

US Treasuries' 'Risk-Free' Status

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In downgrading US government debt from AAA to AA+, Fitch cited a fiscal deterioration in the next three years, a growing general debt burden and bad governance due to repeated political standoffs over the debt ceiling issue. Coming a day after the US Treasury said new debt issuance would rise to US\$1,007bn in 3Q23, up from US\$733bn, with another US\$852bn to come in 4Q23, it is hard to dispel the rating agency's logic. While investors should take the downgrade in their stride since Uncle Sam can easily meet his near-term payments, the action focuses attention on debt sustainability as US fiscal deficits move towards 6% of GDP during a boom period.

The treasury market will likely offer a casual shrug for three reasons: (i) Fitch flagged the risk of a ratings downgrade in May and kept the US on "negative watch" despite the debt-limit agreement that was made in June; (ii) investors are well-aware of the reasons for the downgrade, and so concerns are likely already in the price; (iii) the downgrade is unlikely to affect the use of US treasuries as a bedrock asset. After all, US treasuries remain the Federal Reserve's top choice of collateral for its lending facilities.

For the next 17 months, the US government can comfortably make payments as the Congressional agreement suspends its borrowing constraint until January 2025. The real question is whether the market can absorb such heavy issuance without spurring a surge in yields, and with it the government's funding cost. There are reasons to think that existing demand for US treasuries will be enough to maintain an orderly market:

- If the government debt is funded by issuing T-bills, the liquidity sitting in the Fed's reverse repo facility and commercial bank deposits will help anchor yields. Some US\$2.07trn sits in the Fed's RRP facility and the Fed is paying interest on reserve balances at 5.4%. If new issuance causes T-bill yields to rise much above 5.4%, US money market funds will tend to move money they have parked at the Fed out to buy US T-bills. The same thing could happen to commercial bank deposits, as deposit rates are lower than interest on reserves and T-bill yields. Therefore, there is likely to be enough liquidity at the short end of the curve to meet the coming supply.

Checking The Boxes

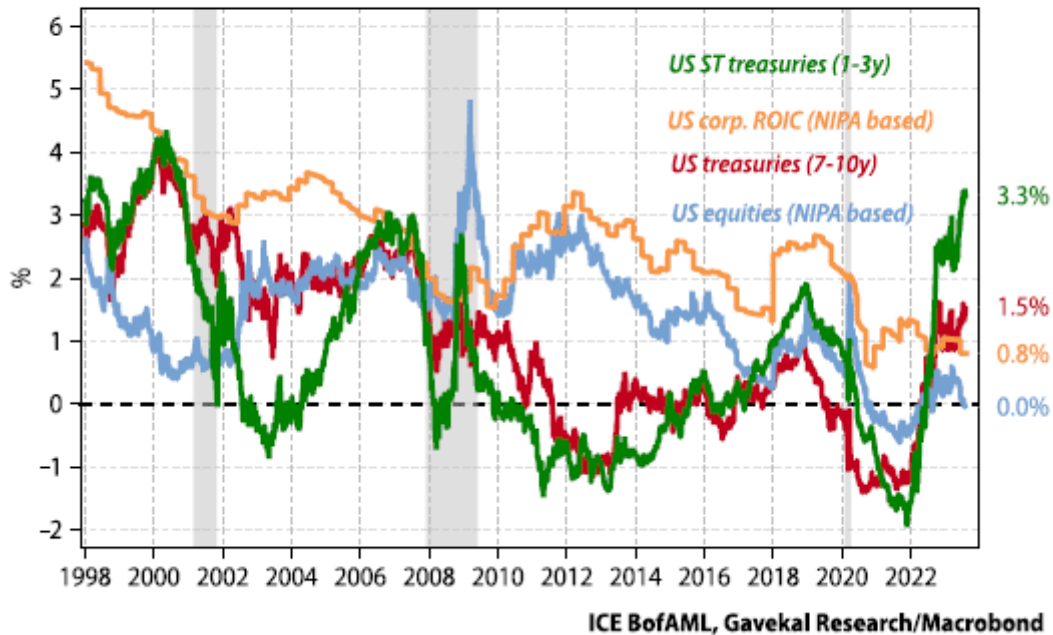
Our short take on the latest news

Fact	Consensus belief	Our reaction
US ISM manufacturing PMI rose to 46.4 in Jul , vs 46 in Jun	Below expected 46.8	Lower employment component suggests weaker activity weighs on manufacturing jobs
Eurozone unemployment rate at 6.4% in Jun , vs unchanged from May	Below expected 6.5%	Labor market resilient amid weak growth but leading indicators point to weakening ahead
Sweden Swedbank manufacturing PMI at 47.6 in Jul , vs 44.8 in Jun	Above expected 46	Sweden leads EZ; first tentative sign of manufacturing cycle bottom in Europe
South Korea CPI at 2.3% YoY in Jul , vs 2.7% in Jun	Below expected 2.4%; core CPI at 3.3% YoY in Jul vs 3.5%	Lowest inflation in 2 years but BoK remains hawkish due to elevated core inflation

- If the government chooses to raise funds using longer-dated treasuries, investors should buy them. On a risk-adjusted basis, the real yield offered by US treasuries is attractive relative to the return earned by the average US firm (the economy-wide corporate return on invested capital) and the equity earnings yield. This situation will tend to put downward pressure on long-term treasury yields, especially if concerns about US economic growth again come to weigh on investor sentiment (see [Buy Or Fade The US Equity Rally?](#)). In the view of Will Denyer and I, there is a high chance such a shift will occur due to the lagged effect of higher interest rates impacting demand (see It Is [Too Soon To Call A Soft Landing](#)).

Risk-adjusted real yields suggest US treasuries are attractive

7-10y bond yields deflated by inflation expectations | Grey = US recessions
All yields adjusted by "normal" (20y median) spread over/under 7-10y UST



Looking ahead, Fitch's concern about a fiscal deterioration in the next three years will likely come to pass. Using Gavekal's trusty "four quadrants" framework to think about future scenarios, US budget deficits should widen in the two most likely outcomes, namely an inflationary boom (as expected by Louis Gave and Anatole Kaletsky) and a disinflationary bust (as still expected by Will and I). When the government receives less and spends more, less is taken away from the private sector and more is spent on goods and services supplied by firms. This aids business profits in the near term (see [War, Recession And... Today](#)). However, further deficit widening will raise long-term debt sustainability concerns if no fiscal action is taken (see [The Three Prices: An Update On US Treasury Yields](#)).

Still, none of this is likely to affect the status of US treasuries as a "risk-free" asset in the near term, however oxymoronic that may sound.

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