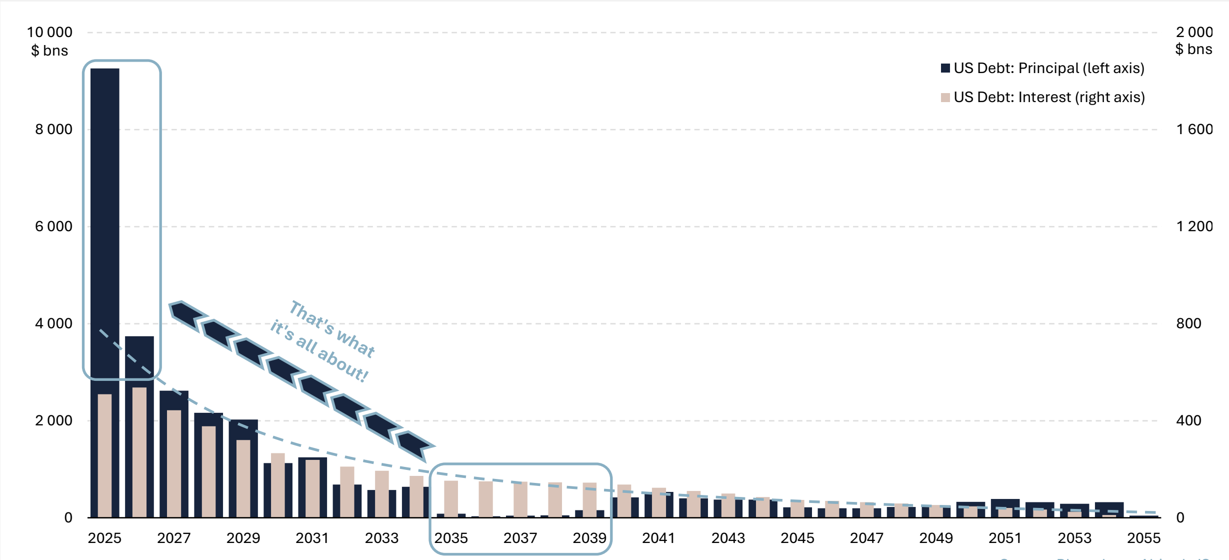
The flexiweekly that reaches new heights - published on 3 March 2025

"YELLEN THE MAGICIAN, BESSENT THE WARLORD?"

- The United States is in a prime position to sell sovereign debt
- However, it is no longer able to issue over the long term without creating tensions
- What are the possible options, for the Treasury, as well as for the Fed?
- How are bond investors seeking returns?

CHART OF THE WEEK: "Financing difficulties become tricky to ignore"



Source: Bloomberg, Altitude IS

BOND MARKET ANALYSIS

Debt is not a problem in itself, as it enables the financing of future profitable activities. It only becomes a problem if it finances unprofitable projects or if its large volume puts the issuer's solvency at risk. We have regularly detailed the four ways of resolving a situation of over-indebtedness: more growth, more inflation, less deficit, lower interest rates. If none of these strategies work, then governments have to choose between defaulting or monetising their debt. Most of the time, they opt for the second option, forcing the central bank to act under the sway of the Treasury, hence the term fiscal dominance: printing money to buy up as much public debt as necessary.

In the case of the three main developed zones, the United States, the Euro Area and Japan, sovereign debt became a problem as excessive public deficits fuelled it (see Figs. 2 & 3). Over the last three decades, the Japanese banking crisis, the subprime crisis, the European debt crisis and the Covid crisis have encouraged governments to spend beyond their means. By borrowing the capital of future generations, they have downgraded the quality of their credit rating and put their solvency at risk.

