

The US Sovereign Debt Is No Longer The #1 Asset

Why investors are getting cautious about treasuries

Russian banks usually invested their foreign exchange reserves in low-risk assets abroad. Speaking of bonds, the most popular are the sovereign bonds of developed countries. Investors have seen the Western debt market as a safe haven for decades, but the system has been recently getting stumbled. Rapid budget deficit expansion of many developed countries has shattered the current state of affairs: investors are becoming more suspicious about the lack of risks when investing into previously safe asset.

Executive Summary:

- US sovereign bonds (treasuries) were previously considered by banks as a risk-free asset for the placement of foreign exchange reserves. But the U.S. state debt is already very large and is constantly growing, which put its ability to repay debt in question. One of the main relevant risks of investing in treasury is the possibility of default in the medium term or the debt repayment with greatly depreciated money.
- Moreover, the US sovereign bonds have negative effective yield and will predictably fall in value: the US sovereign bonds price may plummet seeing excess supply and inadequate demand from non-residents.
- The U.S. sanctions policy also impacts the situation: potential for the seizure of assets or targeted refuse to service the debt is a real threat for the Russian investors.

1. Unattractive for Investment: Price Is Set to Fall, Yield Plunges into Negative Territory

Unlike the European state debt, the US sovereign bonds are still traded at positive yield. However, investment in these securities does not give investors the opportunity to earn. Inflation - the constant feature of the economy - eats into part of this yield: with a coupon at 1 percent of the face value and inflation at 2 percent, the bond redemption money depreciates by 2 percent a year. The issuer pays only 1 percent. It turns out that with the money depreciation, the issuer returns less than it borrowed. Thus, the effective treasuries yield is negative. It is unprofitable to borrow at such percentage, and the option of purchasing inflation protection goods (for example, gold bars) looks more attractive.

Anton Prokudin,
Lead methodologist
prokudin@raexpert.ru

Media Contacts

+7 (495) 225-34-44
(ext. 1706, 1650)

+7 (495) 225-23-54
(ext. 1706, 1650)

pr@raexpert.ru

Expert RA

13 building 2,
Nikoloyamskaya street,
Moscow

+7 (495) 225-34-44

+7 (495) 225-23-54
info@raexpert.ru

© 2020 Expert RA.
All materials of this website
are the intellectual property
of Expert RA (unless the other
authorship is expressly stated)
and are protected by the law.
Any information provided herein
is intended for information
purposes only.

This information may not be
distributed by any means or in
any form without prior consent
from Expert RA and reference to
www.raexpert.ru as the source
of information.

Any use of information in
violation of these requirements
is prohibited.

Ratings express the opinion
of Expert RA and are not
statements of fact or
recommendations to buy, hold
or sell any securities or assets, or
take any investment decisions.
The Agency does not assume
any responsibility for any
consequences, interpretations,
conclusions, recommendations,
and other actions directly
or indirectly associated with
any ratings or rating actions
committed by the Agency, as
well as opinions and conclusions
contained in any rating report
or press releases issued by the
Agency or the absence thereof.
The only source reflecting the
actual rating status is the official
website of Expert RA www.
raexpert.ru.
www.raexpert.ru.

Effective yield of the 3-month to 5-year US notes, with inflation at 1.9 percent, has been negative for the last decade:

