants to avoid its debt to GDP ratio continuing to balloon. As an alternative, the Government *will likely need to* accept higher inflation (to make the denominator, nominal GDP, do the heavy lifting), higher taxes, or lower spending.

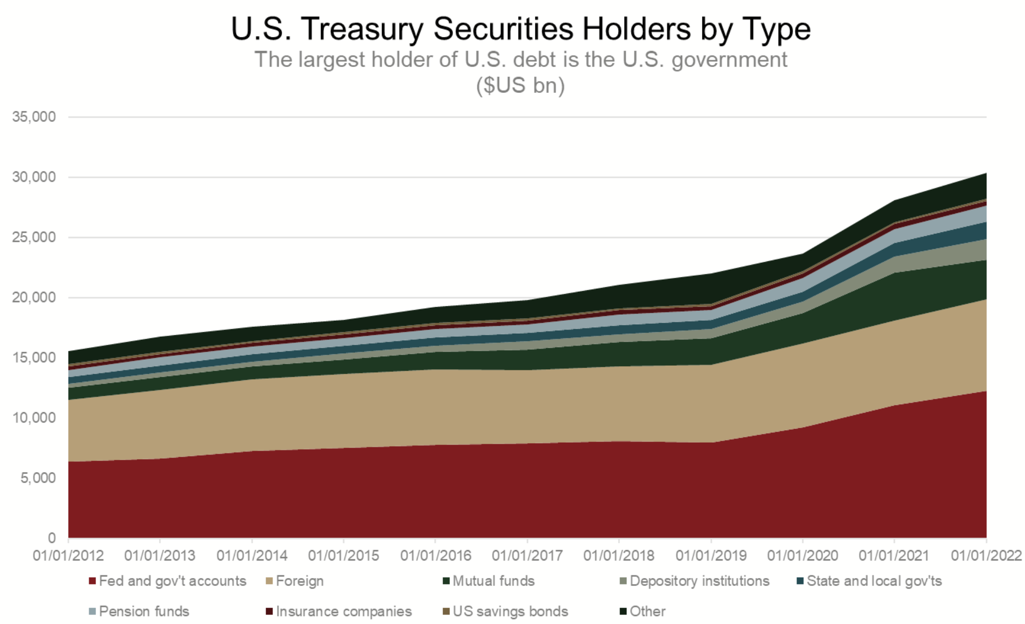
These are all politically difficult choices.

For 2023 alone, the Congressional Budget Office (CBO) estimated back in June 2023 that interest expenses for this year would be an **additional $98 billion**[3] due to the rise in market rates.

WHY DOES THIS MATTER, AND WHERE DOES THE FED COME IN?

A rising debt to GDP ratio could mean that expenditure on interest begins to crowd out other productive expenditure on goods and services that are important – this has landed many emerging markets in trouble over the years!

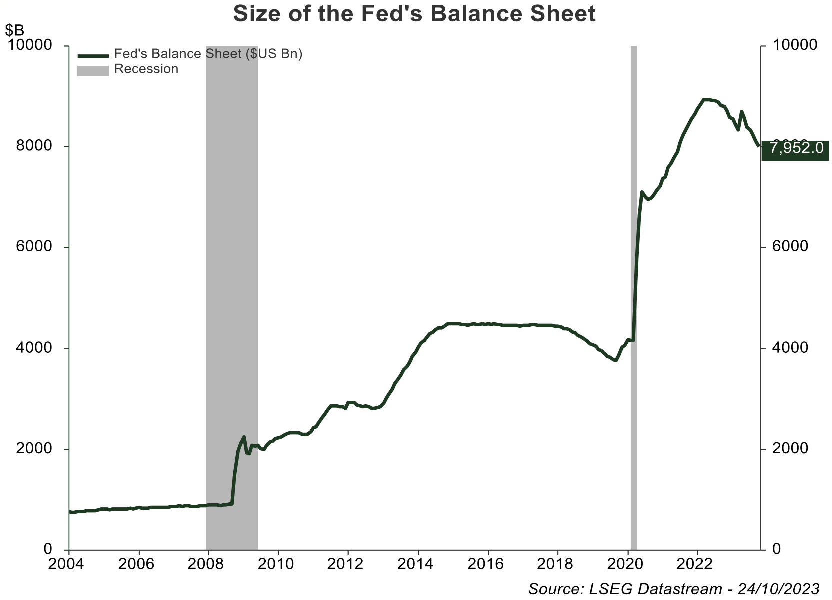
The issue for the US Treasury is that, perhaps uniquely, the Federal Reserve is the single largest holder of US government debt (see the Red area of the chart below):