Fig. 2 - Public deficit in developed countries

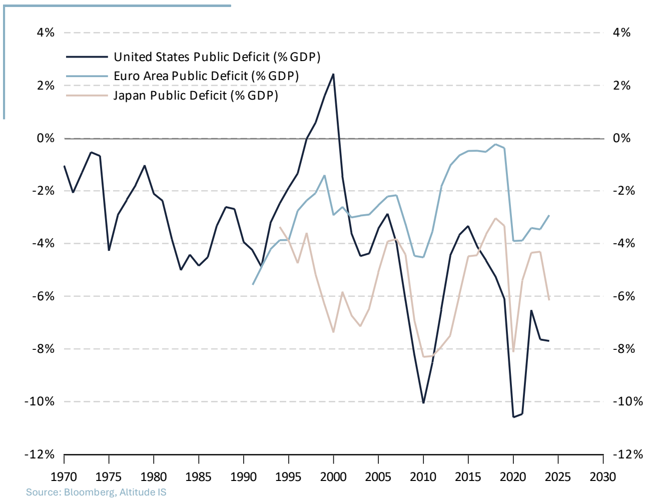
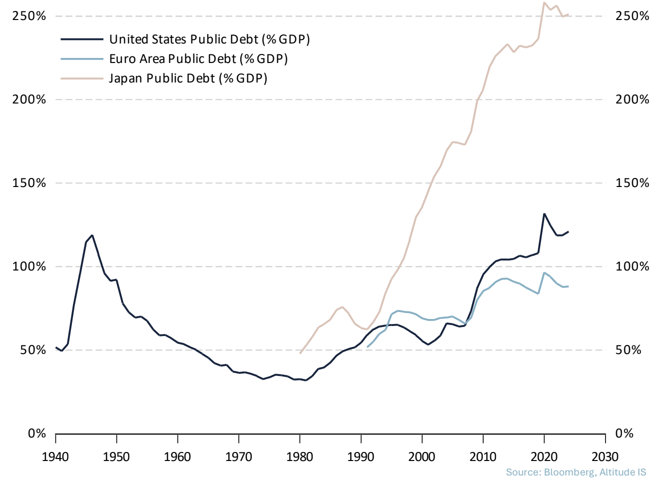


Fig. 3 - Public debt in developed countries



Japan has already crossed the red line. Since 2021, its central bank has been compensating weak demand for government bonds. The BoJ has had no choice but to buy almost half of all JGB issues, positioning itself as buyer of last resort. The Empire of the Rising Sun will not default, but the yen is seeing a sharp devaluation that has only just begun (see Fig. 4).

Fig. 4 - Real exchange rate USD/JPY

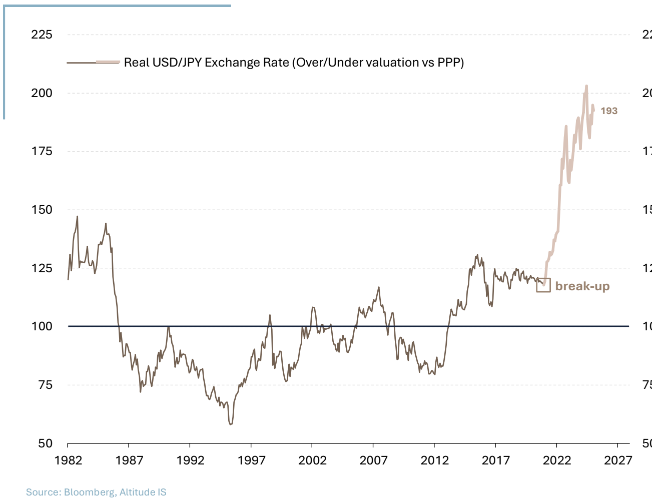
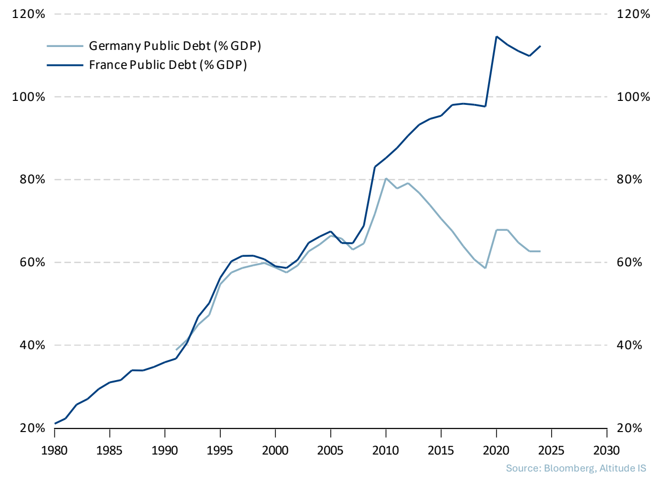


