May 2023

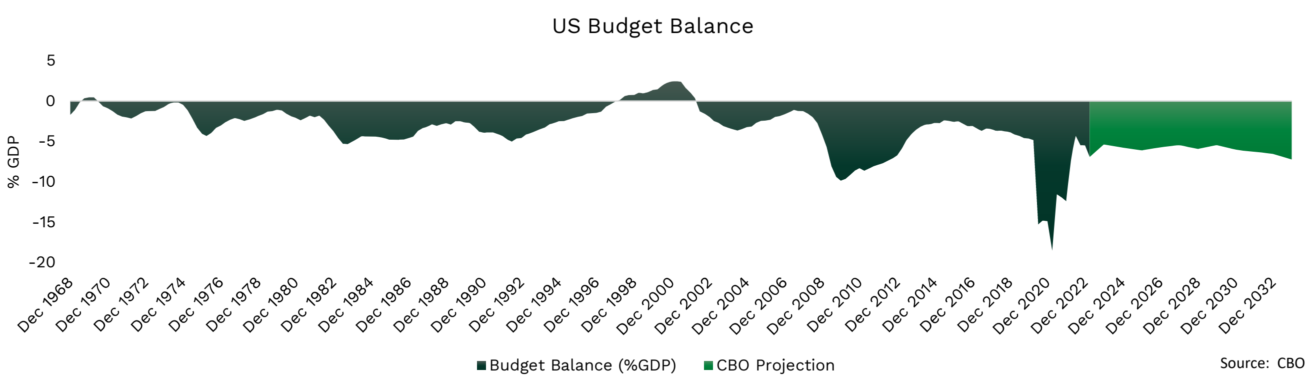
Top Gun: Bond Mavericks

With American foreign policy once again focused on an aggressive Russia, it's only fitting that a long overdue sequel to a 1980s classic became the top grossing film of 2022. Top Gun: Maverick delighted fans with both a high-speed adventure and a nostalgia trip en route to six Oscar nominations.

The film is not the only 1980s revival; indeed, we've been hearing the phrase "not since the 80s" a lot recently, particularly relating to markets and the economy. To combat the rapid rise of inflation the Fed felt *the need for speed* and hiked policy rates at a pace reminiscent of Volcker's campaign against inflation in the early 80s. The recent failures of Silicon Valley Bank, Signature Bank and First Republic Bank knocked Continental Illinois (failed 1984) out of the second spot for largest bank failures in U.S. history – and the magnitude of moves in short term interest rates in the wake of those failures was, you guessed it, the largest since the 1980s.

Though 1980s levels of debt seem quaint by today's standards, the political and market concerns were real. With a polarized populace, a significantly higher level of outstanding debt, and sharply rising interest rates after a nearly linear 4 decade decline *since the 80s*, the national debt is again under the microscope, particularly as the recurring ritual of the debt ceiling debate again comes into focus.

The U.S. Has Been Running Large Deficits Since Before the First *Top Gun...* and Likely Past the Next One



In the 1980s, Ed Yardeni coined the term 'bond vigilantes' for fixed income investors whose actions influenced government policy by pushing rates higher in response to increased fiscal spending. History doesn't exactly repeat, but it does often rhyme. Where the 1980s had 'bond vigilantes', perhaps the new breed of fixed income investors should be called 'bond mavericks', who like the eponymous movie pilot have been waiting for the chance to show they've still got it.

'Rooster' vs. 'Maverick', who's playing chicken?

In the movie, two of the main characters, Rooster and Maverick engage in a game of chicken during their training – testing each other's mettle to see who will continue their downward spiral in a simulated dogfight and who will capitulate first. The futile exercise has become eerily similar to the recurring debt ceiling debates.

Each time we face a debt ceiling, we risk politicians engaging in political brinksmanship, spiraling down toward the earth and waiting to see if the other side gives in.

