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Why Treasury auctions — and rising deficits — are becoming a focal point for markets and investors

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Allison Nathan: I feel compelled to start this episode with a confession. I don't normally pay much attention to Treasury bond auctions. But they've recently become a focal point for markets. Some even think that weakness in recent auctions is sending a troubling signal about US government debt. So, what's behind those concerns? And do they have merit?

Jonny Fine: Where's the demand coming from to satisfy all of this supply? And how much does the yield curve need to reprice in order to effectively accommodate the issuance needs of Treasury?

Allison Nathan: I'm Allison Nathan and this is Goldman

Sachs Exchanges.

[MUSIC INTRO]

Today I'm sitting down the Jonny Fine, who heads up our investment grade business in our Investment Banking business, and Alec Phillips, our chief US political economist in Goldman Sachs Research. Jonny, Alec, welcome.

Jonny Fine: Thank you for having us.

Alec Phillips: Thank you.

Allison Nathan: Jonny, let's start at a really basic level here. For those of us like me that don't live and breathe Treasury auctions, help us understand how they work.

Jonny Fine: Well, first of all I can't believe you don't live and breathe them every single day. I mean, it's the most fun thing that we could spend time talking about. But let me try and break it down for you.

Well, look, firstly, the Treasury auctions off a lot of securities in any one given year. Some of them weekly, some of them monthly, some of them quarterly. There are a lot of them. They're telegraphed well in advance. As an example, there's one today. It's probably happened by now, but I think $70 billion of five-year notes being auctioned by Treasury.

And the way these get auctioned is in what's called a Dutch auction format. Which basically means that participants submit a yield in which they're willing to buy a certain amount of the treasuries that are being auctioned. And what happens is that Treasury reviews all of those bids and then it figures out what's the highest yield that they need to sell those securities at so that the auction ultimately clears. That's how it works in practice.

Obviously, what Treasury's looking for is a lot of demand. And therefore, the best price at which they can auction those securities and markets focused on all the data that comes out after that.

Allison Nathan: So, the lower the demand for these securities, the higher the yields? The more you have to compensate the participants? **Jonny Fine:** That's correct. There are two elements of the auction itself that really the market focuses on when evaluating the quality of the auction itself. One is the bid to cover ratio. That's simply the amount of demand divided by the amount of supply. So, in a $70 billion auction, if there's $140 billion of supply, that's a two times bid to cover ratio.

The second element is the tail. And the tail is the number of basis points at which the auction clears at relative to the yield at which the auction was expected to clear at driven they the futures market. In a bad auction, there's a positive tail. So, for example, there was a Treasury auction earlier on this month that cleared with a 3-basis point tail. Generally, not viewed as a good thing because effectively the market demanded a higher yield for those securities to clear than had originally been anticipated.

Allison Nathan: Right. And just to be clear, there is a demand side and the supply side. So, on the one side, how much do investors want to own these securities? And on the other side, how much supply of them is there? So, 70 billion, the auction that is occurring today, it's a large size.

Jonny Fine: That's a big one, yep. That's a big one. Now, to be clear, if the markets are efficient, and we know that Treasury communicates on a very regular basis. They have quarterly refunding announcements, for example. The Treasury will tell us exactly how many securities they need to issue in any one given period.

So, if markets are efficient, they should embed all of that issuance in the price of securities going into these auctions. Now, markets aren't always 100 percent efficient. And that's why these tails exist. But ultimately, yeah, the supply and demand intersects on auction day. But it's very well telegraphed. No one's ever surprised by the Treasury auction that's announced on any one given day.

Allison Nathan: Right. But on average, the supply side or the size of these auctions has been growing because we have to fund fiscal deficits. I mean, is that really how to think about it? We have a lot of spending that we need to finance.

Jonny Fine: That's correct. Exactly. So, Treasury has to issue more. We're seeing these very, very large amounts having to clear through the market. And as a function of that, there's more attention from people like you on how these auctions are faring. So, people are becoming much more familiar with what bid to cover ratios are. People are becoming more familiar with what tails are.

And also, there's one third element as well, which is the ultimate makeup of who purchases the bonds and notes? There are 24 primary dealers in the United States. All of those primary dealers, Goldman Sachs included, are required to bid in auctions. Think of the primary dealer bid as effectively a backstop to all of the other external parties that otherwise might want to own treasuries.

If the primary dealers end up having a lot of those securities allotted to them, that's genuinely viewed as a bad thing because that means that the rest of the external population of treasury buyers, insurance companies, mutual funds, pension funds, depository institutions, individuals, international investors, so on and so forth. It basically means that they haven't shown up to the party to the extent that Treasury would like.

Allison Nathan: So, we've talked about these supply and demand dynamics at these Treasury auctions. We've actually seen long-dated rates, ten-year treasuries repricing substantially higher. Is that a function of this supply and demand or there's been so much focus on the Fed's trajectory from here, we've pushed back expectations of when Fed cuts will start. So, what's really driving that repricing that we've seen recently?

Jonny Fine: So, the short answer, I think, is that it's much more Fed than it is Treasury supply. But I'm going to compare and contrast the environment today to that which existed in October. In October of last year, the ten-year note hit 5 percent. And a significant component of that move and run up to 5 percent was driven by fears of supply, fears of auctions. It's what everyone was talking about at that particular moment in time.

That went away pretty quickly as, I think, the market really started to take the view that inflation was under control. There were going to be a ton of rate cuts in 2024. We didn't have to worry about this anymore. And in fact, as you'll recall, beginning of the year, we had almost seven rate cuts priced into Fed funds futures.

