THE RATE AND CREDIT VIEW

America Has A Debt Problem

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EXECUTIVE SUMMARY

- Since the debt ceiling debate was resolved back in June, the Treasury department has steadily increased the amount of Treasury debt outstanding. As of September 18, total debt outstanding stood at a record $33 trillion.

- The U.S. will need to refinance over $9 trillion of debt with over $5 trillion due this year and with the amount of Treasury debt that will likely come to market over the next few years (few decades?), the Treasury department will likely need to find additional demand.

- As long as Treasuries are considered risk-free securities, there will always be buyers. Full stop. The question though remains price. And in order to lure non-traditional buyers to the Treasury market, yields will likely have to remain higher for longer.

AMERICA HAS A DEBT PROBLEM

It's been little over a month since rating agency Fitch downgraded U.S. government debt from its highest rating (AAA) to its second highest rating (AA+). The agency cited "the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to 'AA' and 'AAA' rated peers over the last two decades" as the reasons for the downgrade. The two other major rating agencies have not changed existing ratings: Moody's still has the U.S. at Aaa while S&P remains at AA+.

If hoping the Fitch downgrade would serve as a wake-up call to Washington, it hasn't. Since the debt ceiling debate was resolved back in June, the Treasury department has steadily increased the amount of Treasury debt outstanding. As of September 18, total debt outstanding stood at a record $33 trillion, which is up from the $31.5 trillion right before Congress gave the Treasury Department unfettered borrowing capacity until January 2025. Now, to be fair, *only* $26 trillion of that is held by the public (with the rest held within the U.S. Government). But, as seen on **Figure 1** the congressional budget office (CBO) expects total Treasury debt held by the public to grow to over $46 trillion by 2033. The primary reason for the increase in expected debt issuance is an increase in spending. Per the CBO, the U.S. government is expected to run sizable deficits over the next decade in the tune of 5%-7% of GDP each year. So, to fund those deficits, Treasury needs to issue debt.

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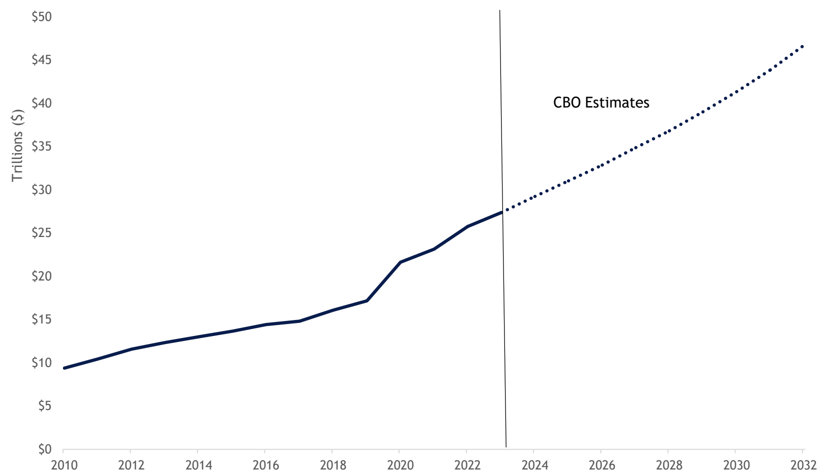
The CBO estimates total government debt will hit $43 trillion by 2032.

1 Total U.S. Government Debt Expected to Hit $43 Trillion by 2032

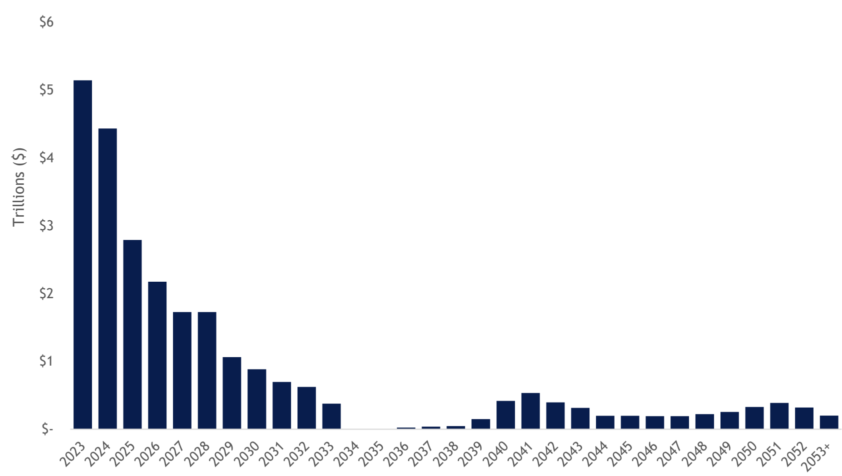


Source: LPL Research, Bloomberg, 09/17/23
Past performance is no guarantee of future results.
Economic forecasts may not develop as predicted and are subject to change.