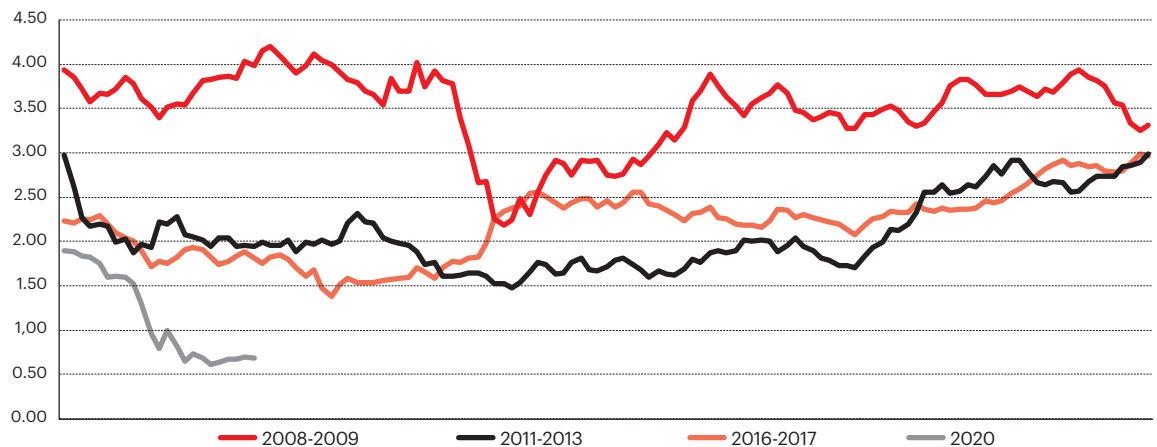
- average nominal yield of 3-month bills reached 0.57 percent;
- average nominal yield of 12-month bills reached 0.74 percent;
- average nominal yield of 5-year notes reached 1.65 percent.

Only 10-year and 30-year securities had effective positive yield, with their nominal yield at 2.4 percent and 3.2 percent respectively.

Inflation expectations set by the market for a 30-year horizon have declined from 1.8 percent in winter 2020 to 1.6 percent at the moment (to 1.3 percent for 10-year horizon). The 30-year bonds is at 1.5 percent (10-year bonds - 0.7 percent), which gives investors no hope of earning. The yield on 30-year bonds was 2.2–2.4 percent in winter, which still made it possible to expect a real yield of at least 0.4–0.6 percent, but such result is now unattainable.

The Treasuries yield has been growing historically, while the effective yield swung back to the positive territory after the acute stages of turmoil at the market. Thus, after the 2012 European crisis the nominal yield of 30-year Treasury securities grew up from 2.5 percent to 3.9 percent (10-year bonds – 1.5 percent to 2.9 percent). After the acute phase of the 2008 crisis, the 30-year bonds surged from 2.6 percent to 4.8 percent (10-year bonds – from 2.2 percent to 3.8 percent).

Chart 1. 10-year US sovereign bonds in times of three crisis and nowadays:

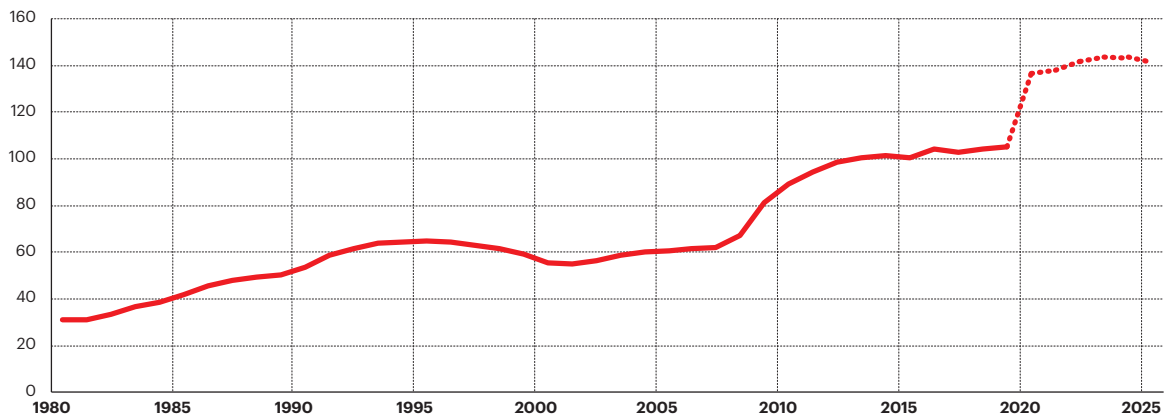


However, pessimistic sentiment is still persisting at financial markets, which means that the rally in risky asset markets, which will weigh on the state debt market, is still ongoing and is far from fading out. Today, the purchase of long-term US sovereign bonds will result in losses due to falling bond prices amid rising yields in the foreseeable future.