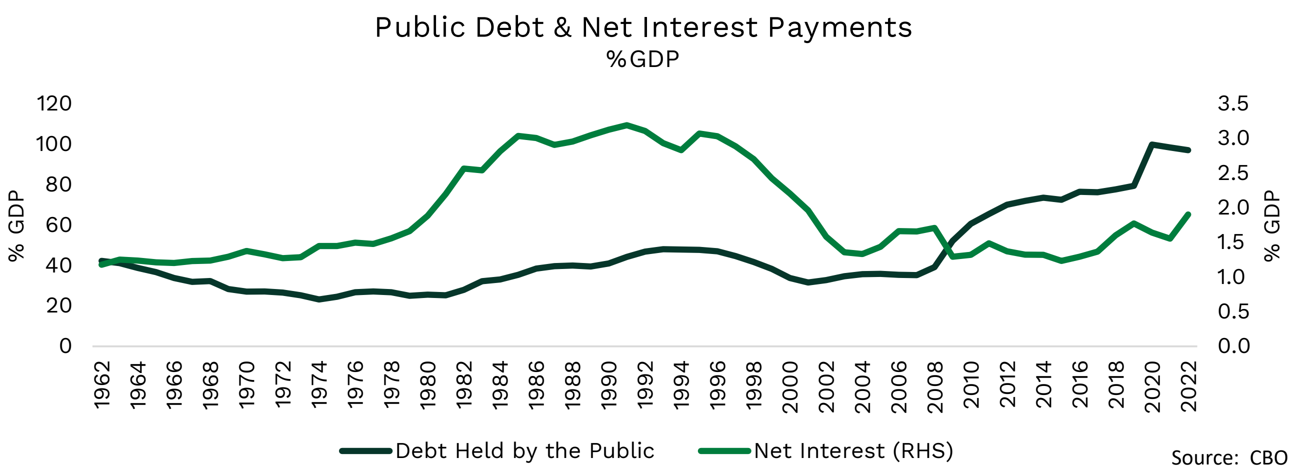
The most egregious example was in 2011, where political battles led to concerns of a U.S. government default; ultimately budget sequestration was agreed to, allowing an increase in the debt ceiling in exchange for future deficit reduction. But the political fighting led to significant market volatility and a downgrade of the U.S. government from its prior AAA rating by S&P.

Whether the current iteration of the debt ceiling debate goes out with a whimper or a bang, it is very far from the last time we will have this concern. In fact, with most estimates projecting budget deficits over the next several decades, as the debt pile grows, we are likely to encounter this issue with more gravity in the future.

Highway to the Danger Zone

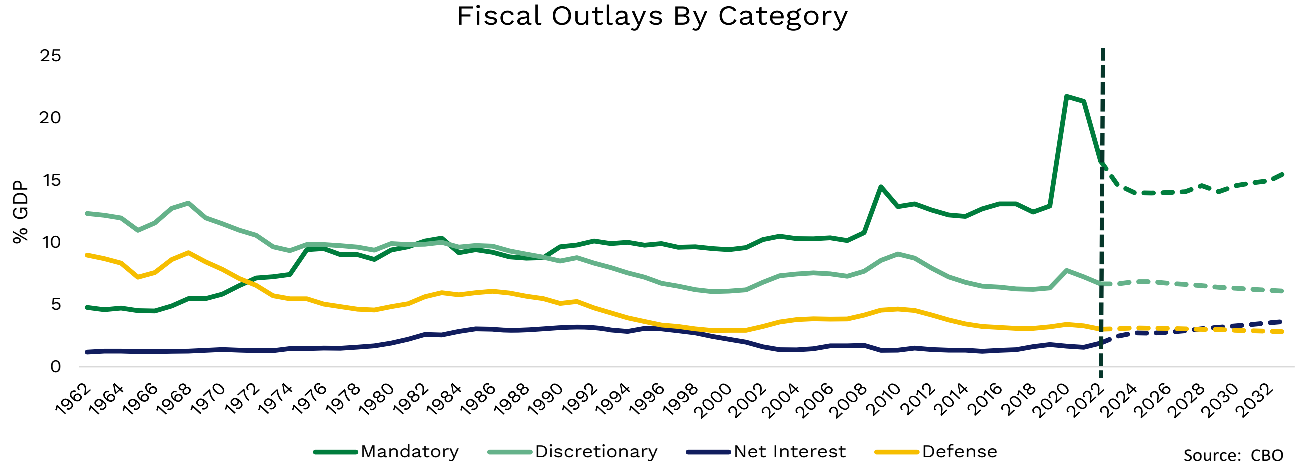
The U.S. government has not run a fiscal surplus in a single year since 2001 and, as we've noted previously, the last president to leave office with a lower national debt than when they took office was Calvin Coolidge! Clearly, the growing national debt is not a new problem, however, it hasn't been a limiting factor either. Secularly declining interest rates provided cover for increased fiscal spending and tax cuts; lower rates muted the impact of the heightened debt levels via reduced debt servicing costs. However, with interest rates rising significantly, the cost to service that debt is now exploding.

