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Fixed Income Strategy

IN-DEPTH ANALYSIS OF THE FIXED INCOME MARKETS

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When Debt Pushes Back

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Key takeaways

» *The rising U.S. federal debt burden now ranks the U.S. among the most leveraged developed-market countries, and puts the U.S. at increased risk of a sovereign-debt credit rating downgrade if the current trend continues.*

» *The refinancing of substantial amounts of Treasury debt in the near term could translate to higher interest-rate volatility in 2018 and 2019.*

» *An increased supply of Treasury debt, combined with weakening demand for Treasury securities, is likely to lead to higher U.S. interest rates.*

What it may mean for investors

» *Investors should prepare for more interest-rate volatility ahead and the possibility of a bond-market overcorrection that could offer investment opportunity.*

» *We favor a more defensive domestic fixed-income positioning in terms of yield curve, credit, and structure today—and selective diversification by sector and geography to address the changing market landscape.*

Many have attributed the recent increase in Treasury yields to concern over the growing U.S. Treasury debt burden and the higher debt-to-GDP (gross domestic product) ratio that is expected to result from recent U.S. fiscal policies. We view this market reaction as a healthy one, given the magnitude, trend and timing of the growing U.S. debt burden. In today's report, we evaluate the impact of these changes on the domestic bond market and share our insights for investors.

U.S. debt magnitude and trend

According to the Congressional Budget Office (CBO), recent changes to tax policy and the budget will increase the U.S. Treasury debt burden by a combined $1.8 trillion over 10 years ($1.46 trillion from tax policy and $320 billion related to the recent federal budget increase, on a "gross" basis). This compares to about $20 trillion in Treasury debt outstanding. There are many differing assumptions related to these baseline figures, including the CBO's projection that interest payments related to the budget actions will rise by $100 billion over the same time horizon, and the Congressional Joint Committee on Taxation's estimate that the tax proposal should increase U.S. economic activity (GDP) by 0.7 percent over the baseline growth rate—generating $451 billion in offsetting revenue over 10 years. But regardless of the assumptions, what we do know is that the federal deficit and debt will grow.

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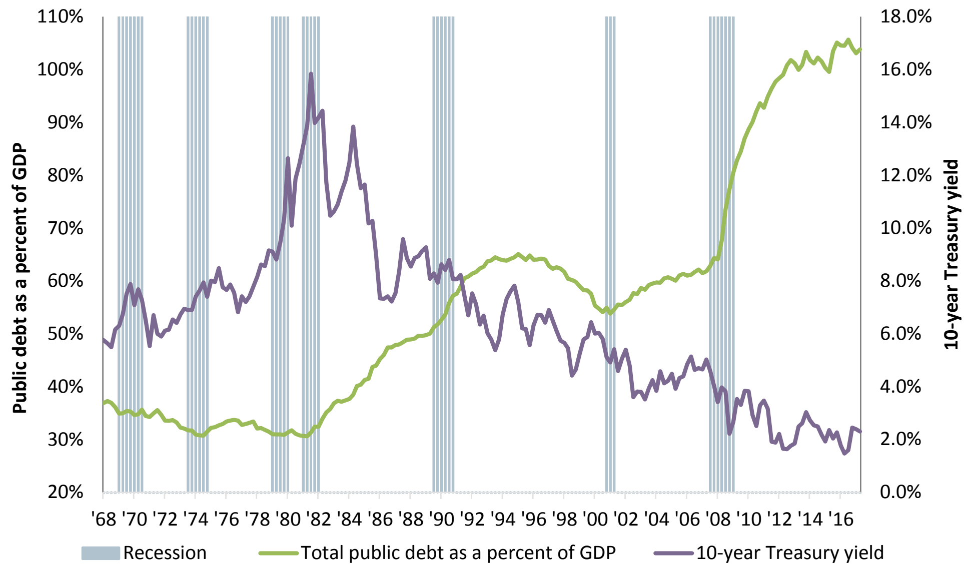
Chart 1. Total U.S. public debt as a percent of GDP

