NEAM VANTAGE POINT

# Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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## Bond Market Riots

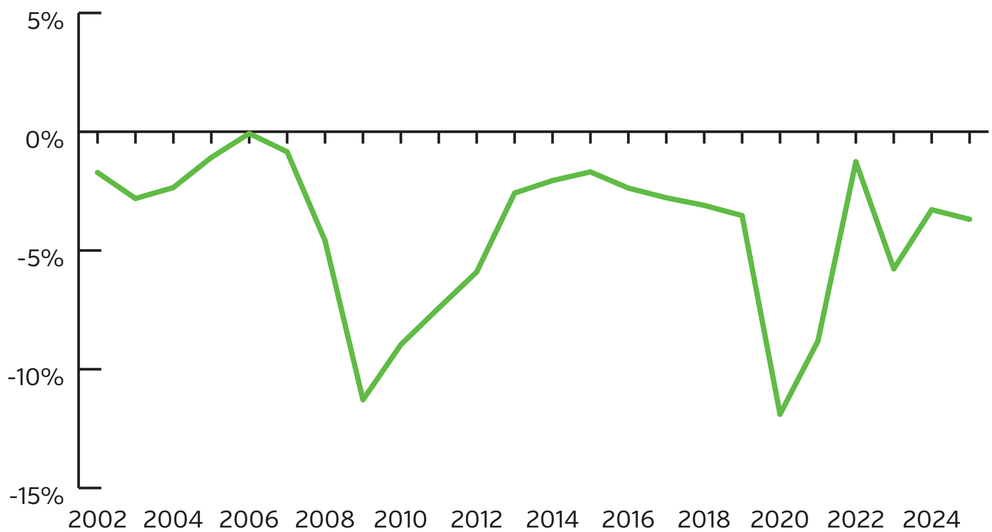
The bond market has historically acted as the "adult in the room" during times of expanding government deficits. What happens when the bond market has had enough?

### GOVERNMENT DEBT IN THE 21ST CENTURY

One of the defining issues of our time is the debt sustainability of sovereign nations. For much of this century, governments around the developed world have lacked the political will or leadership to pursue fiscal austerity measures that would address large fiscal deficits and would put sovereign debt levels on a sustainable path. Politicians have made the determination that it is better to defer addressing the issue, get elected or re-elected, and leave the difficult decisions that may involve sacrifice for a later date or for someone else. The result of this procrastination approach has been ever rising levels of debt on both an absolute basis and relative to the size of the economy.

Chart 1 shows the primary fiscal deficit as a percentage of GDP for the U.S. economy. This balance excludes the interest that is paid on the outstanding Federal Debt which would currently add another 3% points of GDP to the deficit. The Trump administration has a stated policy priority of extending the Tax Cuts and Jobs Act (TCJA) from 2017 and possibly exempting tips, overtime pay and Social Security income from taxes. Regardless of the final solution for the next budget, all scenarios project large deficits for the forecast horizon.