2. The Government's Failures Exposed the U.S. To Crisis: Budget Deficit and Federal Debt Keep Growing

The U.S. government has stuck to counter-cyclical policy for a long time; it did not focus on the prevention of the crisis or aimed at offsetting its economic after-effects, and its decision was a mistake. Public debt did not decline amid the economic growth, which otherwise allowed to approach the crisis with the lower cost burden. The US budget has seen deficit over the last decade, even excluding debt servicing costs. Relative to GDP, the federal debt has been growing all the time and has risen from 55-65 percent to 105 percent of GDP by the end of 2019.

Chart 2. U.S. federal debt/GDP, %: factual and expected

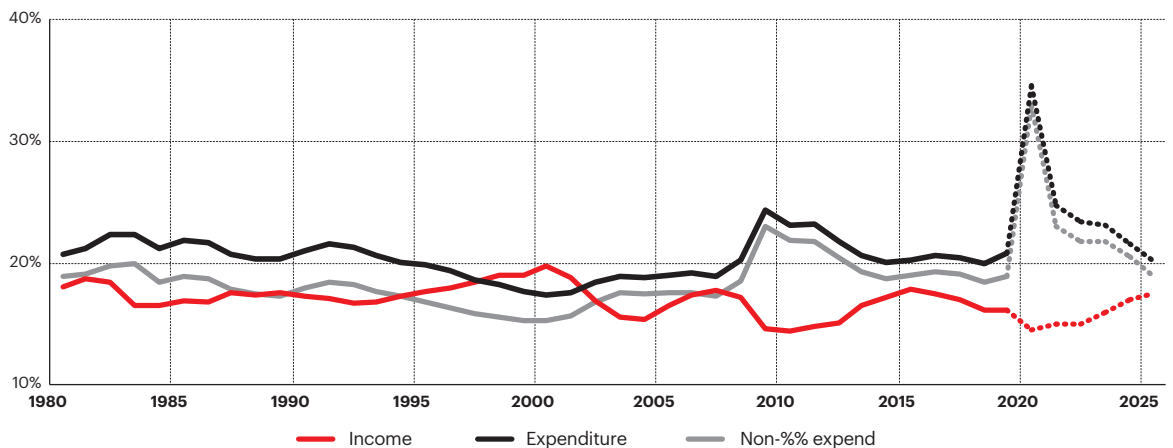


The revenue of the U.S. federal budget has averaged 17 percent of GDP (16.2 percent in 2019) since the mid-twentieth century, and it has decreased amid recessions and the downturn of the stock market to 14.5-15.5 percent of GDP during the recent crises.

Budget expenditure (excluding debt servicing) in quiet times (for example, 20 years ago) totalled 14-17 percent, but it has grown to 18 percent more recently, while the past crises pushed it to 20-22 percent of GDP.

Thus, the primary budget deficit (excluding funds for the state debt servicing) may amount to 7 percent of GDP in the coming years, at the level of economic support similar to the level seen during the previous crisis. According to experts, the deficit will be much higher in 2020.

Chart 3. US federal budget/GDP, %: factual and expected



Lack of Treasury funds may be covered by a limited range of measures. The government may cut its spending, but such a step is hardly acceptable for the US both due to the economic contraction and due to political environment in the country and beyond. There is another option – to continue ramping up the debt - which the US see as preferable.

The Fed is increasingly financing the budget deficit through direct measures such as issuing money, despite the fact that the historical experience of many countries has proved that ill-considered emission leads to higher inflation and currency devaluation.

3. Credit Stability Shaken

The U.S. federal debt totalled 650 percent of the budget income (or 105 percent of GDP) by the end of 2019. It is one of the world's highest indicators and it far exceeds the limit values¹ established by the international institutions. With such state debt and chronic deficit, other countries would find themselves in default – the examples can be seen in the table. Meanwhile, the U.S. federal debt has little chance to reduce due to the severe economic crisis hit in 2020.