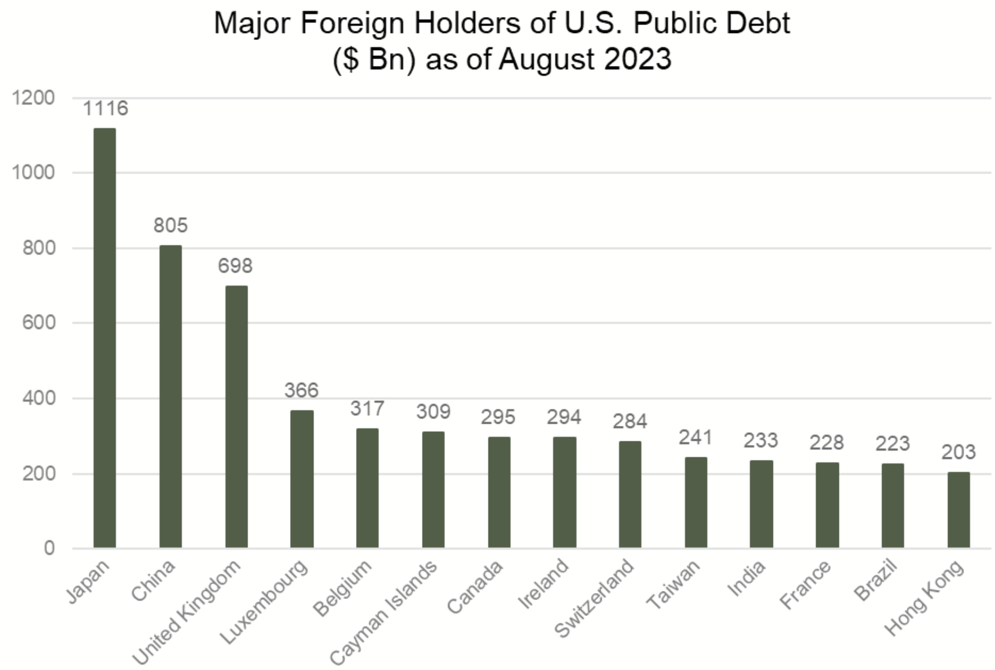
Source: US Treasury Department Jan 2022

Data from the Federal Reserve of St Louis highlights more clearly, that the Fed's balance sheet exploded in size during the pandemic. However, more recently (i.e. since 2022), the ***Fed has effectively turned into a net seller of treasury debt instruments*** through its communicated intention to allow its balance sheet to run off as issues mature (i.e. quantitative tightening).

[3] https://research.stlouisfed.org/publications/economic-synopses/2023/06/02/assessing-the-costs-of-rolling-over-government-debt



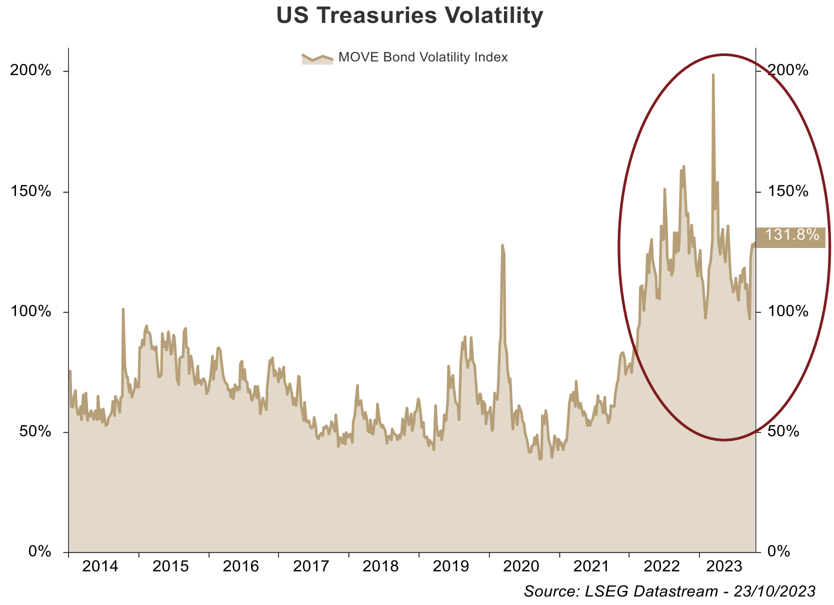
At the same time, it appears at face value that China, as the second largest foreign holder of US debt, has also become a net seller, although exact numbers are difficult to ascertain. Perhaps China has identified the US's fiscal position as a point of weakness to exploit to drive the cost of funding up for the US government. Alternatively, as certain research suggests,China may simply sell more US debt in times of Dollar strength in favour of other reserve currencies, and vice versa.



Source: US Treasury Department Aug 2023

Can you start to see the issue? Over many years, the US government has formed spending habits that have relied upon the Fed being a reliable partner as a buyer of treasury debt issuances (which really is a journal entry for them as the issuer of the *currency* itself). Without this 'partner', and with another potentially large net seller (China), it appears other marginal buyers are stepping away. It is not yet obvious to us what yield would entice heavy enough demand to clear the market in the absence of the Fed as 'backstop' buyer – but we are swiftly moving along that process of discovery in real time.

