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A VIEW FROM GLOBAL FIXED INCOME

Government Bond Issuance Boom to Pressure Yields Higher

A flood of new global sovereign debt will affect market dynamics.

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Our last blog discussed my belief that a soft landing is a fairy tale. However, many of our portfolio managers have favored shorter-than-benchmark duration[1] positioning. That may not seem logical at first glance.

Simply put, while we believe that short-dated fixed income is attractive in many places, we hold serious concerns about the long end of many global government bond markets. Thinking back to "The Four U.S. Treasury Yield Phases of a Fed Tightening Cycle," phase three will be longer and more painful.

Supply Generally Doesn't Matter for an Individual Government Market

The supply of high-quality global government bonds doesn't generate much attention because it generally doesn't matter for an individual market. Because these bonds are the true "core" of the fixed income market, with other types of bonds priced in relation to these developed market high-quality sovereigns, there is almost always enough demand to more than offset additional issuance. As some learned in Finance 101, the markets in these government bonds are the broadest, deepest, and most liquid in the world.

But what will happen when almost all developed market governments need to simultaneously boost sovereign debt issuance? Yields will need to increase across the board to attract buyers to take up the flood of supply. Investors in U.S. Treasuries, for example, will no longer be able to dodge the glut of new issuance in that market that has followed the debt ceiling standoff earlier in 2023 by moving into the gilt market if the UK is also selling an increasing volume of new debt to fund its spending.

Ballooning Fiscal Deficits

Governments around the globe will need to boost their sovereign debt issuance to pay for ballooning fiscal deficits, largely as a result of their COVID-era policies. A lot of private sector leverage moved to the government balance sheet. Now the debt collector is at the door.

The U.S. deficit is likely to end 2023 at about 6% of gross domestic product (GDP), while the UK deficit will probably be more than 5% of GDP.[2] Total government debt-to-GDP ratios in the UK and the U.S. are already at or near 100% and could easily go higher, while the debt-to-GDP ratio in traditionally profligate fiscal spender Italy is over 120%.[3] This has come at a time when the biggest buyers of bonds—global central banks—are stepping away. Many central banks are in the midst of quantitative tightening. More recently, the Bank of Japan similarly started stepping away from yield curve control, which is the last significant quantitative easing-like program in the world.

[1] Duration measures a bond's sensitivity to changes in interest rates.
[2] Source: Bloomberg consensus projections as of September 5, 2023.
[3] Source: International Monetary Fund as of December 31, 2022 (annual data).

The U.S. is also shifting the composition of its new Treasury issuance away from short-term bills and into longer-term "coupon" supply as the T-bills issued after the resolution of the debt ceiling mature. Coupon issuance should account for about 39% of net Treasury supply this year before rising to approximately 86% in 2024.[4] With the yield curve still very inverted, longer-term yields will need to move meaningfully higher to entice buyers away from the attractive short-term rates.

This should result in a "twist" in yield curves, with long-end rates most likely increasing and curves steepening. In 2011, the Federal Reserve purposely targeted lower long-term yields in "Operation Twist" by selling short-maturity Treasuries and buying longer-end securities. Today, however, I think that we may be entering a period where central bank actions don't have much effect on long-term rates because of the distortions caused by the flood of supply.

Action to Shift to Long End of Yield Curves

As a result of these supply dynamics, much of the action could move to the long end of yield curves, while in 2022 shorter-term yields were more volatile as curves sharply inverted. The two-year U.S. Treasury yield increased 370 basis points (bp)[5] last year, while the 30-year Treasury yield "only" climbed 207 bp. German government yields followed a similar course, with the two-year yield rising about 335 bp (from deeply negative territory at the end of 2021) and the 30-year bund yield increasing only 62 bp.[6]

Ominous Potential to Crowd Out Corporates

Most ominously for the economy, a huge boost in high-quality government bond issuance could also crowd out many other borrowers, or at least force up funding rates for corporate borrowers and others that need to refinance. This would raise the cost of funds for corporations and make them less likely to spend on capital projects or hiring more employees, removing a vital source of support for the global economy just when it needs it most. Also, remember that long-end yields act as the discount rate for many other purposes, so this twist could have far-reaching impacts.

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[4] Source: Morgan Stanley issuance projections as of September 2023. Calculations by T. Rowe Price.
[5] A basis point is 0.01 percentage point.
[6] Source: Bloomberg Finance L.P.

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