Table 1. Performance of countries before defaults, caused by budgetary constraints²

| Country, year | Debt/income, % | % /costs Income, % | Deficit/GDP, % |
|----------------|----------------|--------------------|----------------|
| Bolivia, 1979 | 802 | - | 6 |
| Uruguay, 1983 | 341 | - | 9 |
| Peru, 1984 | 518 | - | 3 |
| Pakistan, 1999 | 555 | 55 | 7 |
| Uruguay, 2003 | 414 | - | 4 |
| Belize, 2006 | 355 | 24 | 6 |
| Greece, 2012 | 364 | 15 | 11 |

The interest costs (state debt servicing costs) of the US budget are still close to 10 percent of the budget income. This is an acceptable percentage load, according to the conventional standards³. With a debt at 140 percent of GDP in five years (this is 820 percent of federal budget income), the debt interest rate should be kept at 1.2 percent, so that the percentage load on the budget does not exceed a 10-percent threshold. Moreover, inflation is expected at 1.6 percent in the next 30 years, the economists say. It turns out that the Fed should stick to the real negative interest rate policy for many years only in order to maintain the stability of federal debt.

¹ The Maastricht treaty implies that the EU member states should maintain the debt level at 60 percent of GDP (the upper limit for the long-term stability). The level of 60 percent to GDP is also considered as a normal value of the state debt for the developed countries, according to the various sources. The IMF reckons the debt of developed countries of more than 60 percent as high (IMF Fiscal Monitor, 2010, p.62).

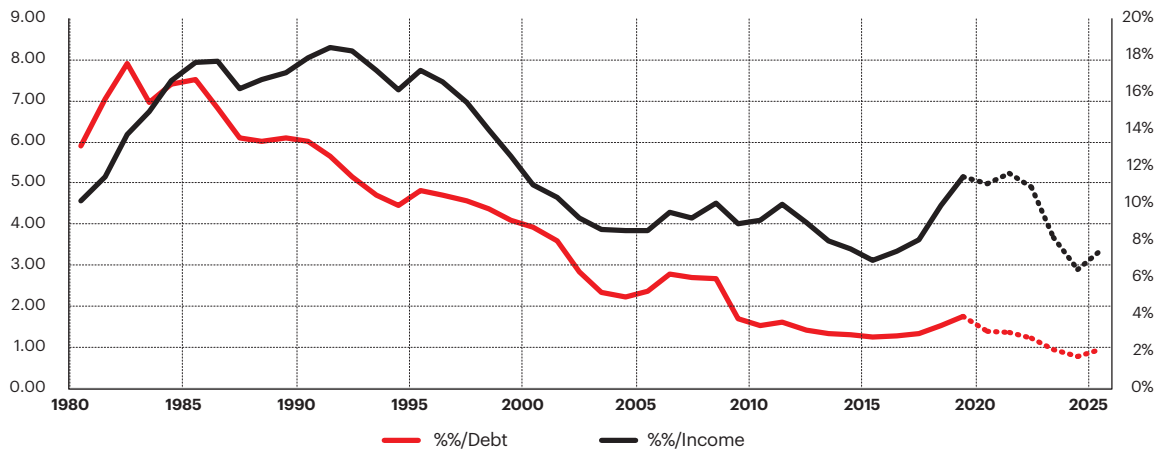
Meanwhile, the budget income of developed unitary states (and consolidated incomes of federal states) to GDP averages about 35 percent, implying that the high value of debt to the budget income is at 170 percent. Although the international institutions set these values within the range of 150 percent (in 1980s) to 240 percent (in 2010s), the various sources read.

Debts of states and counties add another 15% of GDP to debt level.

² Various sources of information were used to compile the table. The represented data may differ from the official data or other sources.

³ In his interview to Reuters on 20.04.2020 https://www.minfin.ru/ru/press-center/?id_4=37035-glava_dolgovogo_departamenta_minfina_rf_konstantin_vyshkovskij_dal_intervyu_agenstvu_reuters, Konstantin Vyshkovsky, the Head of State Debt and State Financial Assets Department, said that a 10-percent share of interest costs in the budget expenses is a normal percentage load threshold. As the growth in the budget expenses will improve the indicator, simultaneously widening the budget deficit, the ratio between interest costs and budget income is used in this article.

