

# Feed the Ducks When They're Quacking

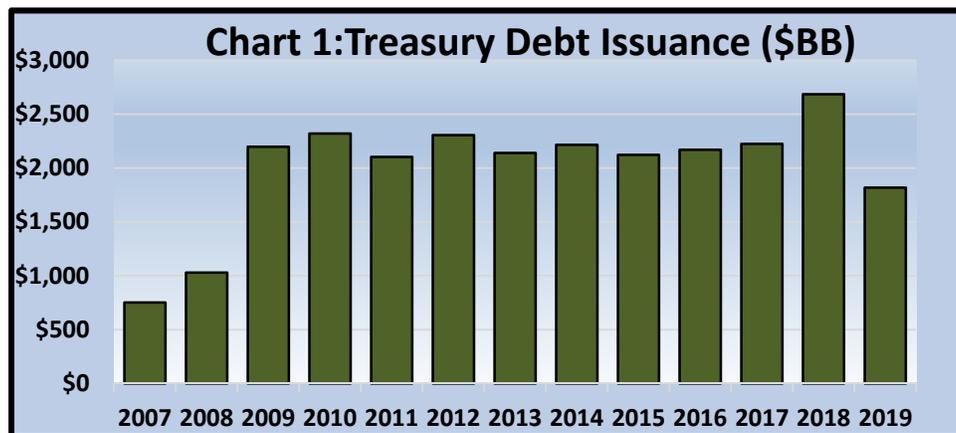
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*In the year 2525,  
If man is still alive,  
If woman can survive,  
They may find...  
... Maturing U.S. Treasury debt issued in 2025.*

OK, I made up that last line; Zager & Evans did not predict the issuance of 500-year Treasury bonds in their massively popular 1969 novelty song. But it could still happen<sup>1</sup> – and, more realistically, we could soon see the Treasury offer 40-year or 50-year debt for the first time ever. It's a good idea whose time has come.

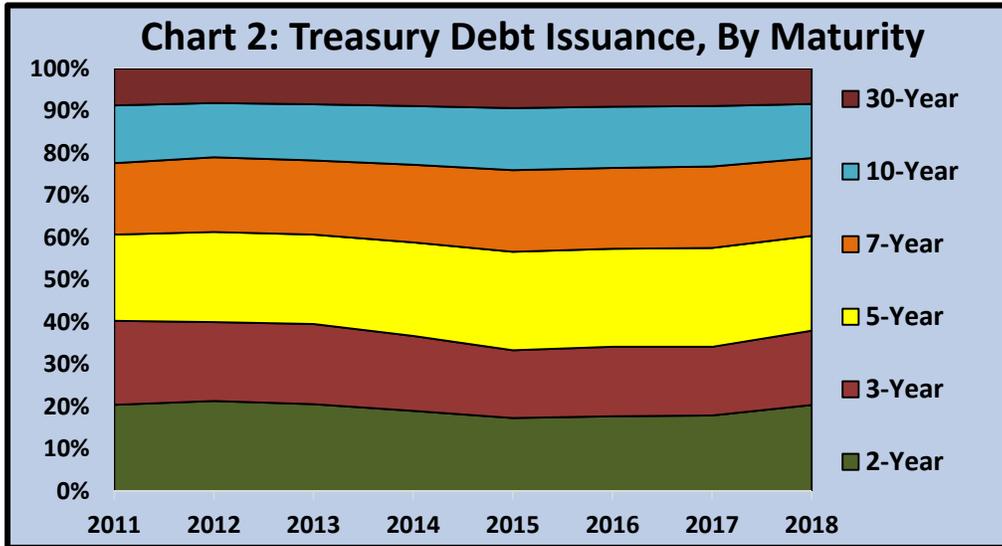
The Treasury Department has many functions in the American economy, but let's focus here just on its role in financing the operations of the federal government. Congress spends about a trillion dollars a year more than it brings in, which means that the Treasury has to cover the difference in new bond issuance (along with rolling maturing debt into new notes and bonds). Every few weeks, it auctions off billions of dollars in new debt with varying maturities. Chart 1 shows the total level of issuance over the past decade (including a spike last year due to the prior year's tax cuts), while Chart 2 shows the mix among the most common maturities offered.<sup>2</sup>



Source: Treasury Department

<sup>1</sup> First Trust economist Brian Wesbury, among others, has argued that the Treasury should issue *perpetual* bonds whose value would be indexed to inflation and whose components could be reconfigured by banks and brokers into various sorts of customized instruments based on investors' needs and market conditions.

