

The Major bond letter

#41. US debt in perspective

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Global

It's the only thing we seem to talk about these days – in the bond market, that is. Surging US debt, credit downgrades, and ultimately the question we get all the time, who's going to buy all those bonds?

Citing “entrenched political polarization”, Moody's shifted its US credit rating outlook to 'negative' from 'stable' whilst reaffirming the rating at 'Aaa' (10 November). The move is not unrelated to the uncertainty surrounding risks of a government shutdown at the end of this week.

The prevailing narrative, however, doesn't mean bond yields automatically go higher from here. In the longer term, increased debt does not on its own explain the direction of bond yields. The view that yields should be even higher sometimes conflates different types of risk – mainly interest rates, inflation, and default – and misses that much is already factored into valuations.

The backdrop to the debt debate is the rapidly expanding US budget deficit. For fiscal 2023 (ended 30 September) it increased 23%, to USD1.70trn (from USD1.38trn at the end of fiscal year 2022). This is the government spending in excess of revenues, and it gets worse when projected into the future: USD2.5trn by fiscal 2033, according to the Congressional Budget Office (CBO). Neither side of the deficit equation looks as though it will improve anytime soon. Federal budget expense items are sticky – healthcare, social security, defence, and interest costs – and this situation has been building when the economy has been relatively strong, so revenues are most likely better today than they will be in a future recession.

It appears to be all one-way traffic, so why think differently?

First, the Moody's outlook shift is, in fact, just a catch-up. Other credit rating agencies had already acted, Fitch ('AA+', 1 August) most recently and, more than a decade ago, S&P ('AA+', 2011). The good news is that all of the above is known. At the time of writing, the 10-year yield is 4.65%, below its mid-October high of close to 5%, but well above the starting point below 4.0% at the end of June.

Table 1. G7 debt levels and change since 2008 (as percentage of GDP)

	Debt of non-financial sector (Q1 2023)				Change since Q1 2008			
	Household	Corporate	Government	Total	Household	Corporate	Government	Total
Germany	54	72	62	188	-6	4	-3	-5
UK	82	67	94	243	-12	-17	49	20
US	74	77	104	255	-25	6	41	22
Italy	41	67	139	247	3	-11	31	23
Canada	102	115	89	306	21	31	28	80
France	66	161	107	334	19	49	39	107
Japan	68	117	232	417	8	19	87	114
G7 average	70	96	118	284	1	12	39	52

Note: Non-financial corporates shown. BIS data used almost exclusively with missing data points filled via extrapolation using IIF data where possible.
 Source: BIS total credit statistics, IIF Global Debt Monitor

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We think that this rise in yields was due mainly to a combination of the 30 July refunding announcement and the credit downgrade that came shortly after (Fitch, 1 August). Combining the existing debt that has to be refinanced and rising deficits means USD300bn of bonds must be sold each month. The 'too much debt' narrative can, however, become different, and there will presumably be no lack of buyers in a recession.

Second, debt is all relative. Comparisons with other G7 countries, on an intra-and inter-country basis, put the US somewhere in the middle of the pack. Our table shows public and private sector debt as a percentage of GDP, thereby reflecting a country's ability to carry the debt, and remember the US is by far the largest country in this group, and its trend growth has been higher. The table shows the level of debt on the left side, and the change since just before the Global Financial Crisis (GFC, 2008). Focusing on the huge nominal figures for government debt misses the private sector, which is why we included households and corporates.

When the private sector raises debt, it is typically used to buy productive assets; think of a loan to build a factory, or mortgage taken against property. In the private sector, revenue generated by the asset goes towards paying interest and principal on the debt. Much of the government borrowing, however, has gone into consumption – examples include healthcare and interest expense for many countries – and there was a big increase due to the pandemic. This distinction matters. Unless government borrowing is directed to productive use (e.g. infrastructure) it likely weighs on future growth, through the debt servicing channel, and risks crowding out the private sector. Note that the table shows some deleveraging in household and corporate sectors.

Third, not all sovereigns are the same. Our table of G7 countries includes three members of the Eurozone. Having relinquished some policy sovereignty by issuing in the shared single currency, the euro, they cannot be directly compared with the US, or any other country that issues freely in their own currency. A Eurozone country has defaulted on its bonds, and long before this happened there was a liquidity crisis in the bond market because of the loss of confidence in the country's ability to pay bond holders. We are referring to Greece and the sovereign debt crisis that started in 2010.

Fourth, willingness and ability to pay. Governments have the power to raise taxes and cut expenses. In theory, there is an ability to pay; in reality, we see questions over willingness, and this is what markets don't like. The move higher in US credit default swaps in April this year reflected demand to take protection, and there has been a modest increase again recently.

However, it would be a mistake to use this to explain 10-year Treasury yields. Real yields are about 1% higher than six months ago. As this is the additional yield an investor receives after adjusting for inflation, the intuitive explanation is that rising real yields reflect resilient growth. This might be partly true, but there is also the increase in the term premium ([October effect](#), 9 October 2023), which is the compensation for the additional duration risk above that of simply holding short-dated Treasury bills. We think a large part of the explanation is the short-term demand-supply imbalance, along with uncertainty about longer-run neutral real rates.

Fifth, if there is a realistic alternative to the USD23trn Treasury market, we don't know what it is. Some central banks have reduced bond holdings – but, for all the extreme forecasts of de-dollarisation, we think this just reflects the rebalancing necessary to offset the US dollar's rally: broad measures are up 6% from July this year and more than 18% from their low point in 2021.

The market value of the Treasury bond market is USD23trn; this is what underpins the US dollar, and it serves as a reference rate for global debt markets of more than USD300trn¹, along with other asset classes, including equities and real estate. The debt accumulated is indeed huge, but a sense of perspective is necessary. A public debt, properly viewed, is an asset, not a liability².

¹ IIF Global Debt Monitor, 19 September 2023

² Bill of Rights Institute, The Compromise of 1790 (accessed on the Bill of Rights Institute's website, 13 November 2023)

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