Fig. 5 - Public debt: Germany & France



Europe fell on hard times between 2010 and 2012, when the debts of peripheral countries reached breaking point. It took the intervention of the European Central Bank (Mario Draghi's now famous *whatever it takes*) and the implementation of powerful austerity measures for the panic to subside.

Since then, some virtuous countries, such as Germany, have reduced their debt ratios, but others, such as France, have continued to let them slip (see Fig. 5). **The risk of a new crisis is therefore very likely.**

The United States is in a prime position. As the world's leading economic, military, diplomatic and financial power, Uncle Sam's country enjoys an incomparable advantage: investors around the world consider US Treasuries as the "risk-free asset". They buy them en masse, encouraging low interest rates. Despite this, in recent years the United States has begun to experience difficulties in properly allocating its sovereign debt. The breakdown of US debt is worse than that of Japan: 45% of bonds have maturities of less than 2 years. **The situation is not yet critical, but it is becoming worrying.**

Let's look at some historical figures. Between 2022 and 2023, the Fed's interest rate hike made T-bills (maturities of less than 2 years) attractive. This had not been the case since the period of zero interest rates (ZIRP) and exceptional money creation (QE, see Fig. 6). Investors have given them a prominent place in their asset allocation, which is why demand for money market funds has soared. Money market funds now manage almost USD 7,000 billion, compared with USD 4,500 billion three years ago (see Fig. 7). The flip side of this phenomenon is that investors have moved away from bonds with longer maturities: T-notes (maturities of between 2 and 10 years) and T-bonds (maturities of over 10 years).

Fig. 6 - Fed monetary policy

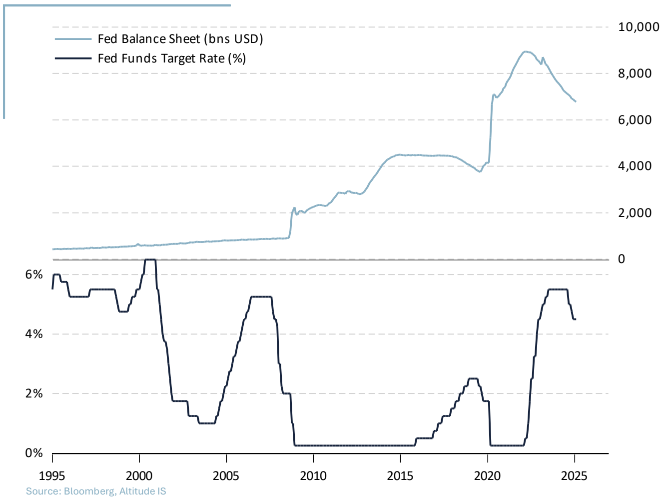
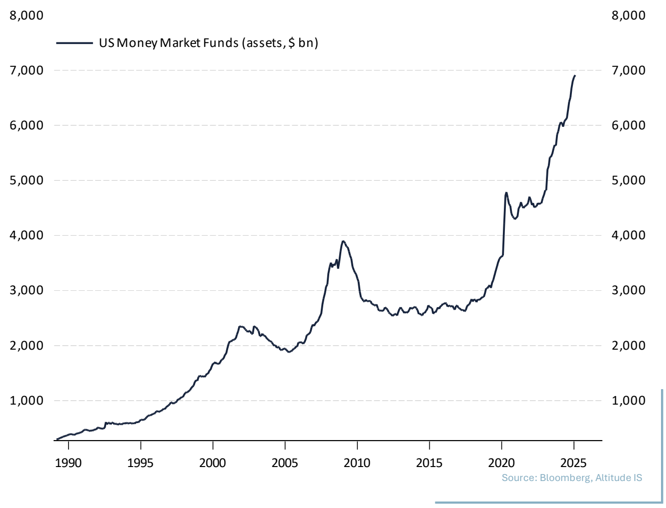