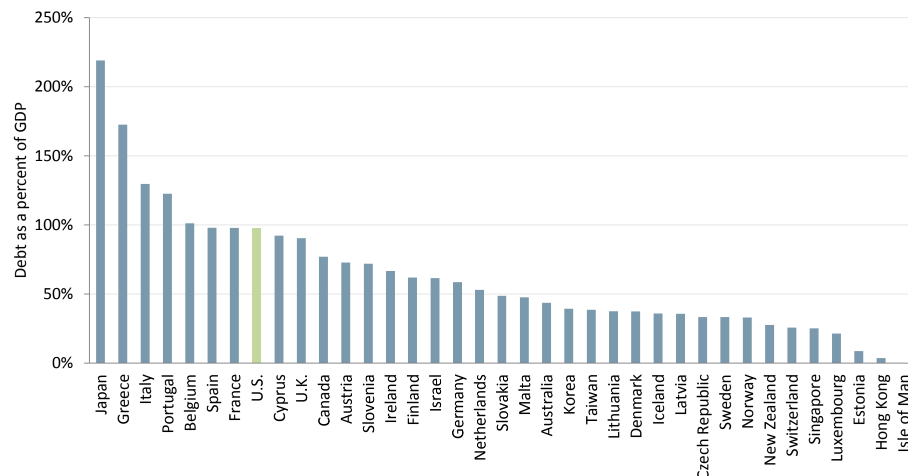


Sources: Bloomberg (10-year Treasury yield); Federal Reserve Bank of St. Louis and U.S. Office of Management and Budget (Public Debt and GDP); February 20, 2018.

Impact of rising debt

While our nation's debt burden has risen significantly (as a percent of GDP) over the past 10 years, in our view, it has not resulted in the increased likelihood of recession. Yet, the past few U.S. recessions have led to subsequent federal debt increases to help bring the country out of recession. Until recently, the rise in debt has not led to a higher risk premium associated with financing U.S. federal debt, and therefore, there typically was no corresponding increase in bond yields. However, we believe that the increasing Treasury debt/GDP ratio puts the U.S. at risk for a potential credit ratings downgrade in the future. The U.S. debt burden continues to grow, while the median debt/GDP ratio for its peer group of countries has declined since 2013. In fact, the U.S. has moved from 12th to 8th highest in debt/GDP ratio ranking since 2008, among the 37 advanced industrial countries (Chart 2).

Chart 2. Of 37 advanced industrialized countries, the U.S. now holds the 8th highest debt/GDP ratio



Source: Moody's Investors Service: Moody's Statistical Handbook Country Credit, November 2017.

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Since 2008, Moody's has downgraded each of the seven most leveraged countries by a minimum of two notches (relative to credit rating). Collectively, these seven countries have been downgraded by a combined 41 notches, and each Moody's downgrade always has cited debt as one of the factors (Table 1). We remain concerned that if the U.S. continues the trend of a rising debt/GDP ratio, it increases the chances of a sovereign-debt credit downgrade by the credit ratings agencies. Any ratings downgrade may shift focus toward greater credit scrutiny for the U.S., which we believe has been lacking as a result of the extreme monetary stimulus since 2008.

Table 1. Moody's long-term issuer bond ratings

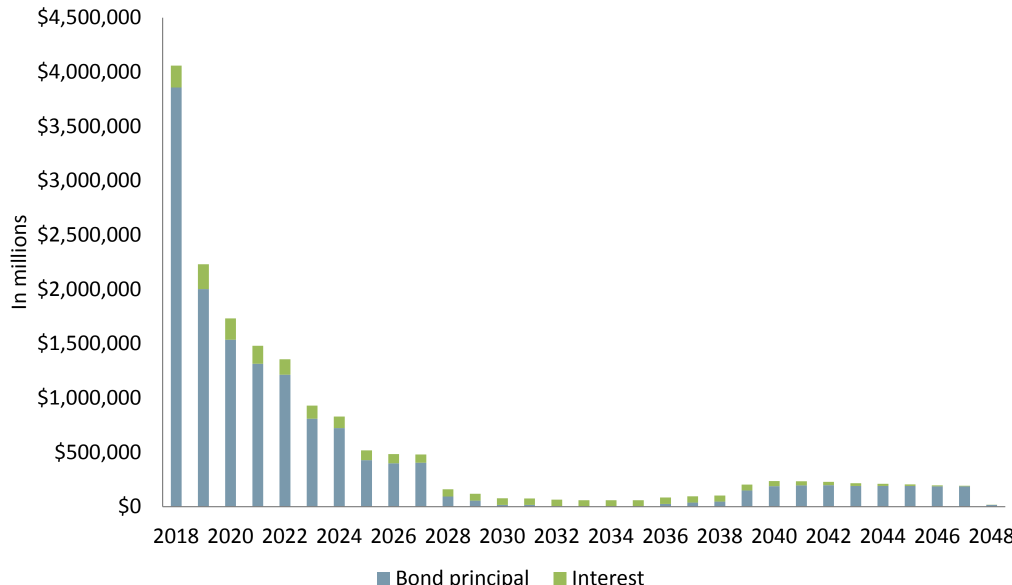
Country	Debt as a % of GDP	Ranking of advanced industrial countries (Debt as a percent of GDP)	Moody's rating (2008)	Moody's rating (2/21/2018)
Japan	219%	1	Aaa	A1
Greece	173%	2	A1	B3
Italy	130%	3	Aa2	Baa2
Portugal	123%	4	Aa2	Ba1
Belgium	101%	5	Aa1	Aa3
Spain	98%	6	Aaa	Baa2
France	98%	7	Aaa	Aa2
United States	98%	8	Aaa	Aaa

Source: Moody's Investor Service, February 21. 2018.