Chart 4. Interest expenses of the U.S. federal government to the income of the U.S. federal budget and to state debt, %: factual and expected



The Federal Reserve System softened the monetary policy three times in March 2020. The considerable array of incentives was introduced in response to the rapidly worsening economic climate due to the COVID-19 pandemics. The first measure to ease economic turmoil – cheap money: the key interest rate was reduced to 0-0.25 percent on March 15 (it was the second interest rate decline per month: previously it was eased from 1.5-1.75 percent to 1-1.25 percent). The Fed has also stated its readiness to acquire unlimited amount of various assets (treasury bonds or mortgage-backed bonds of the three US mortgage agencies) at the secondary market to establish the special fund to buy major issuers' corporate bonds.

The Fed introduced a measure to maintain the stability of the financial system in the form of providing market participants with short-term dollar liquidity at a near-zero rate.

However, the US government will have to, sooner or later, scrap its unprecedented support program and reduce the huge money supply in order to avoid the inflation growth.

In its monetary policy, the Fed is guided by a number of rules that have been simplified into a formula known as the Taylor's rule (invented by Stanford University professor John Taylor in 1993). This rule shows to which extent the interest rate should be adjusted in case of changes in GDP, inflation and other macroeconomic indicators. Typically, the Fed rate includes⁴:

- current inflation rate (1.9 percent in average over the past decade, but at some points it reached 3-3.8 percent);
- modest effective yield (the effective yield in the 1990-s, when Taylor's rule was elaborated, the federal debt real yield amounted to about 2 percent, but after the year 2000 the real yield fell to zero);
- premium for inflation exceeding the target level (the target level has stayed at 2 percent in recent years, while actual inflation reached 3–3.8 percent during the period of economic recovery and growth in the 2010s), the premium may be one half of the difference between actual inflation and target level⁵, then, with inflation at 3 percent, this premium will be at 0.5 percent;
- the increased rate is set when the unemployment rate is too low, in order to cool the labour market (average historical unemployment rate in the U.S. is equal to 6 percent, that is why the premium should be set in the rate during lower unemployment), as it was done in 2016-2018.⁶

⁴ Slightly modified definition of the Taylor's rule. See other foot-notes.

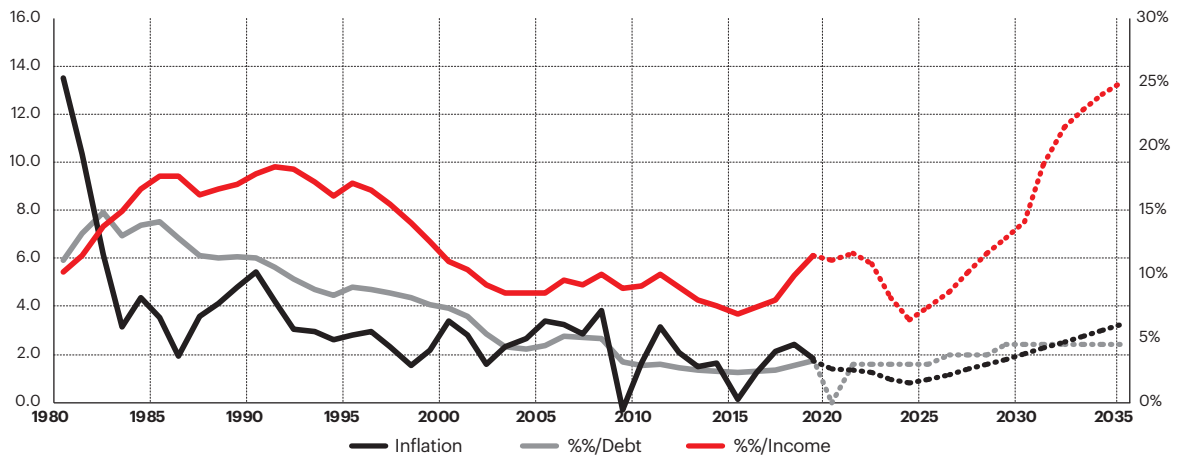
⁵ Coefficient elaborated by Taylor.