**Chart 1. U.S. Primary Budget Deficits as a % of GDP**




*Source: Haver, International Monetary Fund*

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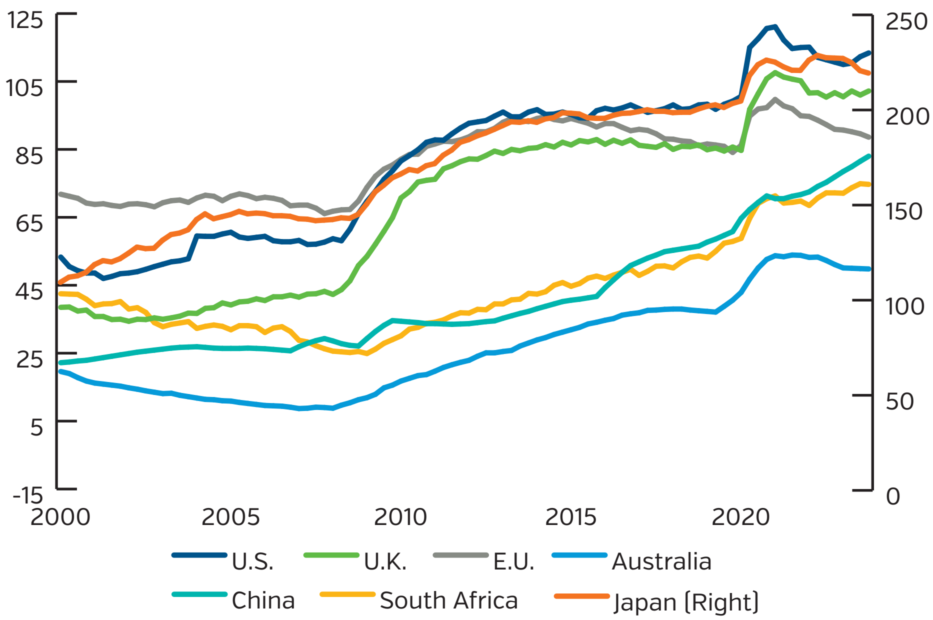
Meanwhile, the debt required to finance these deficits continues to grow and this is not just a U.S. phenomenon as the accompanying chart 2 shows. Sovereign debt as a percentage of GDP across these major developed world economies has risen from approximately 50% to over 100% since the turn of the century. Most recently, the standard bearer for fiscal discipline, the German Government, reversed course and is likely to remove the "debt brake" to allow for increased spending on defense and infrastructure that is above the legal limit. So, how does this end? If the developed world governments are not going to address the issue proactively, what will force them to?

**Chart 2. Sovereign Debt as a Percent of GDP**




*Source: Haver, Bank for International Settlements*

Enter the bond market. In the period post the Global Financial Crisis, central banks around the world supplemented their Zero Interest Rate Policies ("ZIRP") with bond buying or Quantitative Easing (QE). These QE programs effectively suppressed bond market volatility as central banks were large buyers of government bonds, no matter the price. Fast forward to today and central banks have ceased their QE programs, shrunk their balance sheets via Quantitative Tightening (QT) and market forces will now dictate the general level of interest rates for developed world economies. The effect of this is that a sudden rise in yields in reaction to unsustainable deficit spending is the de facto constraint on politicians. The bond market has become the adult in the room.

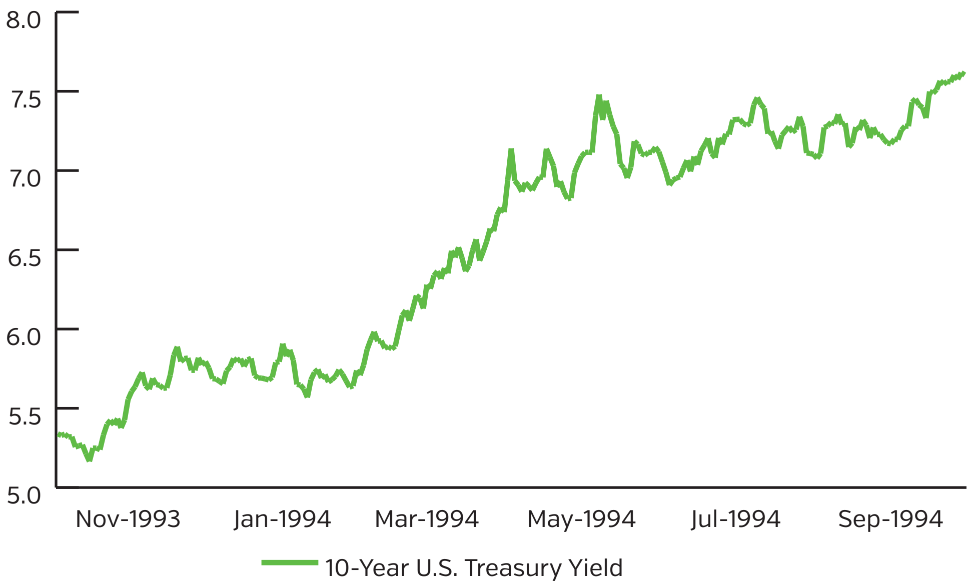
## BOND MARKET RIOTS

To get an idea of what this could mean for fixed income investors, let's consider a couple of examples.

