

US bond market on the precipice when it comes to funding the deficit

Re-funding pressures are already elevated for Treasuries. So much so that we identify a 25bp concession already implicit in the 10yr Treasury yield. We use the spread from 10yr SOFR to the 10yr Treasury yield as a barometer of stress. That's at c.50bp, and on no policy change, is at risk of further widening



Fed Chair Jerome Powell. The Fed's quantitative tightening has already reintroduced approximately US\$2tr worth of Treasuries into the market

Quarterly re-funding is running at some \$1tr and expected to hold there

In cash terms, the US fiscal deficit is running at around \$2tr. Of this, about half is net interest and the other half is the primary deficit. On top of that, debt redemptions run at around \$2tr, which translates into an annual re-funding requirement of a little more than \$4tr. That breaks down to a quarterly re-funding of US\$1tr. That was running at around \$0.4tr in the fourth quarter of 2016 when Donald Trump was first elected president, when the deficit was running at some 3% of GDP (versus 6%+ now).

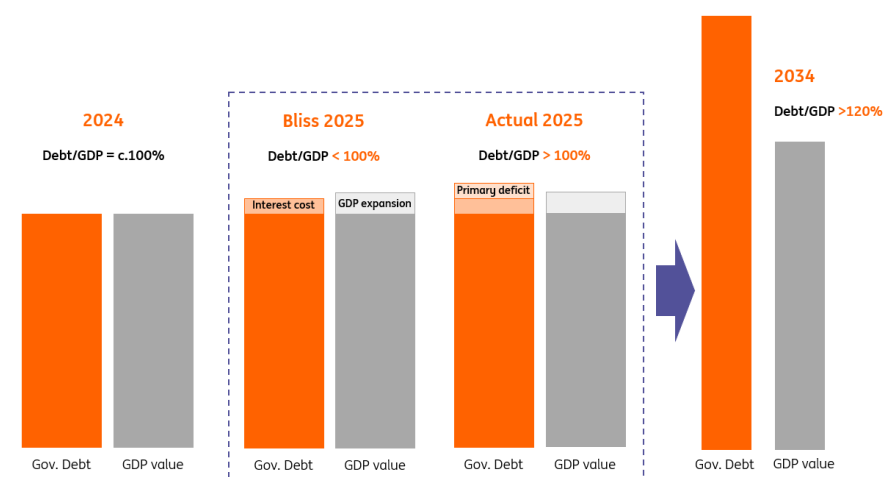
Looking ahead to 2025, it remains to be seen whether there is material success in cutting discretionary spending. This is currently running at around 6% of GDP. In fact, it's around the same

level as the fiscal deficit itself. It's important that discretionary spending as a percentage of GDP gets cut in the years ahead as compensation for the rise in interest payments. The Congressional Budget Office projects that interest spending rises from 3% of GDP today to 4% of GDP in the coming decade. Discretionary spending must fall as an offset.

Even as discretionary spending falls as a percentage of GDP to offset the rise in interest rate spending, it won't be enough to cut the fiscal deficit, unless some material action is taken. The tax cuts executed during the first Trump presidency were advertised as self-financing but weren't. There is nothing to suggest that projected tax cuts this time around will be any different. And the jury is out on the extent to which tariffs can bring in material revenue income. And if nothing changes, the debt/GDP ratio keeps rising.

Re-funding at current levels still ends up in a bad place for overall debt ...

The debt/GDP ratio, and how it can get out of control in a cumulative sense



Source: Macrobond, ING estimates

The spread from 10yr SOFR to 10yr Treasury yield at 50bp contains a 25bp concession already

These are issues the Treasury market must grapple with as we progress through 2025. And indeed into 2026 as tax cuts that get through the legislative process will take effect from January 2026 onwards. Meanwhile, the rising fiscal deficit continues to increase the supply of Treasuries in the market. This is occurring alongside the Federal Reserve's quantitative tightening, which has already reintroduced approximately \$2tr worth of Treasuries into the market.

The main impact of this fiscal pressure has been to cheapen Treasury yields relative to SOFR rates. For example, in the 10yr tenor, the spread from the SOFR rate to the Treasury yield is now about 50bp. That was averaging around 25bp through to the middle of 2023. Since then, there has been a ratchet higher in the spread. It has not been destabilising. Rather it's been a slow and steady process. In its simplest terms, it effectively translates to an extra 25bp demanded by investors to take down Treasuries.

As we progress through 2025 there is no reason to expect this spread to narrow unless there is

some material progress made in terms of deficit reduction. Even deficit containment is liable to pressure the spread wider, as this still equates to a growing supply of cumulative Treasury bonds on the market. Should the fiscal deficit numbers worsen, the risk is the 50bp spread trends wider by another 25bp to the 75bp area. There is no real science to this beyond a possible repeat of the widening seen so far.

We view this as the most likely mechanism whereby the elevated fiscal deficit position impacts the Treasury market. There would not be much market tolerance for a ratcheting higher in the quarterly re-funding requirement. The basic market assumption is that the re-funding amounts have broadly peaked, apart from a natural rise in line with the size of the economy. Any rise from here is a pure reflection of fiscal pressure risks pushing Treasuries participants toward demanding more price concessions.

Watch the SOFR to Treasury yield spread as a measure of fiscal stress

The bottom line is it's too early to conclude that there is about to be a blowout in the Treasury market on account of deficit pressure. But such pressures clearly risk mounting should action to cut the deficit not materialise, or worse, should the deficit go on a rising pattern. It seems, in fact, that this is more of a risk for 2026 when the proposed tax cuts kick in. But even a lack of action to get the deficit on a downward path through 2025 can still spill over into Treasury market vulnerability.

That being said, an impact is already being felt through the prism of the wider spread of Treasuries over SOFR. Watch this spread as the clearest barometer of stress (or de-stress) through 2025.

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