Fig. 7 - Assets managed by money market funds



The yield on long bonds should have risen mechanically, to compensate for the imbalance between abundant supply and weak demand. The phenomenon should have been all the more visible given that the Fed, by reducing its balance sheet from USD 9,000 billion to USD 6,800 billion (see Fig. 6), was also selling long bonds. In other words, since 2022, the Fed has positioned itself as a "competitor" to the Treasury on the bond market. And yet, despite this, yields on 10-year bonds have remained low. Between July 2022 and August 2024, they were even lower than 2-year bond yields (see Fig. 8).

To pull off this magic spell, Janet Yellen's Treasury Department (Chair of the Fed between 2014 and 2018) took advantage of investors' appetite for bonds with maturities of less than 2 years. It even encouraged it by reducing the growth in the size of 10-year auctions. This scarcity effect has succeeded in lowering yields. This strategy is risky, because it creates major distortions in the breakdown of debt, but it is clever. Stephen Miran (former Treasury Department adviser in Donald Trump's first term and now chairman of the Council of Economic Advisers in his second term) and economist Nouriel Roubini have suggested that the Biden administration manipulated bond issuance. They estimate that, **by changing the average maturity of Treasury bonds, Janet Yellen has managed to reduce 10-year yields by around 0.25% in 2024.** This represents a saving of several tens of billions of dollars on the government's annual budget. A real magician's spell!

On his arrival at the head of the Treasury Department, Scott Bessent openly criticised the actions of his predecessor, criticising her for having financed the deficit by favouring short-term bonds rather than extending the maturity of the debt: *"Yellen's reliance on short-term financing leaves the Treasury vulnerable to rate hikes"*, *"the previous Treasury strategy missed the opportunity to lock in low rates for decades"*. He would have liked her to take greater advantage of the period of low rates to secure the country's long-term financing. Since then, he has changed his mind. He has decided not to change the existing financing policy: *"a shift towards long-term debt issuance is still a long way off"*. He will continue with Janet Yellen's strategy and long-term debt issuance will remain limited, so as to avoid a crisis in US sovereign debt.

Fig. 8 – US Yield curve

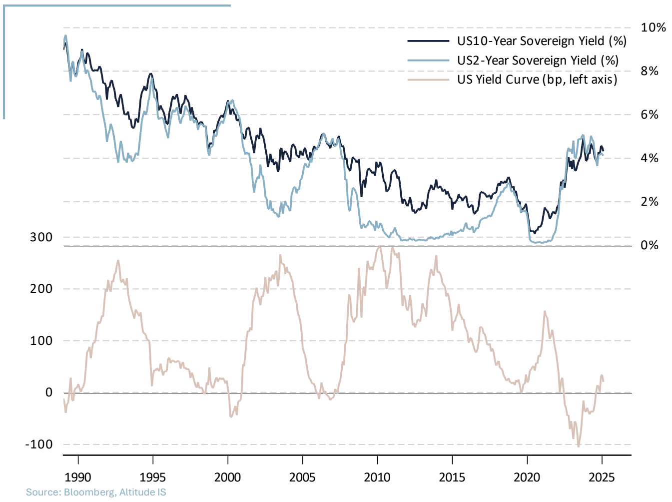
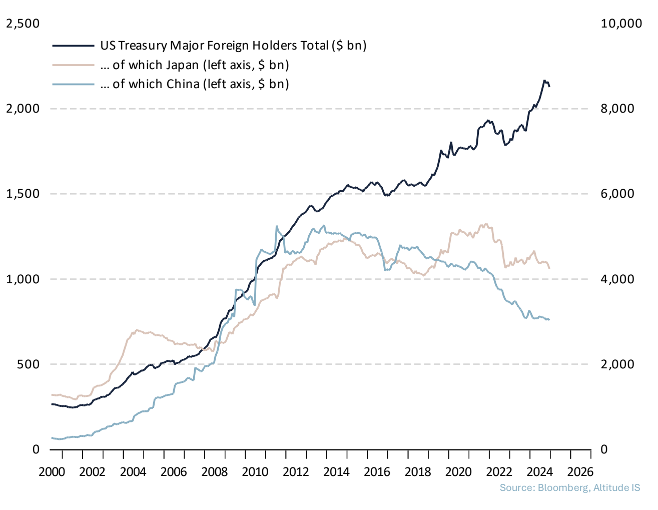