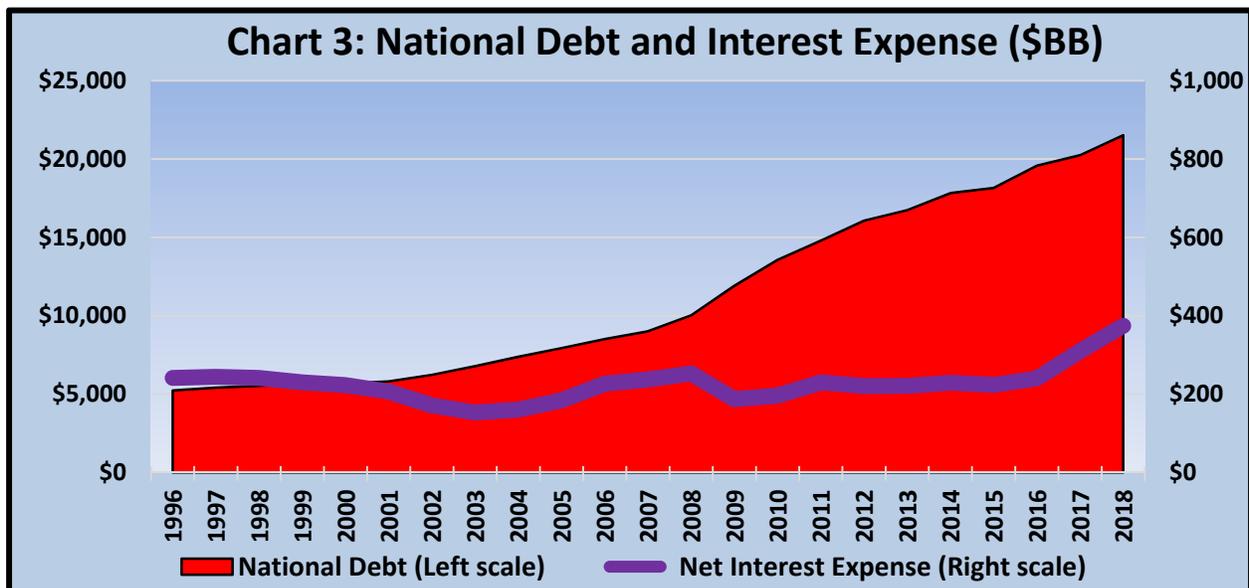
<sup>2</sup> Both of these charts exclude Treasury bills, which mature less than one year from issuance and which constitute more than 75% of all new federal debt. Bills have vital functions beyond funding the basic daily operations of the federal government; they serve as bank reserves and as collateral for loans among banks, and they provide liquidity and stability in currency and money markets. For this reason, I exclude them from this discussion.



Source: Treasury Department

The most noteworthy aspect of Chart 2 is its consistency over time: Through both Republican and Democratic administrations, the Treasury Department has maintained a fairly steady variety of new issuance maturities. In market environments characterized by a steep yield curve, this makes good sense: Too much long-term debt would be too expensive, while too much short-term debt would expose the Treasury to significant refinancing risk.

Throughout the Bush and Obama administrations, this strategy – and a roaring bond market – enabled the Treasury Department to finance a vast expansion in the overall indebtedness of the United States. Chart 3 shows that the total federal government debt grew from about \$7 trillion just before the 2008 financial crisis to \$17 trillion in 2016, yet the interest expense on that debt remained remarkably constant at about \$250 billion annually.



Source: Treasury Department

The federal government was able to double its indebtedness without increasing its financing cost because the average interest rate on that debt fell precipitously over the same time period, as the Federal Reserve kept short-term interest rates near zero and the bond markets pushed long-term rates ever lower.

Beginning with the enactment of President Trump's tax cut, however, this strategy began to unravel, as is evident on the right edge of Chart 3. The tax cut sharply widened the federal deficit, and concurrent Fed tightening led to a rise in interest rates. For the past two years, the government has been paying higher interest rates on a larger pile of debt, leading to a huge jump in interest expense to about \$400 billion last year. Faced with continued trillion-dollar deficits, the Treasury must become more creative.

The "spread it around" approach evident in Chart 2 no longer makes sense. In the past year, the yield curve has flattened and even partially inverted; among other things, this means that issuing long-term debt won't cost the Treasury more interest expense than issuing short-term debt, because the interest rates won't be far apart. From a borrower's perspective, this makes long-term debt extremely attractive. If you can refinance a mortgage for 30 years at low 2-year rates, wouldn't you do it? Yet only about 20% of new Treasury debt matures in more than 10 years.

