

Deficit Threat Drives Bond Yields Higher

Investors expect Trump would widen budget gap with tax cuts

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The prospect of a rising federal budget deficit is fueling a sharp climb in bond yields, with investors betting a challenging fiscal situation will only get worse after the election.

Treasury yields, which rise when bond prices fall, jumped Monday after a \$69 billion government auction of 2-year notes attracted tepid demand from investors. That marked the latest leg in a weekslong bond-market selloff that began after a run of strong economic data undercut bets on rate cuts from the Federal Reserve.

The auctions aren't poised to get smaller soon. When the Treasury Department releases its quarterly borrowing plans on Wednesday, it will almost certainly maintain record-large debt sales over the next three months. There is also a chance that it could hint that further increases are coming next year, according to some analysts.

Most investors expect the budget deficit to remain elevated no matter who wins in next week's elections, with the cost of spending programs such as Medicare and Social Security climbing faster than federal revenues. Still, many think the budget gap will expand the most if Republicans sweep control of both the White House and Congress, leading to extensions of old tax cuts and the possible addition of new ones.

That view has been evident in recent days, with longer-term Treasury yields climbing as betting markets showed former President Donald Trump's chances of victory increasing. Trump's campaign proposals would expand deficits by \$7.5 trillion over a decade, according to a recent analysis—more than double Kamala Harris's proposals.

Trump's plans to impose universal tariffs and crack down on immigration could have substantial economic implications. But bond investors are focusing mostly on the supply of Treasuries "because it is a little more tangible," said Gennadiy Goldberg, head of U.S. rates strategy at TD Securities.

With immigration and tariffs, there is debate about "how much of this is actually just campaign talking points," whereas with the deficit, "we know what happened in the first Trump term," he said.

There are some telltale signs that deficit worries have contributed to the recent increase in yields.

When investors are concerned about the supply of bonds, longer-term Treasury yields tend to rise more than shorter-term yields because they are less tethered to the near-term outlook for interest rates set by the Fed. That often drives up estimates of the so-called term premium—or the component of Treasury yields that accounts for everything other than the expected path of rates, including the supply of Treasuries.

U.S. Treasury yields Source: Tradeweb FTSE closes

The yield on the benchmark 10-year U.S. Treasury note settled Monday at 4.277%, up around 0.26 percentage point since Oct. 16, according to Tradeweb. The 2-year yield has increased a more

modest 0.21 percentage point over that period. Estimates of the 10-year term premium have also ticked higher.

Deficits aren't typically the biggest influence on Treasury yields. The current market selloff kicked off in earnest near the start of this month after the release of an encouraging September jobs report. That reduced fears that the U.S. was heading toward a recession, causing investors to scale back their expectations for how much the Fed will trim interest rates in the coming months and years.

Deficits typically grab the attention of investors when there is a major shift in the fiscal outlook, as can often happen around an election.

TD Securities estimates that the fiscal year 2025 deficit will be around \$2 trillion under any political scenario, up from \$1.8 trillion in the fiscal year that just ended on Sept. 30.

10-year Treasury term premium estimate Source: Federal Reserve Bank of New York Note: Shows estimate from ACM term premium model

The election outcome could make a bigger difference the following year, with TD estimating a \$2.2 trillion deficit under a Republican sweep versus a \$2.05 trillion deficit if Harris wins but faces a divided Congress, a scenario that polls suggest also has a good chance of happening. That gap can largely be explained by the expiration of 2017 tax cuts at the end of 2025, which analysts expect would be fully extended by Republicans, but only partially extended if Democrats hold some power.

The government has discretion over how it borrows money from investors.

Issuance of "coupons"—notes and bonds that mature in two years or more—tends to have a larger market impact than issuance of bills that mature in a year or less. As a result, the government typically funds unexpected increases in the deficit by ramping up bill issuance. It tries to telegraph changes in coupon auctions well in advance and make only gradual adjustments.

Treasury officials, though, also try to avoid maxing out bill issuance during economic expansions in case there is a recession that leads to a big increase in the deficit.