That is obviously a lot of supply that needs to find demand. However, since we know the U.S. rarely (if ever?) actually pays its debts off, there is a lot of existing debt that needs to be rolled over as well. Over the next 15 months (**Figure 2**), the U.S. will need to refinance over $9 trillion of debt with over $5 trillion due this year

The Treasury Department has to roll over $9 trillion in debt over the next 15 months.

2 Over $9 Trillion of Treasury Debt Is Due Before 2025



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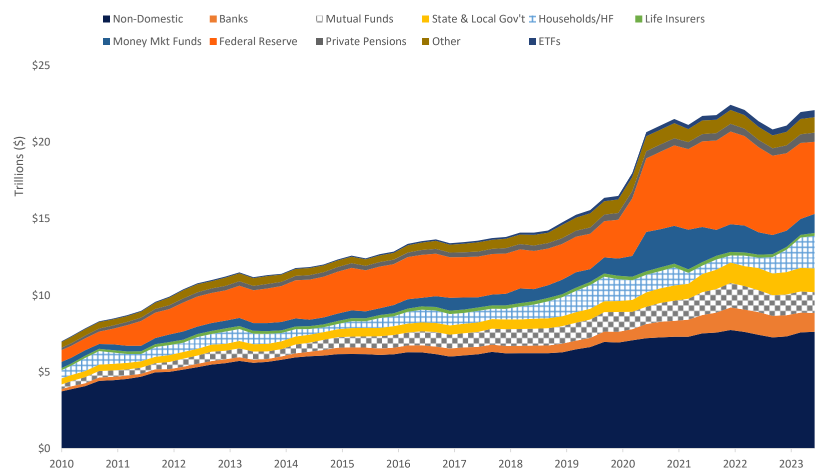
It should be noted though that the majority of the debt due this year ($4.2 trillion) is shorter maturity Treasury Bills (T-bills). And that amount should be easily absorbed since there is still a lot of money sitting in cash (money market funds are the largest buyers of T-bills) as well as the Fed's reverse repo facility but the remaining $800 billion will need to be refinanced alongside the new issuance. According to BlackRock, $2.3 trillion of net duration supply will need to be absorbed this year and an additional $2.4 trillion next year! And it's the longer maturity securities (coupon securities) that could become too much for traditional Treasury buyers to absorb.

THE TRADITIONAL BUYER BASE IS SHRINKING

The largest owner of Treasuries, the Fed, is trying to reduce its Treasury exposure at the same time issuance is expected to increase.

With the amount of Treasury debt that will likely come to market over the next few years (few decades?), the Treasury department will likely need to find additional demand. The current Treasury buyer base is diverse (**Figure 3**), with non-domestic buyers and the Federal Reserve (Fed) serving as the largest owners of Treasury securities. However, the largest owner of Treasuries, the Fed, is in the process of shrinking its sizable balance sheet and is letting $60 billion of Treasury securities roll off each month (though debt that matures above the $60 billion threshold is currently being reinvested in Treasury securities). Currently, the Fed owns slightly more than $5 trillion in Treasury securities, or roughly 25% of issuance, but is on pace to reduce its exposure by several trillion by the end of 2024. While the Fed will likely not be able to get its balance sheet back to pre-COVID 19 levels, it likely won't be a large buyer of Treasury securities in the near term either (unless an unforeseen macro events causes the Fed to implement quantitative easing again). So the biggest buyer of Treasuries is likely on the sidelines.

