What's Hot: U.S. budget deficit returns to the spotlight - Is the inflation trade back?

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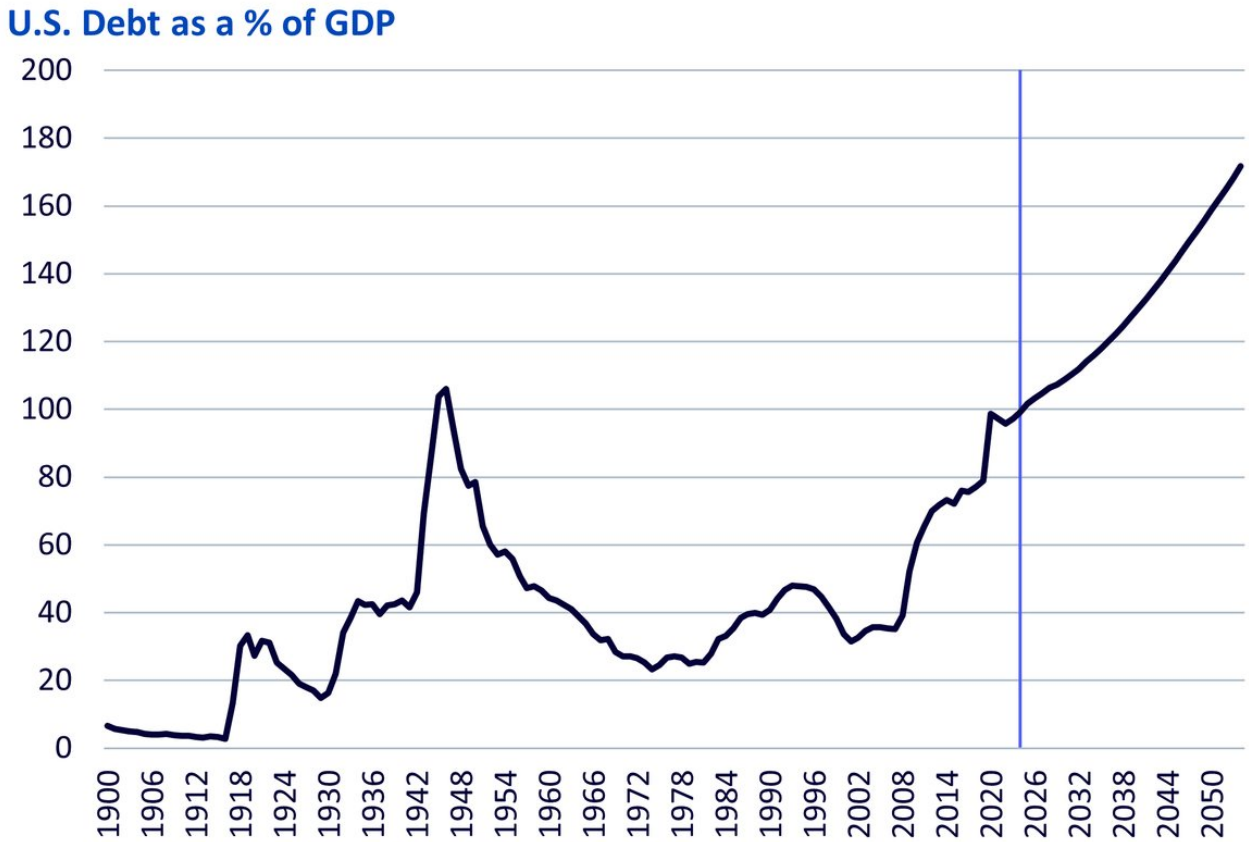
Wichtige Erkenntnisse

- U.S. government budget deficits are expected to grow, regardless of the election outcome, increasing concerns about fiscal sustainability.
- Paul Tudor Jones suggests investors may soon reckon with the unsustainable borrowing levels, potentially driving bond yields higher.
- Without major policy changes, long-term inflation is likely, making assets like gold, bitcoin, and commodities compelling allocations in portfolios.

Last week, billionaire hedge fund manager Paul Tudor Jones joined CNBC's Andrew Ross Sorkin for an interview. As with many hedge fund founders, it is not often they step into the limelight to share their thoughts on markets or overall portfolio positioning. The topic of discussion was the upcoming U.S. election and the ballooning government debt, which has now reached a staggering $35 trillion. Amidst the contentious battle for votes, both sides of the aisle are making promises—tax cuts, spending programs, and more—all aimed at securing the remaining undecided voters.