Net Interest Rising Faster than a Pilot After a Bombing Run



Source: CBO

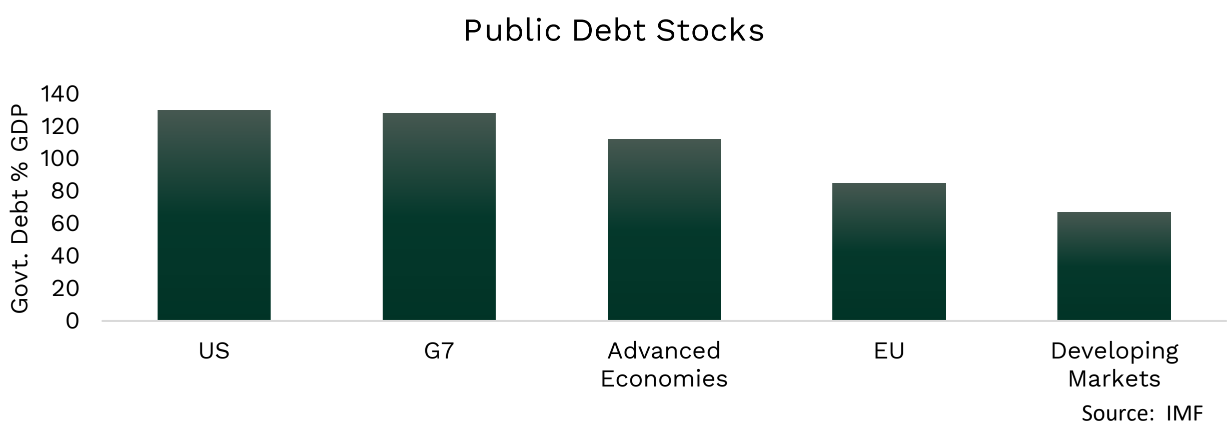
If interest rates in the U.S. remain near current levels, the increase in debt service as bonds mature and need to be refinanced will be significant, costing hundreds of billions of dollars a year above current level. In fiscal 2022, the U.S. government spent $6.3 trillion, with 8% allocated to net interest payments. The increased interest costs could eventually be on par with the annual budget of Department of Defense - $750 billion in 2022. Even if not that high, the increased debt service could add significantly to a budget, that already ran a massive deficit to the tune of $1.4 trillion in 2022.



Before it goes nuclear

The premise of the new Top Gun film is that the pilots must destroy a nuclear reactor before it becomes operational. Once it goes live, it would be catastrophic to destroy it, thus there is a final moment to act before a point of no return.

There is a point – not as clearly defined as in the movie – at which debt levels and debt servicing become a significant problem. Scholarly research suggests that countries have increased financial vulnerability - including default - once the debt to GDP ratio exceeds 75%. These observations have been made of smaller and emerging economies; while developed economies are likely to have higher debt carrying capacity, there is limited historical precedent for the significant number of countries with debt ratios larger than the size of their economy and increasing interest rates.



It is a fair assumption that developed countries would have additional leeway before a market revolt as has been observed in developing counties. And likely the U.S. would have additional room versus other developed nations given the United States' unique position with the world's largest economy, cultural hegemony, unprecedent military might and the dollar's status as the global reserve currency.

Nonetheless, there could be a tipping point at which those factors can no longer keep market forces at bay. As the U.S. debt situation worsens, the hand of bond mavericks strengthens.

A Suicide Mission?

The bombing run in Top Gun is viewed as near suicidal – perhaps the reactor could be destroyed, but after the mission it would be impossible to escape. This, too, is the view for American politicians regarding entitlement spending. In 2022, the U.S. spent $1.2 trillion on Social Security, $750 billion on Medicare and $600 billion on Medicaid with mandatory spending accounting for over 60% of total spending. The outlays for these programs have risen dramatically over time and are projected to continue rising, particularly given the inflation adjustments embedded in the programs. While projections vary, most show Medicare and Social Security likely to be insolvent within 10 years.

In Top Gun, the pilots were able, at great personal risk, to do the impossible. It remains to be seen if any American politician can run the gauntlet of entitlement reform and survive. Absent that, the programs are likely to put further pressure on deficits and debt.

