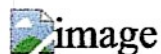


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Dollar Resists Election-Led Debt Worries

Treasurys are selling off as a second Trump presidency is set to increase deficits

When the bond market and the currency are giving off conflicting signals about the national debt, trust the currency. *

On Wednesday, following Donald Trump's victory in the U.S. presidential election, investors dumped Treasurys, pushing yields on 10-year paper to above 4.4%. At the end of September, they were below 3.8%. *

Crucially, however, the WSJ Dollar Index rose about 1.7%. *

Most Wall Street analysts agree that Trump's economic plans will involve wider budget deficits. The tax cuts he delivered during his first term, which are set to expire at the end of 2025, led the federal deficit to expand from 3.1% of gross domestic product in 2016 to 4.6% in 2019. He has promised a further reduction of the corporate-tax rate from 21% to 15% for companies that manufacture in the U.S., as well as a plethora of other new tax cuts. *

Higher tariffs could bring in some additional revenue, but not nearly enough to compensate. The bipartisan Committee for a Responsible Federal Budget estimates that Trump's proposed policies will add between \$1.6 trillion and \$15.6 trillion to the national debt between 2026 and 2035. The final figure may strongly depend on whether Republicans end up taking both chambers of Congress. *

Regardless, the budget deficit's starting point is much higher than in 2016: At the end of June, it amounted to 5.5% of GDP, which is a record outside of wars, pandemics and recessions. *

What happens going forward will thus be a big economic experiment. The national debt was barely a topic of discussion during the campaign, but the portion of it held by the public was 97% of GDP at the end of 2023 and was already set to surpass its record of 106%—reached during World War II—by 2027 and hit 122% by 2034, Congressional Budget Office estimates show. Trump's policies could take it to 140% instead, the CRFB says. *

According to the Federal Reserve Bank of New York, almost two-thirds of the increase in 10-year yields since the end of September hasn't been caused by the market pricing in that the central bank will keep rates higher than previously thought, but rather by investors applying a bigger discount to longer-term bonds relative to expectations for short-term rates. Even before Wednesday, this "term premium," which has been mostly negative since 2016, was increasing federal borrowing costs by 0.2 percentage point. *

Term premiums can rise for a number of reasons, but one is certainly concern over debt and deficits. The concern is that the "bond vigilantes," who according to Wall Street lore drove up interest rates as deficits rose in the 1980s, could make a return and plunge the U.S. into a fiscal crisis. Two years ago, Liz Truss resigned as prime minister of the U.K. following the release of an expansionary budget featuring deep tax cuts that led sovereign bonds to seize up. *

But this theory doesn't quite fit the facts. For one, the term premium remains very low and far from its historical average, which is 1.5 percentage points. It could, of course, shoot up from here, but it is unclear why this should happen

now and not in 2022 and 2023, when rates and inflation were surging.*

An even more important bellwether is the dollar: Foreigners would hardly be flocking into the U.S. to chase high yields as usual if they had any concern about sovereign- debt sustainability. In countries where these worries arise— Turkey and Argentina are recent examples—the currency nosedives in lockstep with the debt. Central banks can buy their own nation's debt, but a depreciation of the exchange rate is the only market force against which even they are powerless.*

Yet the currencies of rich nations— even those that don't have the dollar's "reserve currency" status— still appear insulated from such risks.

Sterling initially fell during the Truss debacle of 2022, but bounced back as soon as the Bank of England said it would buy debt. Again, this is the opposite of what happens in an emerging country undergoing a fiscal crisis, where printing money is seen as a further red flag, and underscores that the U.K.'s bond-market trouble had a lot to do with the unraveling of leveraged trades by pension funds.*

To be sure, massive issuance of Treasuries may pose some temporary challenges to banks and investors trying to absorb it, as has already happened in the past, and lead to the usual congressional spats about raising the debt ceiling. Also, the injection of spending resulting from Trump's deficits could spark some extra inflation, in turn leading the Fed to keep borrowing costs a bit higher. This is why inflation-linked bonds have gotten relatively more expensive over the past month, as chances of a Trump victory rose.*

Finally, true political discord in the U.S. could shake faith in the dollar or Treasuries in ways unforeseen. So far, though, the prospect of a second Trump term seems to be reinforcing King Dollar's reign, rather than shaking it.*

—Jon Sindreu

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