Timing of the U.S. debt burden

Although rising U.S. Treasury debt has not historically fueled higher interest rates (until recently), the timing of the U.S. debt burden may play a larger role. Specifically, the U.S. currently finances its debt on a relatively short-term basis, and it likely will need to refinance close to $4 trillion in debt over the course of this year alone (Chart 3).

Chart 3. Debt distribution for U.S. Treasury securities is heavily skewed to the short term



Source: Bloomberg, February 15, 2018.

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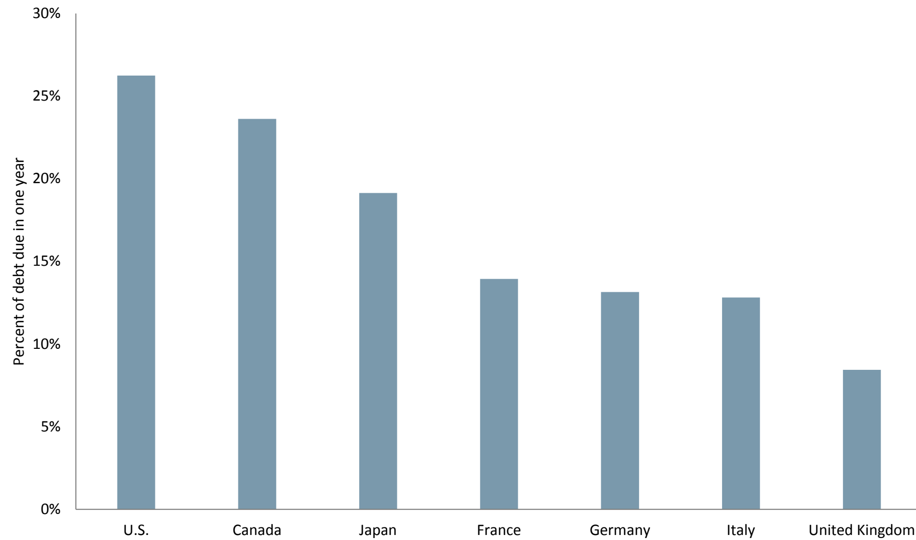
This U.S. short-term financing need is the largest among many of its developed-market peers as a percentage of GDP (Chart 4).

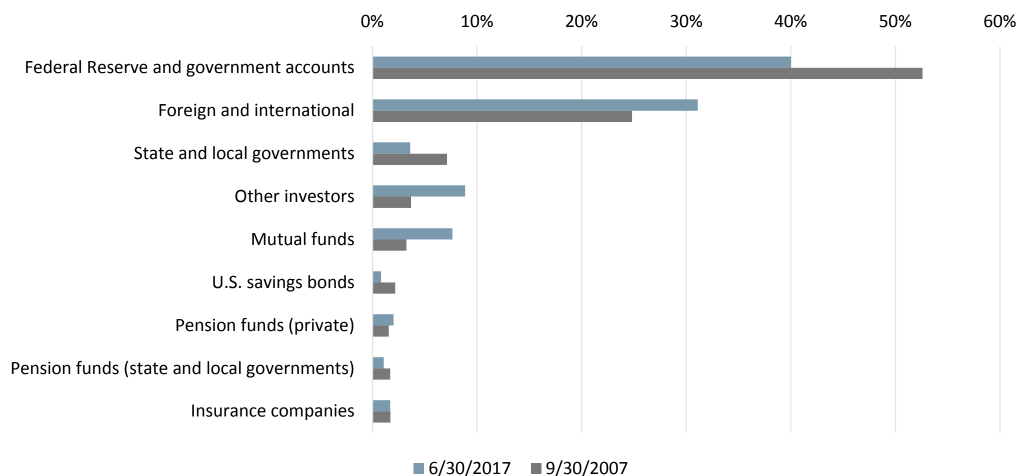
Chart 4. The U.S. currently has a high percentage of debt due in one year



Source: Bloomberg, February 15, 2018.