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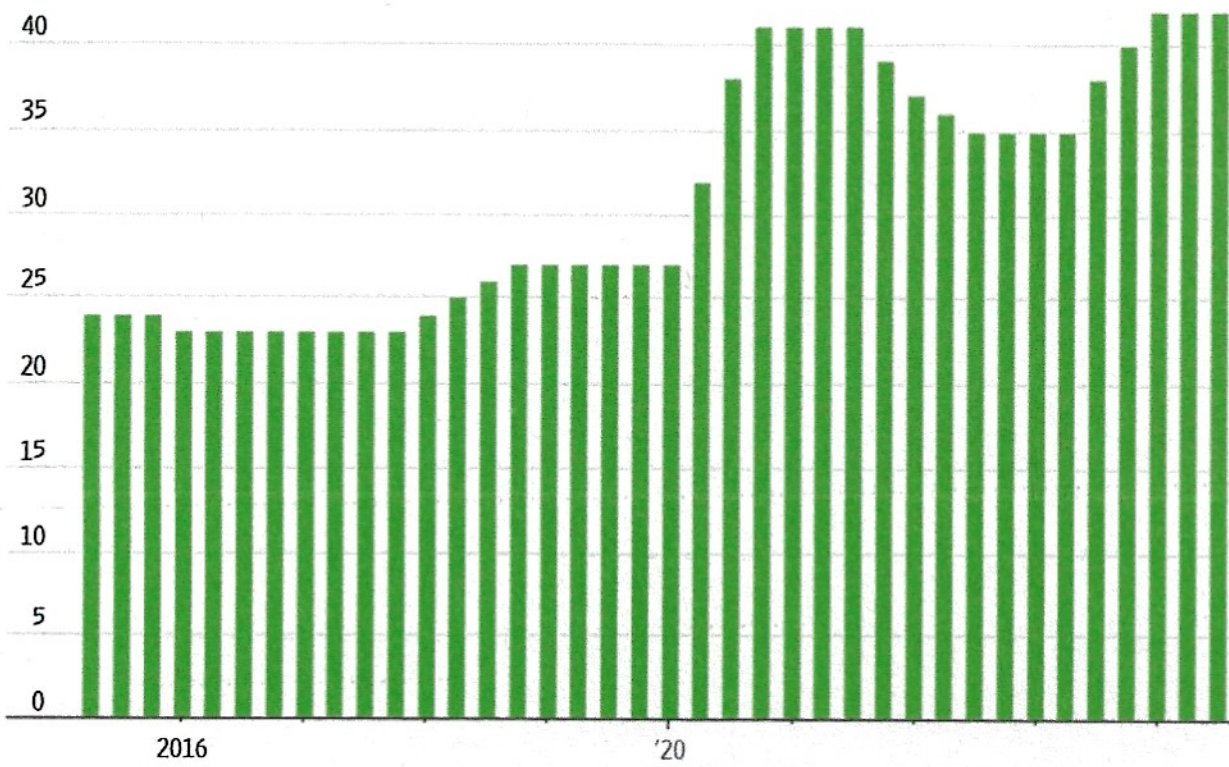
Bills made up 21.7% of outstanding Treasuries at the end of last month. That is a little higher than the 15%-20% range recommended by a private-sector Treasury advisory group in 2020 but still below the long-term average of about 22.4%.

In a recent report, analysts at Goldman Sachs argued that there is a chance that Treasury officials on Wednesday could signal openness to increasing coupon auction sizes next year to avoid a scenario in which the share of bills climbs too high.

But analysts at BNP Paribas struck a relatively relaxed tone on the issue. "Having more T-bill flexibility allows for steady coupon issuance," they wrote in a recent report, adding that "T-bills are easier to absorb for markets."

Size of 10-year U.S. Treasury note auctions

\$45 billion



Notes: Shows new-issue auctions only
Sources: BMO Capital Markets; Treasury Department

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U.S. Treasury yields

5.2%



Source: Tradeweb FTSE close

3 3