⁶ The Taylor's rule describes the difference between the GDP level and the GDP trend value, which is difficult to apply. Other descriptions of monetary policy dwell on the assessment of the unemployment and not GDP: if its actual rate is very low, the interest rate should be increased.

That is why the Fed will at least set the rate at 3 percent⁷, in order to address the high inflation rate in the first place and the overheated labour market later on.

Interest rate on long-term sovereign bonds even may rise to 4–5 percent: such rates were historically considered as normal, before the central banks carried out the experiments with zero rates and quantitative easing. The interest load on the US budget will then reach 23 percent (at a 3-percent interest rate), with a potential to grow up to 30–38 percent (at 4-5 percent interest rates). Such a load will inevitably lead to default. Therefore, the Fed will hinder the growth of interest rates by keeping the real interest rate in the negative territory.

Chart 5. Interest expenses of the U.S. federal government to the income of the U.S. federal budget (right scale), state debt rate and inflation, % (left scale): factual and expected at the rate hike to 3 percent



As seen at the example of Greece, an alternative austerity scenario does not seem feasible: the country’s economy fell by third, while the state debt exceeded the pre-default level and reached 450 percent of the budget income even after the debt discharge in 2012 and lower interest rate.

If the US government keeps supporting its economy at all phases of the cycle in the next decade, then with an average economic growth at 2.5 percent, the debt will come closer to Japan’s debt level. In this country, the debt issue does not even have a theoretical solution, and the government admits it. Thus, the entire federal debt pyramid is supported by a near-zero interest rate and financing of the budget deficit by pension savings.

4. Demand will not meet supply

The substantial deficit of the U.S. federal budget, which may reach 20 percent of GDP and remain at a high level in the next 1-2 years, will lead to the surplus of the new sovereign bonds. In that case, the crowding out effect (the reduction of private investment caused by the rising government expenditures, and therefore, the growth of the government borrowings and rate) will entail the devastation on the market in 2020, excluding almost any corporate sector borrowings, which will hit the economy. From this perspective, the growth in prime long-term loans is inevitable, as the Fed regulates the short-term rate, and the Fed should directly purchase the long bonds to regulate the long-term rates⁸.

⁷ With a 3-percent inflation and high unemployment rate, the interest rate will approach the inflation level of 3 percent. If the inflation rate is at 2.7 percent and the unemployment rate is moderate, the rate will tend to 3 percent level. The interest rate will be pushed to the 3 percent level even if the inflation is about 2-3 percent and the unemployment rate will be low, as it happened in 2016-2018. The interest rate hike to 3 percent was interrupted in 2019 due to an expected start of recession, although the market was expecting it in the end of 2018. By comparison: the inflation held at 2 percent in the 1960s with the Fed rate of 4 percent (See Chart 6 below).

⁸ The Fed conducted Twist operation in order to decrease the long-term rates, by buying out the long bonds. Such operations are currently out of question.

If the Fed fails to redeem an ample stock of federal bonds to avoid rapid growth in long-term rates without spurring inflation, the long-term trend towards lower interest rates will crack (see Charts 6 and 7 below), and this will lead the market participants to reassess their expectations and will lead to a gradual increase in interest rates on all long bonds in the future. A similar situation developed in the United States in the late 1950s, which entailed an interest rates hike in the 1960s and 1970s, while the inflation spiral was unwound: the Fed rate rose from 0 percent in 1958 to 20-22 percent in 1980 over a few economic cycles.

