U.S. RATES UPDATE

Allaying the Fears of "Refunding" Tourists

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Ms. Patton is a Specialist Portfolio Manager in the Fixed Income group and is Co-Head of Global Rates. She is responsible for the portfolio management of U.S. Treasuries, global sovereign bonds, TIPS, agencies, money market instruments, commodity strategies, and derivatives. In conjunction with the generalist portfolio managers, she implements decisions on duration and yield curve across our products. Ms. Patton joined TCW in 2022 from Wells Fargo where she ran the enterprise's Derivative Trading and Hedging Strategy team. Prior to joining Wells Fargo in 2017, Ms. Patton spent 13 years on the sell side at Lehman/Barclays where she focused on interest rate and foreign exchange products. She sits on the board of the Police Activities League, a non-profit organization with the goal of empowering and enabling economically disadvantaged students to capitalize on opportunities for advancement. Ms. Patton holds a BS in Computer Science from Princeton University and is a licensed private pilot.

The U.S. deficit and Treasury supply are rarely considered hot topics, but investors from all walks of life are suddenly paying attention to the Treasury's Quarterly Refunding Announcements and budget estimates. They are even giving it an unnecessary acronym, the "QRA." As an aside, we rates people just say "refunding" for short when we don't feel like spelling out the whole title.

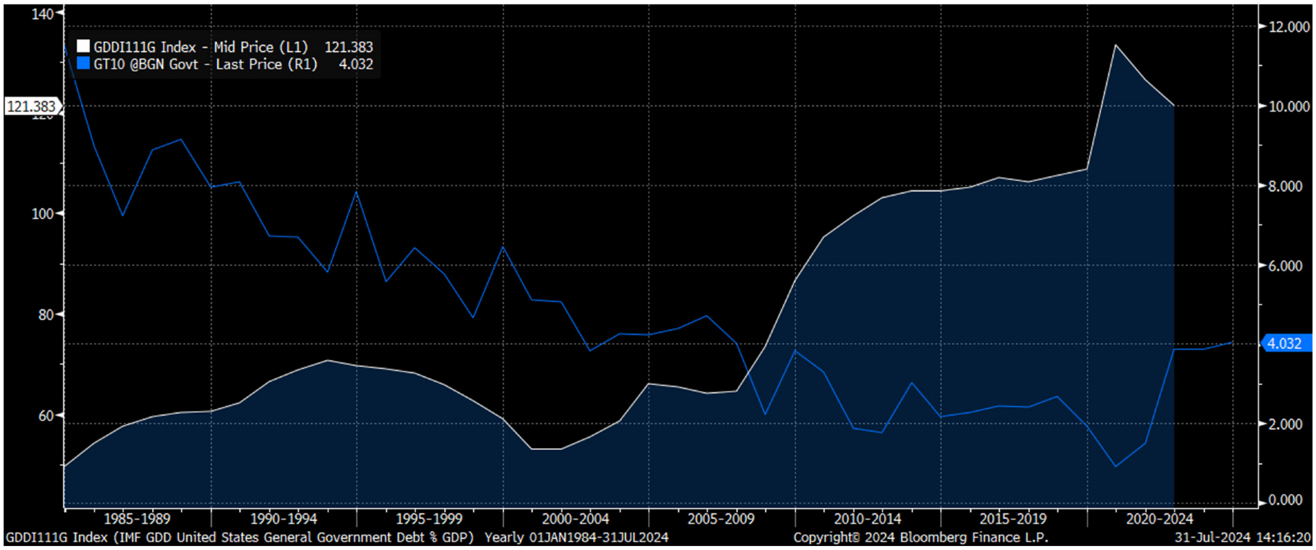
While the eye watering numbers are creating anxiety among investors across asset classes, we remain unconcerned. That's not to say a huge and growing deficit requiring massive amounts of debt issuance is anything other than fiscally irresponsible and imprudent. But we find the amount of press and level of alarm to be unwarranted.

The Treasury has also shown a degree of flexibility in their issuance strategy – while remaining "regular and predictable" – which we think is a big deal. This delicate balance has been effective in alleviating the narrative that too much supply will lead to higher rates.

The genesis of the unwarranted anxiety is that we are all accustomed to analyzing the balance sheets of companies and countries. But the U.S. – as the world's reserve currency – is not an appropriate subject for the same debt sustainability analysis. Nor is the U.S. at risk of a loss of investor confidence. Other than the noise generated by political brinkmanship around raising the debt ceiling, the U.S. will pay its debt. And its status as the world's reserve currency is not at risk either. After all, who or what could practicably replace the U.S. dollar?

There is no shortage of additional arguments as to why a ballooning deficit should be of the market's utmost concern. Most commonly, we hear fears around increased debt issuance leading to higher interest rates. Historically, however, there is no correlation between the amount of Treasury issuance and interest rates. Increased issuance does increase term premium, resulting in steeper interest rate curves. But steeper curves are better for investment and consumption. The worrisome curve shape is the flat or inverted curves we see today.

U.S. Government Debt % GDP Versus 10-year U.S. Treasury Yields



Source: Bloomberg

There is also a prevalent view that high levels of government debt crowd out more productive private investment. Without strong private investment, the concern is economic growth will slow. Slower growth would result in lower rates, more and faster Fed rate cuts, and interest expense would no longer be growing exponentially. Again, no need for concern.

Another fear is that high levels of debt will limit the political appetite or ability of lawmakers to effectively respond to a natural disaster, security threat, sharp economic downturn, or other national emergencies. This concern seems farfetched to us. When the Global Pandemic hit in 2020, the deficit was nowhere to be found on policymakers' list of considerations. Nor should it have been.

The loss of fiscal flexibility as debt levels rise is another common concern. Future generations and Congresses will have less capacity to make their own tax and spending decisions. We wholeheartedly agree with this troubling dynamic, but its impact won't be felt for decades.

The ballooning deficit doesn't keep us up at night. While it will likely one day be a big trade, the trade is not today's. The last thing I need is another reason for my kids to be up at night, but if there is a good one, this would be it. Until then, we'll focus on sleep training and enjoy crossing at least this one concern off our list. ■