Fig. 9 - Foreign ownership of US debt



Why might the breakdown of US debt end up posing a problem? Ideally, it is in a government's interest to spread its liabilities evenly across the different maturities in order to avoid excessive concentration of repayments over a given period. A poor distribution could create a high refinancing risk. If too large a proportion of the debt matures at the same time, the Treasury runs the risk of having to renew its borrowings under unfavourable market conditions, either because interest rates are high or because the appetite of creditors is low.

Over the past few years, around $5 trillion has been borrowed on a very short-term basis, to avoid the risk of pushing up interest rates to 7, 10 or 15 years (see Chart of the Week). Despite this, the interest that will have to be paid between 2032 and 2039 already amounts to more than $150 billion a year. When debt is issued over these maturities, the annual burden it will represent is likely to be unsustainable. The United States will therefore continue to do everything in its power to prevent rates from rising too sharply.

A number of questions remain to be answered:

Will investors naturally extend the duration of their bond investments? It is unlikely. Admittedly, if interest rates stabilise at their current levels, the roll-down effect will enable a long bond to generate a slightly better return than a short bond. But as the yield curve is almost flat (see Fig. 8), meaning that the constraint of tying up capital for a long time is not decently remunerated, the preference for the present will encourage investors to take short-term positions. As a result, the Treasury will not be able to issue a large quantity of 10-year paper.

Will the Fed finally lower its key rates more than investors were expecting? Quite possibly. Long-term interest rates must not rise any further to avoid a crisis, but the yield curve also needs to steepen. Short-term rates must therefore be lowered. Interestingly, investors are expecting only two or three key rate cuts before the end of 2026. However, it would not be surprising to see the Trump administration put strong pressure on Fed governors, led by Jerome Powell, to act much more aggressively. Unless Scott Bessent agrees to wait until May 2026, when the Fed Chairman's term of office comes to an end. As luck would have it, his successor could be much more in line with the Treasury's objective of cutting short-term interest rates.

Is Scott Bessent preparing to implement a strategy of financial repression? There is nothing incongruous about that. The Secretary of the Treasury will probably seek to activate different levers, different forms of financial repression, so as to "encourage" natural bondholders to buy more of them. Individuals could be exempted from federal taxation on coupons received. For their part, banks would be allowed to exclude Treasuries from the calculation of certain financial risk ratios. Fed Chairman Jerome Powell recently backed this proposal: *"the amount of Treasuries is growing much faster than the intermediation capacity has grown, and one obvious thing to do is to reduce the effective supplemental leverage ratio"*. Insurance companies and pension funds could be legally obliged to buy more 10-, 20- or 30-year Treasuries, as the UK has done in the past. Finally, Scott Bessent could follow a proposal made during the Mar-a-Lago accord, namely to encourage some of their foreign creditors (see Fig. 9) to exchange their current Treasury bills for very long-term bonds, or even bonds with no coupon. Will they be able to force them to do so? A warlord attitude!

Conclusion:

The investor consensus is coming to terms with the fact that 10-year yields cannot climb too high. In order to finance its debt naturally, the US is forced to lower rates, while maintaining a slope on the yield curve. All this will benefit bonds and duration. Barring financial repression, which would allow long rates to be artificially captured without lowering Fed rates, steepeners should continue to perform well.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2025 Year-to-Date (%)	2024 (%)	2023 (%)
Equities							
World (MSCI)	863.0	44.39	-1.3%	-0.6%	2.8%	18.0%	22.8%
USA (S&P 500)	5 955	44.30	-1.0%	-1.3%	1.4%	25.0%	26.3%
USA (Dow Jones)	43 841	47.98	1.0%	-1.4%	3.3%	15.0%	16.2%
USA (Nasdaq)	18 847	38.01	-3.5%	-3.9%	-2.3%	29.6%	44.7%
Euro Area (DJ EuroStoxx)	559.6	63.38	0.2%	3.5%	11.0%	10.2%	19.5%
UK (FTSE 100)	8 810	66.66	1.9%	2.0%	8.3%	9.6%	7.7%
Switzerland (SMI)	13 004	69.40	0.4%	3.2%	12.1%	7.5%	7.1%
Japan (Nikkei)	37 785	30.12	-4.1%	-6.0%	-6.8%	21.3%	31.0%
Emerging (MSCI)	1 097	43.80	-4.3%	0.5%	2.3%	8.0%	10.2%
Brasil (IBOVESPA)	122 799	40.70	-3.4%	-2.6%	2.1%	-10.4%	22.3%
Mexico (IPC)	52 326	45.83	-2.5%	2.3%	5.9%	-11.0%	22.4%
India (SENSEX)	73 008	23.84	-2.8%	-5.5%	-6.1%	9.6%	20.3%
China (CSI)	3 888	48.13	-2.2%	1.9%	-0.9%	18.2%	-9.1%
Com. Services (MSCI World)	129.7	40.38	-2.8%	-3.6%	4.0%	31.9%	38.1%
Cons. Discretionary (MSCI World)	418.0	36.16	-2.4%	-4.9%	-0.8%	20.7%	29.5%
Cons. Staples (MSCI World)	289.1	65.45	1.1%	4.3%	6.2%	4.7%	3.2%
Energy (MSCI World)	249.2	48.20	-0.7%	1.8%	4.4%	2.9%	6.0%
Financials (MSCI World)	193.5	62.83	1.4%	1.8%	7.9%	25.1%	16.4%
Health Care (MSCI World)	374.1	61.04	1.0%	1.1%	7.4%	1.5%	4.1%
Industrials (MSCI World)	390.9	48.42	-0.1%	-0.4%	4.0%	12.8%	22.5%
Info. Tech. (MSCI World)	745.1	38.41	-4.4%	-2.0%	-3.0%	31.9%	51.4%
Materials (MSCI World)	320.9	44.43	-1.7%	0.1%	5.0%	-7.7%	12.6%
Real Estate (MSCI World)	996	64.60	1.3%	3.0%	4.7%	-0.4%	5.3%
Utilities (MSCI World)	166.0	53.69	-0.5%	1.6%	3.7%	13.0%	1.6%
Bonds (Bloomberg)							
World (Aggregate)	3.54%	61.94	0.4%	1.4%	2.0%	-1.7%	5.7%
USA (Sovereign)	4.14%	73.51	1.3%	2.2%	2.7%	0.6%	4.1%
Euro Area (Sovereign)	2.69%	60.15	0.5%	0.7%	0.5%	1.9%	7.1%
Germany (Sovereign)	2.23%	59.72	0.5%	0.6%	0.0%	0.6%	5.6%
UK (Sovereign)	4.43%	61.75	0.9%	0.8%	1.6%	-3.0%	5.6%
Switzerland (Sovereign)	0.57%	53.88	1.1%	-0.3%	-0.8%	5.4%	7.9%
Japan (Sovereign)	1.15%	42.72	0.4%	-0.8%	-1.7%	-2.1%	0.9%
Emerging (Sovereign)	6.75%	70.75	0.9%	1.5%	2.9%	7.0%	11.0%