In fact, the U.S. Treasury is issuing more than $250 billion in Treasury securities during auctions this week alone, and the three and six month Treasury bill auctions will be the largest on record. This large issuance may allow for the market to push back on concerns over increasing debt (by demanding higher yields). Additionally, the short-term financing issue could become challenging during budgetary impasses when political confrontation leads to additional market angst over the federal government's willingness to properly finance its debt. This issue arose in September 2011, when the Standard & Poor's rating agency eventually lowered the U.S. debt rating to AA+. Although this debt downgrade did not lead to the higher interest rates that had been anticipated, we remain concerned that the heavy reliance of the U.S. on short-term financing could present challenges and increased market volatility down the road.

Chart 5. Ownership of Treasury securities is shifting away from central banks and governments



Source: U.S. Treasury Bulletins, December 2009 and December 2017.

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Declining demand for U.S. Treasury debt

We believe that overall demand for U.S. Treasury debt may decline, which is an important changing dynamic for the bond market. The U.S. Federal Reserve (Fed) and foreign holders together own more than 50% of U.S. Treasury debt (Chart 5.). As the Fed continues to reduce its balance sheet, in 2018, it will repurchase $420 billion less in fixed-income securities (mainly U.S. Treasury securities) than the maturing debt that rolls off. Additionally, we expect the trend of foreign holders reducing their exposure to U.S. Treasury debt to continue. It is widely believed that increased U.S. Treasury debt purchases were a result of countries abroad increasing their foreign-exchange reserves in an effort to offset strengthening currency moves. We don't expect the need to boost foreign-currency reserves to continue in 2018. Other significant buyers of U.S. Treasury debt, such as pensions and insurance companies, may continue to reallocate to fixed-income holdings to better align their assets with their liabilities. Nevertheless, we are not confident that this demand will be enough to offset the weakened demand from the Fed and foreign governments. Additionally, we believe there may be periods of selling pressure on Treasury securities from the "bond vigilantes" in 2018 as concern over the increased U.S. debt burden gains further visibility. Bond vigilantes (investors who sell bond holdings to force fiscal discipline) have not been visibly active for quite some time, although the pressing nature of the increasing federal debt burden may make them more active in the near future.

Higher inflation resulting from stimulus

As fiscal stimulus begins to run through the U.S. economy, it will fuel additional economic growth, which likely will increase inflation. While additional Treasury debt alone generally has not shown a correlation to higher interest rates, higher inflation has (Chart 6). U.S. inflation has remained dormant during the period of economic expansion since 2008, and developed-market central banks had been more concerned about disinflation and even deflation (rather than inflation). However, signs are emerging that inflation may be picking up slightly, with recent upticks in wage, consumer and producer price inflation. Future inflation expectations can be evaluated through Fed's five-year forward breakeven (inflation) rates. The Fed's five-year forward breakeven rates stayed in a tight band of 1.75-1.85 throughout the second half of 2017. Yet, they now have broken through 2.00 and climbed to 2.14. The correlation between the Fed's five-year forward breakeven rates and 10-year Treasury yields recently has been fairly strong, and with breakeven rates increasing, we would expect to see a corresponding rise in interest rates. We believe that inflation will continue to increase moderately in 2018, which likely will lead to moderately higher interest rates as well.

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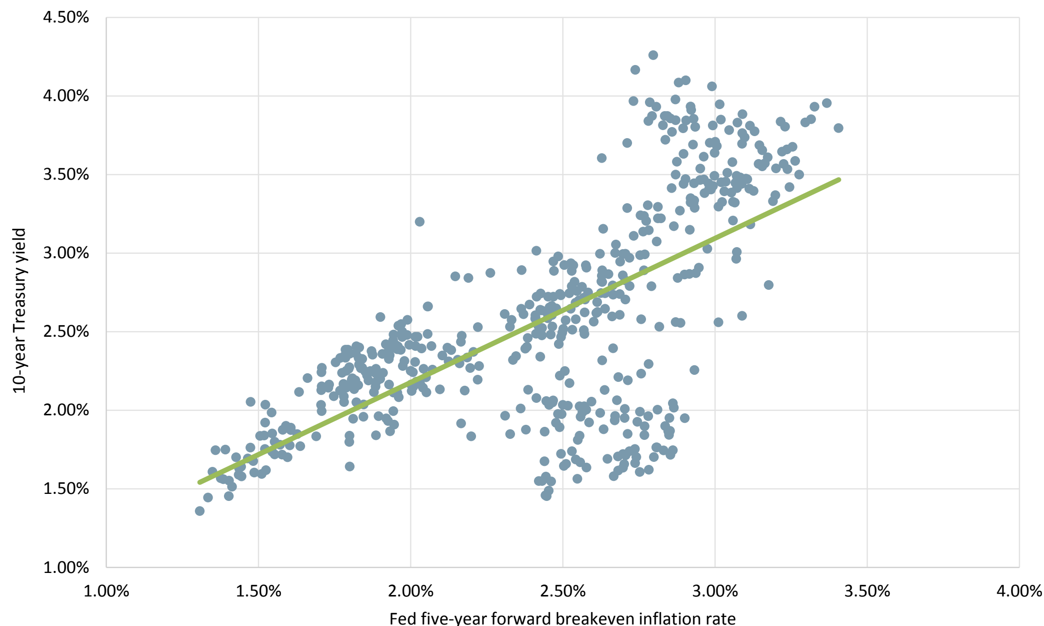
Chart 6. Relatively strong correlation between 10-year Treasury yield and five-year forward breakeven inflation rate