3 **Treasury Security Buyer Base is Diverse But Shrinking**



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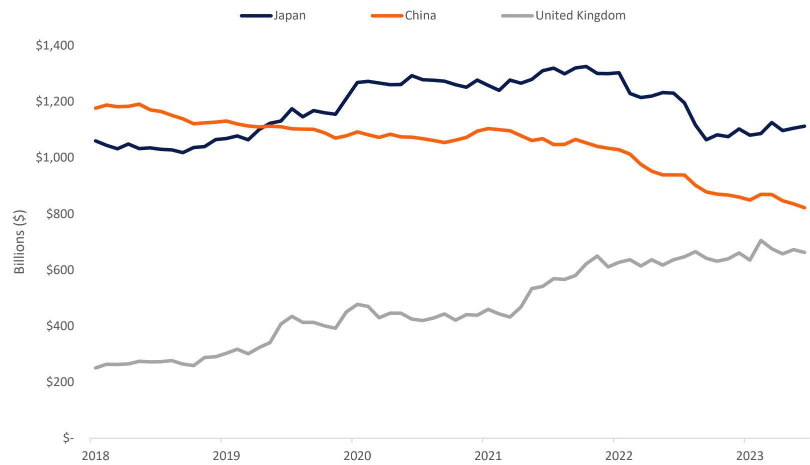
Despite the largest foreign owners of Treasuries reducing their exposure, foreign demand actually increased in recent years.

Additionally, the two largest non-domestic holders, Japan and China, (**Figure 4**) have been reducing their holdings with both countries seeing their share of Treasury securities shrink by $100 billion and $256 billion, respectively, since 2020. And while Japan ($1.1 trillion) and China ($821 trillion) are still sizable holders of Treasury debt, it's unclear if either country will be buyers of Treasury debt anytime soon. However, according to the most recent Treasury data, foreign investment in Treasury securities has increased since 2020, despite the largest holders reducing their share. The United Kingdom (added $212 billion since 2020) and Canada (+$136 billion) have both been meaningful buyers of late (although Canada only ranks as the 8th largest owner of Treasuries). That said, given the still strong dollar and higher yields in many foreign investors' home market, foreign demand will likely be less than it has been over the last decade.

4 Japan and China Are the Largest Foreign Holders of Treasuries… For Now



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Japan and China, both large owners of Treasuries, have reduced their ownership. The UK has been a recent buyer of Treasuries though.

So, with essentially the top three owners of Treasuries seemingly reducing their share and with currency-hedged Treasury yields no longer as attractive to foreign investors broadly, where will the additional demand come from? It will likely have to come from households and mutual fund investors primarily and it could come at a cost (more on that in the next section).

Household investors and mutual funds (both areas with a pattern shade) have both been increasing their ownership in Treasuries and will likely need to keep increasing share to keep up with expected supply. As seen on the chart, historically, neither has been an overly large buyer of Treasuries but with yields at levels last seen over a decade ago, households, in particular haven been adding Treasury bills and bonds to portfolios. Through 6/30 (the latest data available), households have added over $1 trillion in Treasury securities over the past 12 months and now own over $2 trillion of Treasuries, which is the largest amount ever owned by households. They will certainly need to keep adding Treasuries to portfolios to help offset supply. And with demographics shifting and baby boomers retiring, higher yielding Treasuries will likely continue to remain attractive.

Household investors have been big buyers of Treasuries recently and now own over $2 trillion of Treasuries.

So where does that leave us? As long as Treasuries are considered risk-free securities, there will always be buyers. Full stop. The question though remains price. At what price would it take for non-traditional buyers to get interested? So far, we haven't seen a tremendous drop off in interest during Treasury auctions but there could be an eventual fatigue, which would mean yields would need to increase to attract that additional demand.

THE COST OF EVENTUAL TREASURY FATIGUE

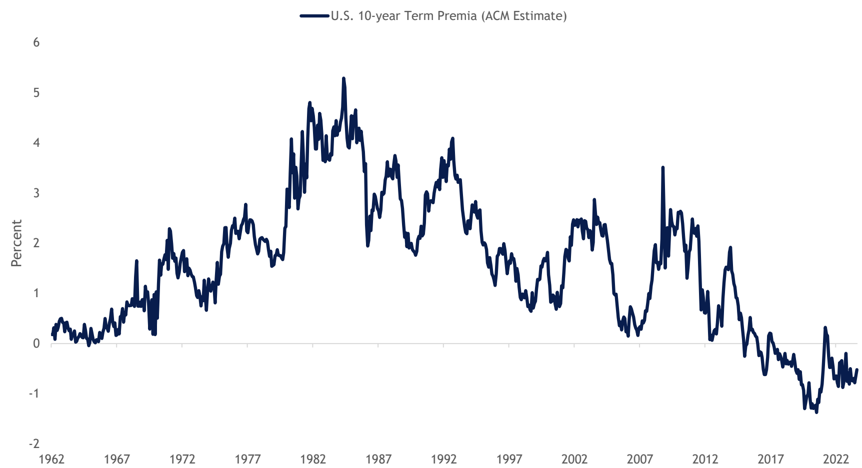
After the historic back-up in Treasury yields over the last two years, yields are back within normal ranges (as discussed in this video here). Data since 1880 shows that interest rates have tended to trade in a 3% to 5% range so at around 4.5%, Treasury yields aren't really high by historical standards. Again, they're at a normal level. So where do rates go from here?