All this is increasing bond market volatility. The chart below shows the BOFAML MOVE Index, which measures bond market volatility and highlights meaningfully higher levels of volatility in 2022/23 compared to the average of the past ten years.



What is the end game here? We don't know, but to stabilize the bond market (which has seen historic losses already), ***we wouldn't be surprised to see the Fed being forced to do an about-turn with respect to its policy of balance sheet reduction***. Might we even see a return to outright QE again, and possibly sooner than expected?

This would be especially damaging for the Fed's credibility, especially if inflation hasn't yet reached its arbitrarily determined, yet repeatedly reinforced, 2% target. If the Fed was BY FAR the largest buyer of paper during the Covid era and the US is dealing with a new reality of a much-weakened balance sheet, while displaying little appetite to rein in spending, the pressure will only grow on the Fed to step in once again as the only willing marginal buyer to stabilize funding costs for both the government and households alike.

While an 8% 30-year mortgage rate by itself isn't an issue, in combination with median house prices costing $400k+ in the US, reduced savings rates and other household debts, it's a big issue for new buyers which could have a knock on to the housing market.

On the plus side, the inversion of the yield curve has been reduced by the long end having moved up and if short rates are cut due to either (or a combination of) inflation abating or a deeper recession the long end of the bond curve may indeed offer attractive value.

IS THE FED REALLY INDEPENDENT ANYWAY?

The heading at the beginning of this report questioned whether interest rates would collide with the Fed's 'independence' – with the emphasis on our use of parenthesis. While being a supposedly independent governmental agency / institution, it is hard to not reach the conclusion that the Fed and Treasury acted in concert during the Covid-19 pandemic. On 27th March 2020, the Coronavirus Aid, Relief and Economic Security (CARES) Act was signed into law by Donald Trump, in a stimulus package totalling $2.2 trillion, including $300 billion in one-time payments directly to individuals' bank accounts. Treasury would have issued new debt instruments to fund this program, and from early March until May of that year, the Federal Reserve's balance sheet expanded from $4.3 trillion to $7 trillion – a difference of $2.7 trillion. The Fed directly funded the Treasury, and then some. So, it looks like that the proponents of Keynes and (or) Friedman were at the same rendezvous. Despite their co-ordination during the Covid-19 time of stress, the fight of these two powerful bodies, the Federal reserve and the US government, seems to be continuing. The Fed are trying to rein in inflation while the government keeps spending more money boosting demand and growth (almost the exact opposite).

So, how independent is the Fed really? We would watch this space because the pressure is growing by the day. If you would like to read more on this topic, the below paper by Will Bateman is very topical in this regard and it explores the history of the interplay between the US Federal Reserve and Treasury.

CONCLUSION

We're in a very interesting time in bond markets. The 10-year treasury bond yield has not hit levels this high in over 15 years (since July 2007). Once the Global Financial Crisis ensued, rates did fall precipitously for many subsequent years and thus if we enter a recession in the US, coupled with inflation declining, it wouldn't surprise us to see the Fed cut rates and the long end of the bond curve shift lower. Bonds, especially those with duration, will do very well in that scenario.

One quick way for the Fed to win their battle against inflation is by seeing a reduction in government stimulus. Growth would slow and inflation would decline – an unlikely outcome due to the political challenges of this. Another worrying scenario could be that the fiscal dominance continues, and the Fed support the government through a new QE programme to keep rates low. There would be further debt issuance and expansion of the Fed balance sheet. Eventually investors would worry about extended high inflation from the fiscal stimulus and suppressed rates from a new QE programme. The Dollar would likely weaken as investors worry about debasement of the Dollar.

Perhaps the most likely scenario, which isn't necessarily ideal, is that the Dollar remains strong, and rates remain elevated while the Fed "fight" the government by reigning in inflation until such time as the government debt is unsustainable. In that case, the Dollar would weaken, and the government would face a fiscal crisis. We're not there yet but it is something on our radar.

FURTHER READING

The Fiscal Fed, WILL BATEMAN, Australian National University, Law School

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ABSTRACT

"The US Federal Reserve System is conventionally understood as a private-market stabilising institution that has no settled role in supporting the fiscal power of the Treasury. Contra that view, this article argues that the US central bank has always had an extensive fiscal role: building, smoothing and rescuing US Treasury debt markets. Employing a long-duration institutional analysis which draws on the empirics of the Fed's internal deliberations, financial transactions and legal framework, the Fed's fiscal functions are explored with a particular focus on operations during the World Wars, the Great Depression, the Cold War, the Global Financial Crisis and the COVID-19 Pandemic. In each period, the Fed's main fiscal instrument was large-scale debt purchase programs, buttressed by other direct and indirect credit transactions with the Treasury. A deeper understanding of the Fed's fiscal functions has implications for the constitutional design of economic institutions and legal-theoretic accounts of the financial system".

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