Sources: Bloomberg, Federal Reserve, February 20, 2018. Chart shows correlation between Fed's five-year forward breakeven inflation rate and the 10-year Treasury yield. Correlation measures how two asset classes or investments move in relation to each other.

Increasing Treasury debt late in the business cycle

Another unique aspect of the rise in U.S. fiscal stimulus this year is that we are adding federal debt late in the domestic business cycle. It is true that our economic growth rates following the 2007-2009 recession have not approached the levels seen coming out of previous recessions, and as we shift from highly accommodative monetary policy, even Fed officials have called for additional fiscal-policy support. Yet, historically, the U.S. has not taken on major fiscal policy changes and significantly increased debt this late in the expansionary period. Unfortunately, this may leave the U.S. in a position in which it is more heavily dependent upon monetary policy should an economic shock or downturn occur before the benefits of growth offset the increased debt assumed.

A changing market landscape

While the high (and rising) U.S. debt/GDP ratio does lead to some concern, there is little convincing evidence that this *alone* will cause U.S. yields to rise. However, we believe there are three key conclusions from our U.S. debt analysis. First, our quickly escalating debt/GDP ratio puts the U.S. sovereign credit rating at risk for a future downgrade by some rating agencies, if left unchecked. Second, the short-term rolling over of Treasury debt may lead to increased interest-rate volatility over the coming years. Third, the combination of increased debt supply with weakening demand for Treasury securities will continue to place upward pressure on interest rates. We also believe that a pickup in inflation resulting from fiscal stimulus (and the resulting U.S. economic growth) will contribute to slightly rising interest rates. Finally, we believe

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that adding fiscal stimulus this late in the business cycle warrants concern, because any sign of weakening growth likely will need to be addressed through more aggressive monetary policy in the future, at least in the short term.

Investment implications

We believe that investors should prepare for a moderately increasing, and more volatile, interest-rate path than we experienced in 2017. We favor a more even yield-curve exposure today (with positions across maturities) and a more defensive (higher-quality) credit profile—as volatility and heightened credit concerns could lead to significantly wider spreads in the high-yield-bond market. While we support exposure to mortgage-backed securities (MBS) in portfolios today, some caution is warranted, as MBS may face some rising yields (and spreads) as the Fed reduces its balance sheet (along with term extension risk). We believe that investors may benefit from owning TIPS as inflation has been increasing and upside inflation risks may remain. In summary, we would:

- Seek a more defensive bond positioning in terms of yield curve, credit and structure
- Prepare for more interest-rate volatility and the possibility of a market overcorrection creating investment opportunity
- Seek TIPS that should benefit from mildly increasing domestic inflation
- Diversify globally within fixed income, especially in emerging-market debt.

Rising Treasury debt late in a business cycle does represent a market risk. By diversifying broadly across fixed income sectors and geographies, as well as across asset classes, investors may be able to mitigate the risks of rising interest rates.

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Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

U.S. government securities are backed by the full faith and credit of the federal government as to payment of principal and interest. Unlike U.S. government securities, agency securities carry the implicit guarantee of the U.S. government but are not direct obligations. Payment of principal and interest is solely the obligation of the issuer. If sold prior to maturity, both types of debt securities are subject to market risk.

Treasury Inflation-Protected Securities (TIPS) are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the "inflation compensation" component of the principal. A holder of TIPS may be required to report this income annually although no income related to "inflation compensation" is received until maturity.

Although Treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

For mortgage-backed securities, commercial mortgage-backed securities and asset backed securities, the yield, average life and the expected maturity are based on prepayment assumptions that may or may not be met. Changes in prepayments may significantly affect yield, average life and expected maturity.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

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