If the Treasury dramatically expands its issuance of long-term debt (including ultra-long maturities like 40- and 50-year paper) and reduces the proportion of new debt with shorter maturities, it could solve several challenges simultaneously:

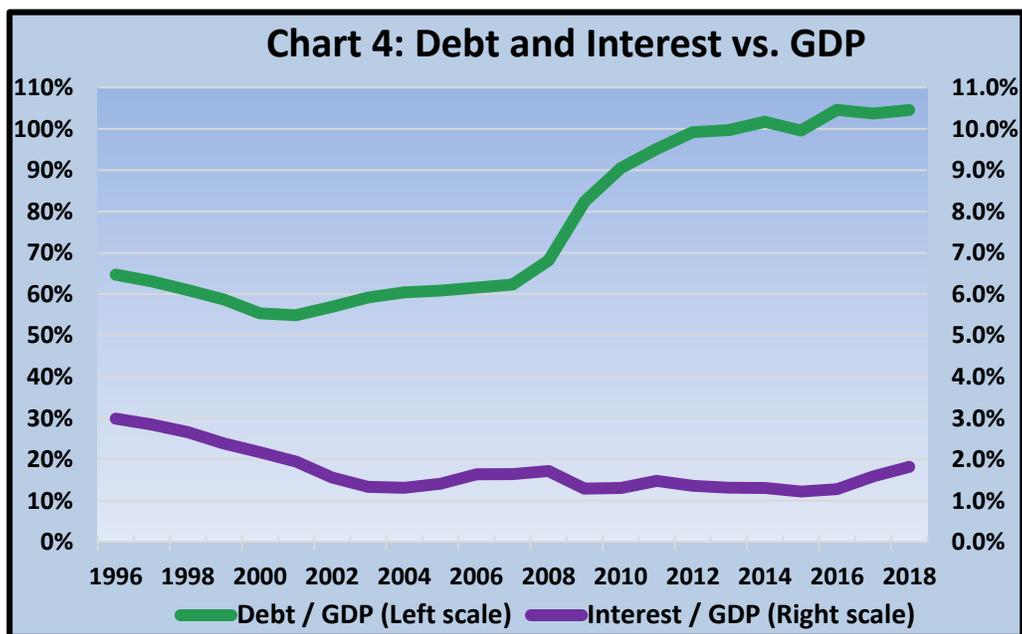
- It would lock in low interest rates for a long time into the future, delaying or eliminating the risk of an interest rate shock to the federal budget by fixing the total interest expense near current levels.
- It would, at the margin, tilt the yield curve toward a more positive slope, as the larger supply of long-term maturities might reduce their price (and raise yields) while the smaller supply of new short-term debt might correspondingly lower short-term yields. The steeper yield curve would help persuade investors that recession is not imminent.
- It would gently depress the value of the U.S. dollar, which has soared this year as global investors have sought both safe haven and higher interest rates than they can find anywhere else.

Conversely, the prospect of issuing ultra-long-term debt raises two important questions that Treasury must consider: First, can the government afford it? And second, will the market like it? Most likely the answer to both questions will be yes.

Many observers have complained that the vast expansion of the U.S. national debt is unaffordable, or that the only way to finance the debt would be through a massive increase in inflation. The data simply don't support this theory, however. The national debt is backed by the taxing authority of the federal government, which means that it is ultimately dependent upon the productive capacity of the U.S. economy. A strong economy can pay higher taxes than a weaker economy can.

Chart 4 compares the national debt and interest expense to the country’s Gross Domestic Product, the total output of the U.S. economy. Not surprisingly, debt/GDP (the green line in the chart) soared in the aftermath of the financial crisis a decade ago, as Congress spent prodigiously to get the economy back into forward gear. Since then, however, debt/GDP has remained fairly stable at about 105% – higher than seen in Germany, for example, but far less than the comparable figure in Japan. This level of debt/GDP is nowhere close to disastrous, or even problematic; it is stable and manageable.

Perhaps even more telling is that federal government interest expense has actually *decreased* relative to the size of the economy over the past two decades, as shown by the purple line on Chart 4. Lower interest rates have helped, but the main driver has been economic growth. The upshot is that the U.S. economy can easily support current (or higher) levels of interest expense; shifting debt issuance to longer maturities (including 40- or 50-year debt) is well within the government’s capacity.

