BUDGET DEFICITS COME INTO FOCUS

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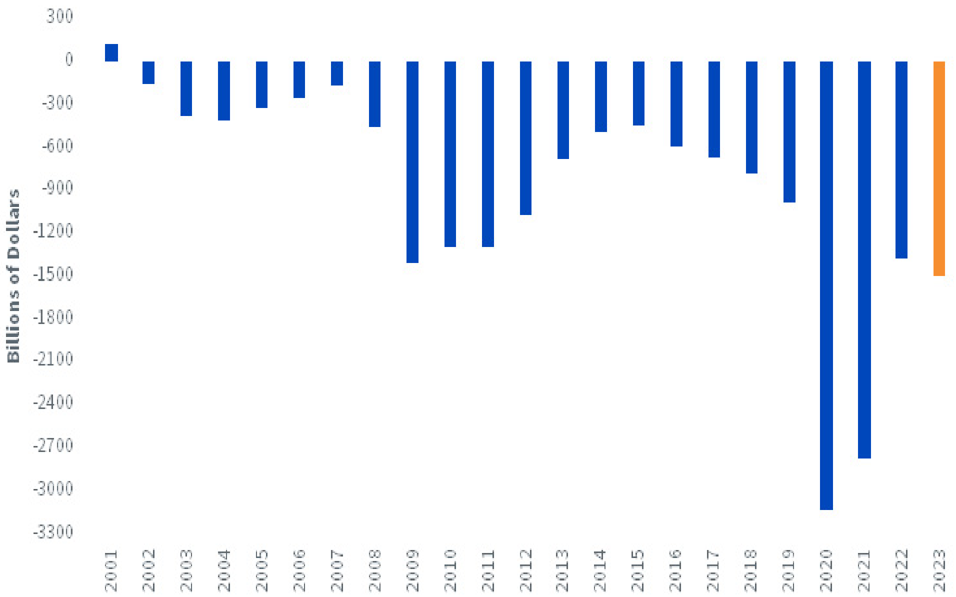
One question I get asked from time to time is, what are your thoughts on the U.S. budget deficit and its potential impact on Treasuries (UST)? Typically, the UST market takes its primary cues from the macro outlook, specifically the economic and inflation setting. Of course, an integral part of the puzzle is the prospect for Fed monetary policy as well. However, there are times when the U.S. government's finances make headlines, and not just from a debt ceiling perspective. Last week was one of those times, so I thought it would be useful to offer some insights.

U.S. Budget Deficit/Surplus



Source: St. Louis Fed, as of 8/4/23.

Without a doubt, one of the more notable deficit-related headlines was that Fitch Ratings agency downgraded the U.S. government's long-term rating a notch to AA+ from AAA. The rationale behind this move was summarized in three points: "the expected fiscal deterioration over the next three years, a high and growing general government debt burden and the erosion of governance." The final point has to do with the dysfunction in Washington, D.C., highlighted by repeated episodes of debt ceiling debate.

For the record, I do not believe this downgrade will change the global investment community's view of Treasuries as being the "store of value" and safe-haven asset of choice in periods of uncertainty and risk-off trade. Interestingly, this was the situation following Standard & Poor's ratings downgrade for Treasuries in 2011. For the record, Moody's and S&P currently have a stable outlook.

Back to the deficit. As the enclosed chart reveals, the budget shortfall following COVID-related issues did get cut by more than half in fiscal year (FY) 2022, but the deficit still remained at historical levels, coming in at just under $1.4 trillion. For FY 2023, the Congressional Budget Office (CBO) is estimating the red-ink total to increase by about $100 billion to $1.5 trillion. In fact, trillion-dollar deficits appear to be the baseline scenario going forward, unless the federal government implements some significant fiscal restraint measures.

That brings us to the next part of the equation, funding the trillion-dollar deficits. We had already seen increases in t-bill auction sizes following the debt ceiling deal, but the nation's debt managers took the next step last week and increased nominal coupon auction sizes. According to the announcement, Treasury will be increasing issuance size anywhere from $1 billion to $3 billion per month for each issue through October. Treasury floating rate note auction sizes will be raised by $2 billion per month as well. In addition, the debt managers stated that "further gradual increases will likely be necessary in future quarters."

Conclusion

While the recent run-up in UST yields had its genesis in the macro side of the equation, it appears that the secondary push higher may very well have been due to the aforementioned increase in auction sizes. One thing does seem for sure—UST yields will not be getting relief from supply issues any time soon.

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DEFINITIONS

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Inflation : Characterized by rising price levels.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Debt ceiling : The maximum amount of money that the United States can borrow cumulatively by issuing bonds.

Credit ratings : An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor’s, Moody’s or Fitch.

AA+ Credit Rating : The AA+ rating is issued by S&P and is similar to the Aa1 rating issued by Moody's. This rating is of high quality and falls below the AAA ranking. It comes with very low credit risk, even though long-term risks may affect these investments. The AA+ rating is considered one of the rankings for investment-grade debt.

AAA credit rating : This is the highest issuer credit rating assigned by Standard & Poor’s, signaling strong confidence that the issuer will be able to maintain its payment obligations.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

Treasury Bill : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).