

The big US fiscal deficit and effect on market rates

Even though the US Treasury has taken some pressure off longer tenors by morphing new issuance towards shorter tenors, the size of the fiscal deficit still matters for the bond market. For any given Fed funds rate it means a steeper curve from the back end. We target a minimum 100bp curve along the 2/10yr segment when the Fed gets to the next cycle low



The US Treasury has taken pressure off the back end by morphing issuance towards the front end

Higher market rates and a steeper curve are the consequence of an excessive fiscal deficit

The US fiscal deficit in cash terms has hit US\$2tr – a substantial number, equating to some 7.5% of GDP. Some unusual factors caused a shortfall on the revenue side, but there is a structural excess of government spending over receipts in the area of 6% of GDP. The baseline expectation is we are stuck with this in the coming years, at least until we see a policy overhaul. These are scary numbers that mean one key thing for bond markets – sustained supply pressure.

The question then is what this means for rates. It's difficult to be precise on these things, but an elevated fiscal deficit should place upward pressure on rates, despite Treasury Secretary Janet

Yellen's recent assertion to the contrary. The key question centres on the size of this effect. The often-quoted Harvard/Bank of England 2019 study suggests that every 100bp increase in the budget deficit as a percentage of GDP adds 35bp to market rates.

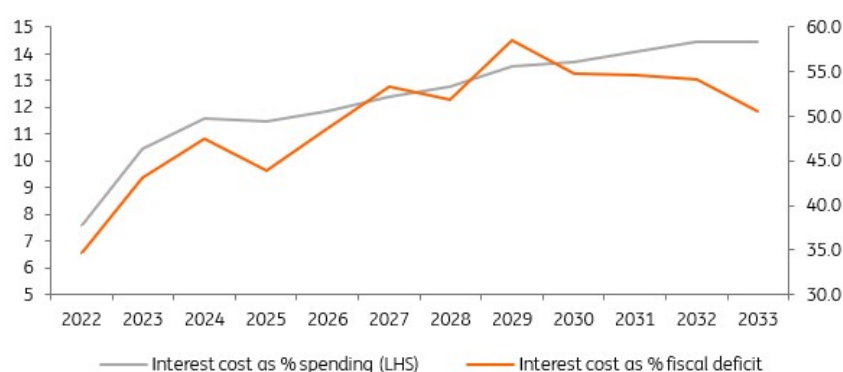
We'd overlay this by asserting that the average US fiscal deficit has tended to be in the 3% area. The current 6% deficit is 300bp above that. If the study is correct, this should add 100bp to market rates. We'd also assert that the bulk of this should be impacting the shape of the curve, so for any given funds rate we should expect to see a steeper curve (all other things being equal). And the bulk of this could come from higher real rates.

Growth will not exceed real coupon prints by enough to counter the large primary deficit

Debt dynamics are also key here. There are a few items to consider:

First, we have interest payments. These are projected at US\$745bn for 2023, equating to 2.7% of GDP. That's up from 1.9% of GDP for 2022, and is projected to extend to 3.7% of GDP over time as bonds get rolled over. Absolute interest payments are projected to hit US\$1tr by 2028. And interest payments as a proportion of the fiscal deficit will rise from 35% today to 60% by 2029, on unchanged policies. This data comes from the Congressional Budget Office and extends through ING estimates.

Interest rate costs are on the rise too...



Source: Macrobond, Congressional Budgetary Office, ING estimates

Second, we have debt dynamics. The US currently has a primary deficit of 3.3% of GDP (the rest of the fiscal deficit is interest payments). And the primary deficit remains in the 3% to 3.5% range in the coming years. This pushes up overall debt at this pace every year unless real GDP growth exceeds the average real coupon print by a greater amount. The current average real coupon print is around 1%, but this will head to 2% if we assume that something like the current curve remains in place. The US would have to grow by 5-6% per annum to offset the primary deficit. Based on that, the trajectory for the debt/GDP ratio sees it heading to 200% of GDP (currently around 100% of GDP) in the coming two decades.

The same Harvard/Bank of England 2019 study suggests that every 10 percentage point rise in the debt/GDP ratio also adds 35bp to market rates. Based on the current trajectory, we'll have a 10ppt

increase in the US debt-to-GDP ratio by 2027. This is less impactful, as it's a slow grind effect. But the cumulative effect is still significant and places an underlying steepening effect on the curve. The US Treasury has taken pressure off the back end by morphing issuance towards the front end. But this does not take the weight of the supply issue away.

The deficit as a stand alone results in a steeper curve and higher longer term rates

Suffice it to say that US debt dynamics are troubling based on current policy. Both the size of the deficit and debt as a percent of GDP have a meaningful impact and pressure the curve steeper and long rates higher, mostly through the channel of higher real rates. These are important impulses to take into account when it comes to assessing the likely trajectory of the curve. We argue that the 2/10yr curve should be at least 100bp when the Fed gets to the bottom of the next cycle.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.