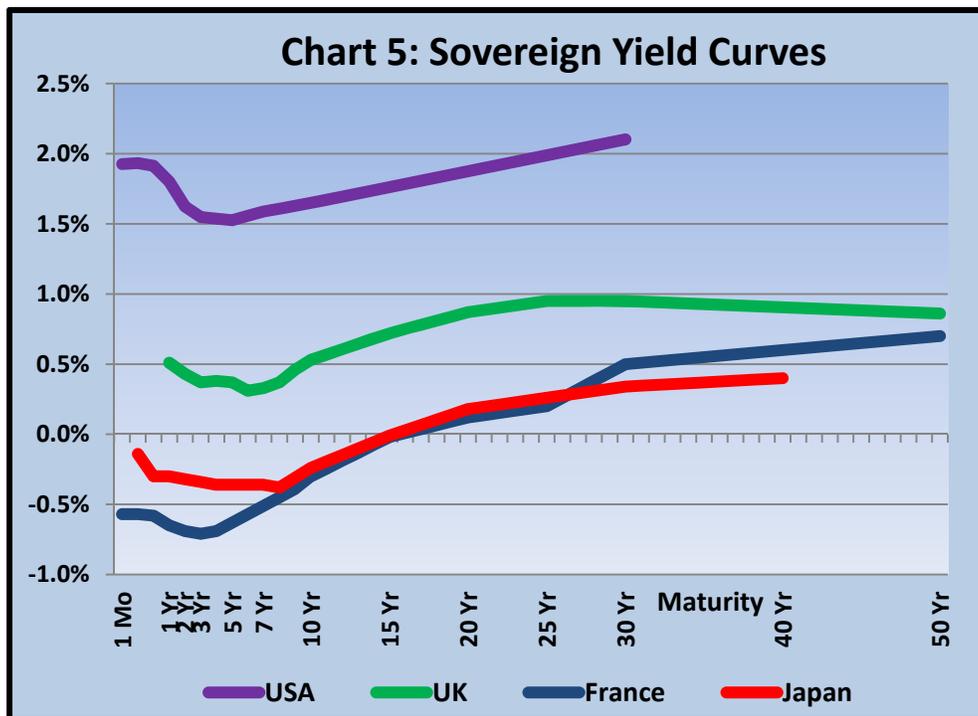


Source: Commerce Department, Treasury Department

Before changing its longtime practice of issuing a wide range of maturities, the Treasury Department would be wise to assess the bond market’s readiness to purchase ultra-long-term debt. With no history to guide them, officials don’t have any easy way of gauging market demand. A year ago, Treasury Secretary Steven Mnuchin said that he had surveyed bond market participants and concluded that insufficient demand existed for 50-year debt; perhaps so, but the higher level of interest rates and the steeper yield curve a year ago may have also dissuaded him about the affordability question.

Today, the markets would likely be happy to see a larger issuance of long-term and ultra-long-term government debt. A consensus is emerging among Wall Street banks that it’s worth a try, and the initial experience in other countries has also been encouraging.

Chart 5 shows the yield curves of four major global economies, three of which have issued ultra-long-term debt. Japan has issued 40-year debt, which currently trades at only 6 basis points (0.06%) above its 30-year debt; that's effectively a free ten-year extension. In France, 50-year government debt trades at about 20 basis points above 30-year debt, which is likewise a tiny price to pay for an extra 20 years of financial stability. Finally, Britain's 50-year debt actually trades at a 9 bps *discount* to its 30-year debt; the sovereign U.K. yield curve is inverted in two separate places separated by a normally inclined series of maturities.



Source: FactSet

None of these economies is exactly like the United States, of course. Britain's markets are confounded by Brexit, while Japan's population is shrinking and its economic growth likewise under long-term pressure. The French economy isn't quite as diversified as ours, and the nation has ceded control of its currency to the European Central Bank. But even though none of these countries is perfectly comparable, in aggregate they still suggest that investors will readily buy ultra-long-term debt.

*In the year 9595,  
I'm kinda wondering if Uncle Sam is gonna be alive,  
He's taken everything and the money's spent,  
And he ain't repaid a cent.*

*Now it's been ten thousand years,  
Man has cried a billion tears  
For the Treasury debt comes finally due  
Is the T-bond's reign now through?*

This moment may not last. Recently, long-term investors such as insurance companies and pension plans have snapped up 40- and 50-year sovereign debt issues, to the point where they are barely being paid to take on the extra maturity risk. But many factors could change in the coming months. The most likely trigger might be a change in central bank policy in Europe or Japan, and it's also possible that trade détente could spark a jump in equity prices. Either way, the outcome could be a less receptive bond market for sovereign issuers.

A shrewd and rapacious salesman I knew earlier in my career once told me, "You've got to feed the ducks when they're quacking." Chart 5 shows that the ducks are quacking for ultra-long-term debt issuance. It's time for the U.S. Treasury Department to feed them.

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