Next Generation Fighters

In its last iteration, the battle between government policy and bond vigilantes was fought and won with government policies being subject to market forces. In the interim, a new generation fighter has demonstrated its powers to combat market forces.

In the 2008 financial crisis, the Fed expanded the toolkit it was willing to use to combat market stress. The alphabet soup of Fed easing programs, in addition to the more conventional changes to the Fed Funds Rate, stemmed the market crisis. At the outset of the economic shutdown during the COVID crisis, the Fed revived and expanded on these tools, including introducing a corporate credit buying program.

The Fed has clearly shown it has the tools to buffer markets during periods of stress, however, the challenge the Fed faced in these earlier episodes was falling growth and inflation, while the current and prospective environment is much different. Stabilizing inflation is critical to prevent spiraling Treasury yields, however persistently higher yields also increase interest costs. In an environment tilting towards fiscal dominance would the Fed engage in a dogfight against the Bond Mavericks and deploy new tools such as the yield curve caps implemented in the 1940s to try and restrain further advances in yields?

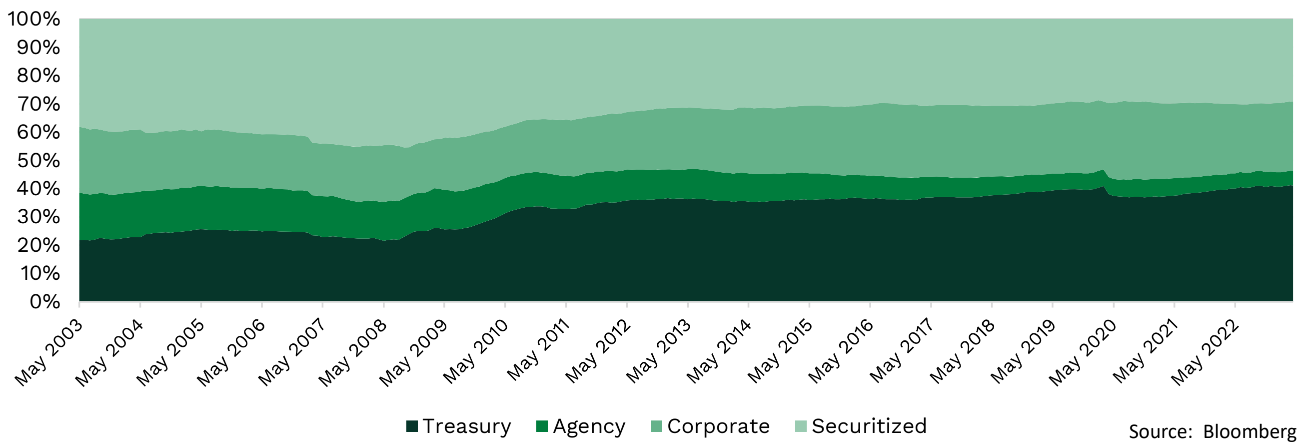
Returning to Base – Conclusions and Outlook

Large deficits in the past led markets – bond vigilantes – to 'punish' politicians with higher interest rates. While possible deficits today will lead to the same outcome, in our view, it is far from assured. Certainly, from a supply / demand dynamic, a greater supply of debt should equate to lower prices and higher yields, but this assumes constant demand. As seen in 2011, demand for Treasuries rose as a result of risk-off sentiment driven by a downgrade in the selfsame Treasuries. What would happen today? Would increased supply push rates up or would fears of a crisis (yes even if it's a debt crisis) lead to a flight to quality?

In all likelihood, the market will gyrate, perhaps violently, between these sentiments and the most certain outcome would be volatility.

From a fixed income market perspective, the increase in debt service costs and the current inability to pay them without the issuance of additional debt is likely to lead to higher issuance of U.S. government debt. The Bloomberg Aggregate currently has approximately $10 trillion of Treasuries in it – a number likely to grow significantly to finance both continued deficits and higher debt service costs. The increased Treasury issuance could continue to reshape the traditional bond market.

Bloomberg Aggregate Index By Sector



Source: Bloomberg

Soaring deficits and higher interest rates create the potential for new challenges for the economy and for markets. Though the United States has advantages likely to protect it to a greater degree than other nations, it also faces a higher debt burden and higher interest rates than other major developed nations. In this uncertain environment, where Bond Mavericks flex their muscles, the steady hand of experienced pilots will be needed to navigate the turbulence.

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