Chart 6. Nominal yield rate of 20-year US bonds, Fed Funds rate and US inflation during 1955-80 years

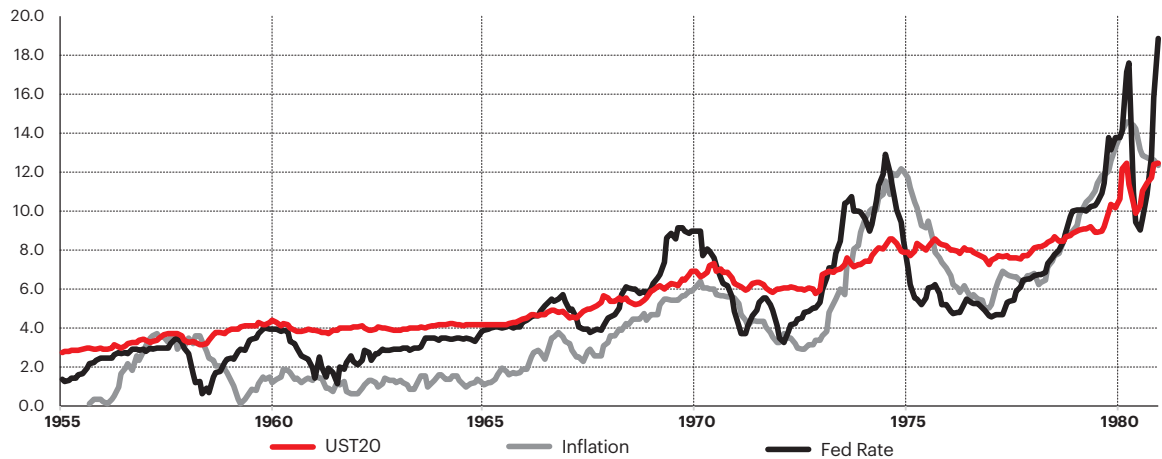
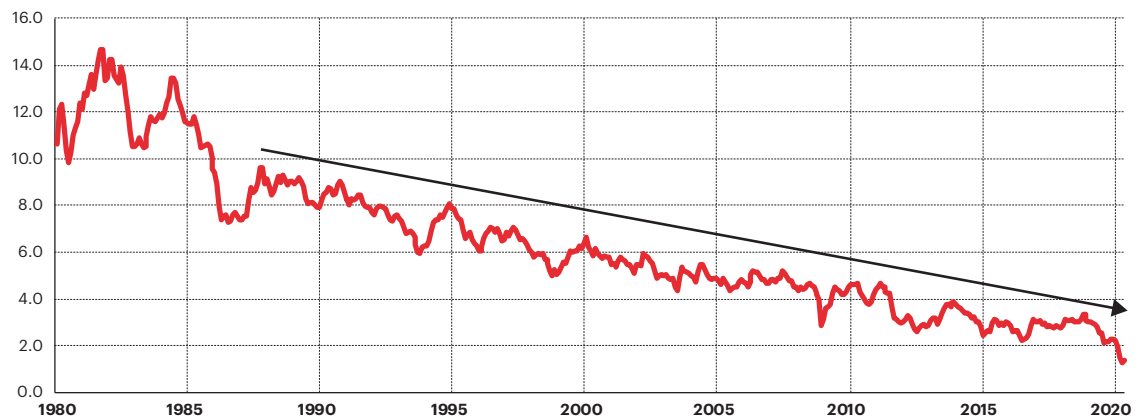


Chart 7. Nominal yield rate of 30-year US bonds since 1980



The reaction of the foreign residents financing the U.S. budget deficit for years is unpredictable. China and other developing economies may turn their backs on the U.S. either due to political reasons or due to the dropping reserves. Then the federal debt will start to collapse, having lost its donors, or the Fed will significantly ramp up the monetary base, creating inflation risks. All this will weigh on the bond prices in the market.

5. Political risks of selective default or seizure of assets

State debt can be used for political purposes: for example, the sovereign bonds for a certain lender may be defaulted, while the other lender's debt obligations will be serviced. A clear example of such behavior was witnessed in Ukraine in 2015.

Since treasuries are dollar-dominated, investors have to use the storage and accounting services of the US banks and depositaries, controlled by the US government. The American authorities have already demonstrated their ability to put pressure on undesirable players both through the threat of financial sanctions during the international trade and military negotiations