Jones shared his primary concern on the ever-growing U.S. budget deficit, which is further exacerbated by these election-year promises. The U.S. Congressional Budget Office estimates that national debt will rise from its current $35 trillion to $48 trillion over the next decade, with some forecasts, like Statista's, suggesting it could climb as high as $54 trillion[1]. Today, the U.S. collects roughly $5 trillion in tax receipts annually while operating with a $2 trillion deficit every year. With this level of deficit spending, the US is on track to expand the debt to GDP (Gross Domestic Product) ratio from near 100% to over 170% by 2054[2]. As Jones pointed out, the debt is only going to grow, offering serious implications for the fixed income markets.

Figure 1: US Government Debt to GDP, Historical and Forecasts



Source: Congressional Budget Office, as of October 2024. **Historical Performance is not an indication of future performance and any investments are subject to risk and uncertainties. Forecasts are not an indicator of future performance and any investments are subject to risk and uncertainties.**

To make this clearer, he offered a compelling analogy: Imagine he's your neighbor, earning $100,000 a year, yet he already owes you $700,000. Now, every year, he turns around and asks to borrow another $40,000 until that $700,000 is repaid. Would you lend him the money? Most would say ‘no’. Jones argues this is precisely the proposition the U.S. government is making to Treasury bondholders—a situation that many other countries mirror. So why do investors still buy U.S. bonds? As Bill Gross, co-founder of PIMCO and often called the ‘Bond King’ famously put it, the U.S. is the ‘cleanest dirty shirt’ in the laundry basket of global bonds.

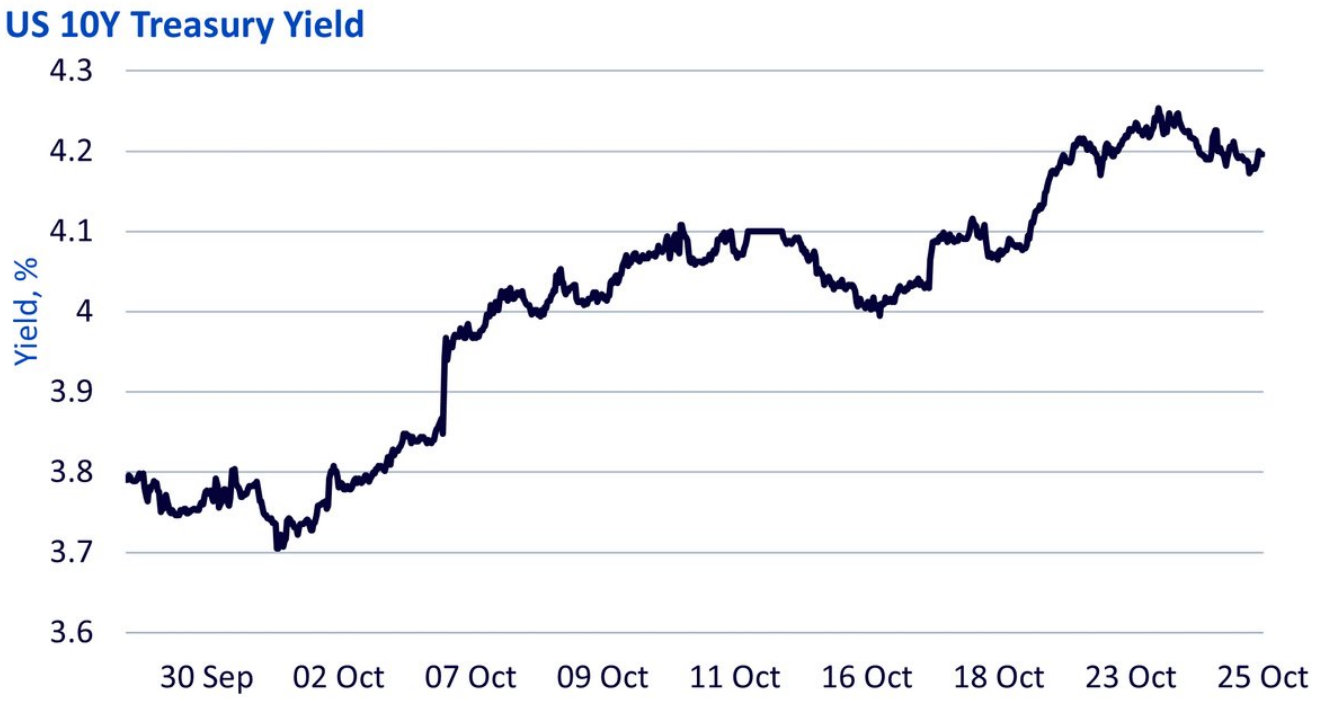
Awaiting a Minsky Moment: The Bond Market Reckoning