The most infamous "bond market riot" took place in the US in 1993-1994. Bill Clinton had been elected President and had Democratic majorities in both houses of congress. The Clinton Administration wanted to pursue a universal health care program for the United States (the Health Security Act) which was projected to cost $1.5 trillion over the next 5 years (source: Heritage Foundation). This would have more than doubled Federal spending over the period. When the bond market became aware of the potential significant expansion in the size of the Federal Budget, yields began to rise. The 10-year US Treasury rose from 5.25% in October

1993 and reached 7.5% by September 1994. This rapid rise in interest rates got the attention of politicians and voters. In the mid-term elections, the Republicans gained control of both houses of Congress and the Clinton Administration was forced to pursue a more disciplined fiscal path (The Clinton Administration and the Republican Congress working together actually balanced the budget and produced a budget surplus by 1998 – imagine that).

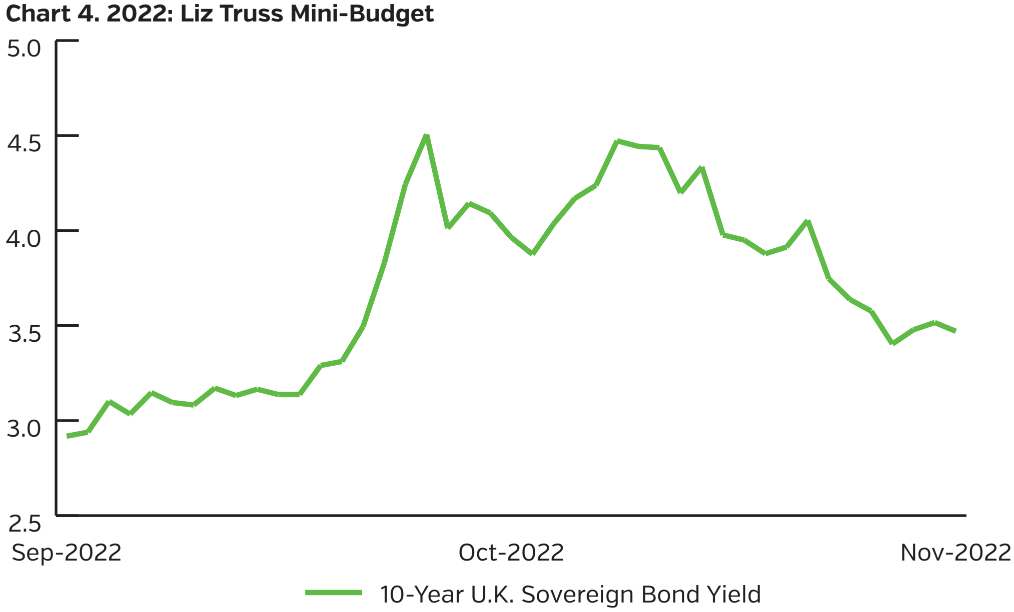
**Chart 3. US Bond Market Vigilantes: 1993 to 1994**




*Source: Bloomberg*

Another example of the bond market forcing fiscal discipline on government occurred in the U.K. in 2022. In September of that year, Prime Minister Liz Truss announced a mini-budget that included substantial tax cuts and increased spending commitments (particularly for an energy price cap). The financial markets reacted negatively and swiftly, with the yield on the 10-Year U.K. sovereign bond rising from 2.9% on September 1st to 4.4% by October 10th. The Bank of England was forced to intervene in markets to stabilize yields and Liz Truss was forced to resign after just 44 days in office.

**Chart 4. 2022: Liz Truss Mini-Budget**




*Source: Bloomberg*

Based on past episodes, bond market reaction can be swift and definitive as the arbiter of government plans and their effect on deficits and debt burdens. For the U.S., and as the Federal Reserve's ownership of Treasury securities has declined, the market's reaction to perceived fiscal profligacy could be made loud and clear, creating volatility for bond investors.

## KEY TAKEAWAYS

- A significant number of developed world economies continue to run large fiscal deficits at a time when debt levels are already at historically high levels.
- The bond market has become the de-facto constraint on governments' fiscal policy plans.
- This will add an element of volatility to bond markets and support a persistent "term premium" in the shape of yield curves.
- By looking at previous examples of bond market riots, fixed income investors can develop an expectation of possible market environments to come.
- Insurance companies should be prepared for potential market volatility that will allow for opportunities to invest in high quality fixed income investments at attractive yield levels.

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