USA (IG Corp.)	5.08%	68.99	0.8%	2.0%	2.6%	2.1%	8.5%
Euro Area (IG Corp.)	3.06%	66.43	0.2%	0.4%	1.0%	4.7%	8.2%
Emerging (IG Corp.)	6.33%	84.33	0.6%	1.8%	2.7%	7.0%	6.7%
USA (HY Corp.)	7.15%	72.54	0.3%	0.9%	2.0%	8.2%	13.4%
Euro Area (HY Corp.)	5.48%	83.44	0.1%	1.2%	1.7%	8.2%	12.1%
Emerging (HY Corp.)	8.26%	66.83	0.3%	0.9%	2.4%	14.9%	13.1%
World (Convertibles)	450.6	44.66	-1.0%	-0.4%	2.3%	9.4%	12.3%
USA (Convertibles)	608.4	42.92	-1.1%	-1.3%	1.7%	10.1%	14.6%
Euro Area (Convertibles)	247.9	68.58	1.1%	2.8%	6.5%	14.7%	7.3%
Switzerland (Convertibles)	254.3	68.54	2.3%	2.7%	5.6%	-10.5%	5.8%
Japan (Convertibles)	226.7	46.91	-0.8%	-0.3%	0.0%	6.4%	7.6%
Hedge Funds (Bloomberg)							
Hedge Funds Industry	1 634	81.91	n.a.	1.5%	1.5%	11.1%	7.8%
Macro	1 364	69.36	n.a.	1.6%	1.6%	7.4%	1.6%
Equity Long Only	2 208	69.35	n.a.	-0.1%	-0.1%	12.0%	15.9%
Equity Long/Short	1 707	80.28	n.a.	1.8%	1.8%	14.0%	7.7%
Event Driven	1 743	75.33	n.a.	1.0%	1.0%	8.7%	7.3%
Fundamental Equity Mkt Neutral	1 663	95.59	n.a.	0.7%	0.7%	12.4%	6.6%
Quantitative Equity Mkt Neutral	1 696	88.33	n.a.	1.9%	1.9%	9.8%	7.8%
Credit	1 613	96.61	n.a.	1.1%	1.1%	8.5%	8.1%
Credit Long/Short	1 636	100.00	n.a.	0.5%	0.5%	10.0%	11.2%
Commodity	1 808	87.00	n.a.	1.0%	1.0%	14.7%	7.3%
Commodity Trading Advisors	1 359	55.13	n.a.	1.3%	1.3%	7.9%	-3.6%
Volatility							
VIX	19.63	60.08	7.8%	19.5%	13.1%	39.4%	-42.5%
VSTOXX	18.63	60.66	13.1%	21.3%	9.5%	25.3%	-35.0%
Commodities							
Commodities (CRB)	539.2	n.a.	-2.1%	-0.4%	0.5%	5.1%	-8.0%
Gold (Troy Ounce)	2 863	n.a.	-3.0%	1.7%	9.1%	27.2%	13.1%
Silver (Troy Ounce)	31.19	n.a.	-3.6%	-1.3%	7.9%	21.5%	-0.7%
Oil (WTI, Barrel)	69.76	n.a.	-1.2%	-5.4%	-2.7%	0.1%	-10.7%
Oil (Brent, Barrel)	73.43	n.a.	-2.1%	-5.6%	-0.9%	-4.6%	-4.5%
Currencies (vs USD)							
USD (Dollar Index)	107.31	49.43	0.7%	-1.5%	-1.1%	7.1%	-2.1%
EUR	1.0404	48.11	-0.6%	0.6%	0.5%	-6.2%	3.1%
JPY	150.44	58.17	-0.5%	2.9%	4.5%	-10.3%	-7.0%
GBP	1.2593	54.67	-0.3%	1.1%	0.6%	-1.7%	5.4%
AUD	0.6215	37.81	-2.1%	-0.2%	0.4%	-9.2%	0.0%
CAD	1.4449	37.96	-1.3%	-0.1%	-0.4%	-7.9%	2.3%
CHF	0.9027	49.72	-0.6%	0.8%	0.5%	-7.3%	9.9%
CNY	7.2922	45.24	-0.6%	-0.7%	0.1%	-2.7%	-2.8%
MXN	20.473	49.54	0.0%	-0.5%	1.7%	-18.5%	14.9%
EM (Emerging Index)	1 742.6	46.08	-0.7%	0.0%	0.9%	-0.7%	4.8%
XBT	91 928	n.a.	8.8%	-9.8%	-1.9%	120.5%	157.0%

Source: Bloomberg, Altitude Investment Solutions — Total Return by asset class (Negative \ Positive Performance)

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