Jones went on to highlight the potential for a ‘Minsky moment’, where financial markets suddenly wake up to the reality that this level of borrowing is unsustainable. Jones believes that the U.S. is facing a scenario where bond markets could soon demand higher yields for the increased risk of lending to a heavily indebted government.

Hearing this, one can’t help but feel a sense of déjà vu, recalling the U.K.’s Liz Truss and her ill-fated 2022 'mini-budget' proposal. Her plan, deemed financially reckless, sent bond markets into turmoil, pushing borrowing costs higher and forcing her to swiftly reverse course.

Jones argued that investors are living in a false sense of security, blindly accepting the current fiscal conditions without acknowledging the looming risks. Much like in the U.K., the bond market could eventually force the U.S. government to 'pay the price' for its spending spree, leading to a sharp correction. As of time of writing, the US 10Y treasury bond yield has been on the rise over the last month, having risen from around 3.8% up to 4.2%, a large move in yields for a relatively short period of time.

Figure 2: US 10Y Treasury Yield



Source: Bloomberg, as of 25th October 2024. For period September 27th, 2024 to October 25, 2024. **Historical Performance is not an indication of future performance and any investments are subject to risk and uncertainties.**

Inflating Away the Debt: The Inevitable Path Forward

Jones claims that, historically, there's been only one reliable way for governments to manage massive debt burdens: inflation. By inflating the debt away, they reduce its real value, albeit at the cost of eroding the purchasing power of their citizens. As Jones succinctly put it, 'All roads lead to inflation.' While there may be potential policies that could help balance the budget, none seem politically feasible given the current landscape. Inflation, then, becomes the most likely path forward, gradually reducing the debt burden relative to the size of the economy.

He outlined the policy playbook: run inflation at or above 2%, while keeping interest rates below the inflation rate, allowing nominal growth to outpace inflation, which should help to stabilize the debt to GDP ratio. Inflation acts as a slow tax on the population, but it's a necessary mechanism to manage unsustainable debt levels without needing to make politically painful choices like cutting spending or raising taxes.

His portfolio positioning aligns with this outlook. Jones is long on bitcoin and gold and has short positions on long-term US Treasury bonds (10-30 years). He also sees commodities as undervalued, and views stocks, particularly those in the Nasdaq, as another alternative hedge against inflation.

Positioning for Inflation with Alternatives

In a relatively short interview, Jones makes a compelling case for emergence of long-term structural inflation in the U.S. economy. The case could very well be extrapolated to many other major economies that face similar problems. The recent move in 10-year yields supports this narrative, and we've seen strong price performance for bitcoin and gold over the past year. If his outlook is correct, the current momentum we are seeing stands to continue.

Whether or not we experience a 'Minsky moment' where markets abruptly wake up to fiscal reality, the bull case for bitcoin, gold, and commodities remains clear. Fiscal irresponsibility, rising geopolitical instability, and central banks accumulating hard assets like gold—and, in some cases, bitcoin—only strengthen his argument. As currencies and fixed income rely on a central government's ability to promote economic strength and stability through policy, it's crucial for investors to stay mindful of the risks when decisions may not lead to the desired outcomes. In such uncertain times, diversifying into alternatives like gold, bitcoin, and commodities, which can offer long-term value and inflation protection, becomes increasingly compelling.

Interview Link: Legendary investor Paul Tudor Jones: I am clearly not going to own any fixed income

[1] Federal debt forecast U.S. 2034 | Statista

[2] The Budget and Economic Outlook: 2024 to 2034 | Congressional Budget Office

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