Each security on the Treasury yield curve can be thought of as the expected fed funds rate over the maturity of the security, plus or minus a term premia. The Fed told us that they are likely close to the end of the rate hiking campaign, and since the release of the Fed's dot plot showed fewer rate cuts in 2024, the Fed will likely be on hold in the near-term. So, the next sustainable move higher in yields will likely come from a repricing of the term premia.

Despite the steady interest in Treasuries, given the amount of supply coming to the market, yields may need to stay high to attract demand.

The term premia represents the additional compensation investors demand for holding longer maturity Treasury securities. Term premia is generally impacted by monetary policy as well as growth and inflation expectations (more specifically the volatility of growth and inflation expectations). As seen in **Figure 5**, after averaging roughly 1% from 2003 until 2015 (and closer to 3-4% during high inflation regimes), the bond term premia has been negative recently (meaning fixed income investors have not demanded additional compensation for owning longer maturity Treasury securities). This time period coincided with steadily falling inflation as well as central banks that were actively owning large amounts of Treasury bonds. If those two conditions are fading, along with a supply/demand picture that remains tenuous, then the bond term premia may indeed be headed higher. How high? Getting back to normal would imply around a 1% term premia. Most of the increase would likely come from an increase in inflation volatility but roughly 40%, or so, could be attributed to the increase in Treasury issuance, according to estimates. But, since markets are forward looking, roughly half of that increase has likely already occurred. So, the upward pressure on yields due to the increase supply is almost over, in our view, with the rest likely being priced in over the next few quarters.

5 **The Additional Compensation for Holding Long-Term Debt May Need To Increase**



Source: LPL Research, Bloomberg, 09/17/23
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WHAT DOES THIS MEAN FOR INVESTORS?

The longer Treasury yields stay higher, the more enduring fixed income is as an asset class. If Treasury yields remain elevated that of course means yields for other bond asset classes will be higher as well which means fixed income returns will likely be higher

For bond investors, unless something breaks, the fed funds rate is likely going to stay higher than it has over the past decade, which means the 10-year Treasury yield is likely going to stay higher than it has over the last decade. If the neutral fed funds rate is around 3.0%, then that means the 10-year Treasury is likely going to be around 4.0% (assuming a 1.0% term premia). Now of course, that rate will fluctuate on a daily basis but the 10-year yield could average around 4% over the next decade, which is what it generally averaged in the decade before the Global Financial Crisis (GFC). The good news for bond investors: from the start of 2000 until the GFC, the Bloomberg Aggregate Bond Index generated around 6% average annual returns. Paradoxically perhaps, the longer Treasury yields stay higher, the more enduring fixed income is as an asset class. Starting yields are the best predictor of future returns (over longer time horizons) so if Treasury yields remain elevated that of course means yields for other bond asset classes will be higher as well which means fixed income returns will likely be higher too.

In the near term, though, there could be more upward pressure on yields due to the increase in supply but also due to stronger than expected economic growth. The yield curve remains deeply inverted so, as economic data continues to surprise to the upside, markets have started to price out the prospects of recession causing the yield curve to dis-invert. Unless/until the economy slows, we could see yields increase from current levels but we reiterate that higher rates make cash and fixed income attractive asset classes once again.

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The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Please read the full *Midyear Outlook 2023: The Path Towards Stability* publication for additional description and disclosure.

A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage, or more commonly a collection ("pool") of sometimes hundreds of mortgages. The mortgages are sold to a financial institution (a government agency or investment bank) that "securitizes", or packages, the loans together into a security that can be sold to investors. The structure of the MBS may be known as "pass-through", where the interest and principal payments from the borrower or homebuyer pass through it to the MBS holder, or it may be more complex, made up of a pool of other MBSs.

Floating rate bank loans are loans issues by below investment grade companies for short term funding purposes with higher yield than short term debt and involve risk.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

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Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

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