So, what's happened since the beginning of the year, maybe most importantly and so far as term yields are concerned? I would argue the most important thing has been the repricing of the terminal rate. I.e., that is where does the market now predict that the Fed will cut to at which point rates will remain stable? Again, Fed funds today, 5.25 - 5.5 percent. The terminal rate expected, kind of call it a couple years forward at the beginning of the year, was around 3.1 percent. That terminal rate today is 3.8 percent. 70 basis points higher.

What have ten-year yields done over that same period? They're 70 basis points higher. So, that to me would indicate that ten-year yields are where they're at today as a function of the move in terminal rates as opposed to necessarily the sheer volume of supply that Treasury's going to have to auction.

Allison Nathan: Right. And the market coming around to this view, higher for longer.

Jonny Fine: Yes. Absolutely.

Allison Nathan: So, as you just said, these happen all the time. But there seems to be a lot of concern around them. And we've discussed that these auctions are larger than, potentially, on average they have been in the past. Is that the main concern? Or what is the main concern?

Jonny Fine: Yeah, that's the main concern. Is that where's the demand coming from to satisfy all of this supply? And how much does the yield curve need to reprice in order to effectively accommodate the issuance needs of Treasury? And then, obviously, the corollary to that is that when you look at ten-year yields where they're at today, is that are there a certain number of basis points, and think of those as what contributes to mortgage interest rates for example, are there a certain number of basis points included in there that is solely as a result from the sheer amount of supply that the US government needs to issue?

Allison Nathan: Alec, let me turn to you. You're our chief US political economist, which means you spend your days thinking about how the government and the economy interact. We just heard the market perspective. Now let's talk about the political perspective. Is this something that politicians and government officials are worried about?

Alec Phillips: I think maybe slightly, but not that much more than before. And I think the question is what exactly should they be worried about?

So, you have, obviously, an elevated debt level in the sense of debt as a share of the economy. Debt to GDP. But if you look back at what we had post acute COVID, so say at the start of 2021, the debt level has basically remained rough the same since then. How can that be when the federal government ran a cumulative deficit of around 7 trillion over that period? And the answer is that you have low interest rates, and you also had a substantial increase in inflation that inflated away a lot of the existing debt.

And so, now you have potentially politicians coming in next year, post election, and the question will be for them, what should they be worried about? They can't really worry about the level of debt because it is what it is. There's nothing they can do about that. They can't really focus on the interest rate because they don't control it. So, the only thing they can really focus on is the deficit itself.

But there it's unclear that there's any real political benefit to doing that. If one looks at the polling question that Gallup has asked for a long time, essentially what is the most important problem in the country, you have right now

2 percent of respondents saying that the deficit or the federal budget is the most important problem. And you compare that with back in the early 1990s around one quarter of the public, and even more recently, you know, post financial crisis, 15 to 20 percent of the public. And so, I think it's just not as much of a political focus as it once was.

Allison Nathan: Interesting. So, why is there so much less concern about it today?

Alec Phillips: So, I think part of it is that we've now been through this a couple of times. So, I remember starting at Goldman almost 25 years ago when the concern in fixed income markets was that the Treasury was going to pay off all of its debt and there would be no benchmark interest rate anymore.

And so, now we have come a long way. We've seen multiple situations where the debt level has jumped by 20 or 30 percentage points of GDP quickly. And yet, here we are still, you know, muddling along. And so, I think part of it is just the fact that people seen this story before and are less worried having already seen it.

I think part of it is also the fact that there's just not a political emphasis on it. So, you look back to the early '90s when you had such a fiscal focus, at that point, remember you had Ross Perot running in the 1992 presidential election on a primarily fiscal platform that was generating a lot of attention. More recently, during the post -financial crisis period, you had Mitt Romney and Paul Ryan running, talked about Medicare reform and Social Security reform. Now, both candidates are emphasizing, essentially, that they won't cut Medicare or Social Security. And more generally, not talking about fiscal issues. So, I think we're just in a different environment than we were back then.

Allison Nathan: Right. Both candidates, as this US election approaches, neither one, just keying off of your comments as well, Alec, neither one is running on a platform of fiscal restraint. It's just not a key issue. So, you don't expect that to change.

Alec Phillips: So, I have been a little bit surprised at the lack of fiscal discussion in the presidential election. Not so much because the debt level demands it or because it should happen as a result of the longer-term fiscal challenges. But more specifically, because we have a big fiscal event coming up next year, which is the expiration of all of the personal tax cuts enacted in 2017.

And so, the election result will determine how that's handled. I think our view is that you'll have some of that and probably a lot of it extended under any scenario. But different scenarios will result in different outcomes. And so, I've been a little bit surprised that we haven't heard more about that.

With that said, I think the main distinction from the election in terms of fiscal policy outcomes isn't necessarily Trump versus Biden. I mean, those two things would be different. But the main distinction is do you have one party controlling everything or do you have divided government of some kind?

Allison Nathan: So, what does that difference really mean?

Alec Phillips: In a scenario where one party controls everything, so the House, the Senate, the White House, you typically end up with major fiscal legislation passing. And that's in part just because it's one of the most important things that the government does. But it's also in part because there is a lower threshold to pass fiscal legislation in the Senate, in particular, than to pass any other kind of legislation.

And so, even if with a 50/50 split and the vice president's breaking the tie or 51/49 in the Senate, similar margins in the House, even with that kind of a narrowly divided outcome, you probably would still see pretty big fiscal legislation pass.

So, in the case of an all-Republican scenario, that probably means extending all of the expiring tax cuts plus probably a little bit more on top of that in terms of tax cuts. And actually, probably also, slightly greater spending growth than what we have today under divided government.

And under a Democratic scenario, if you look as an example at the President's most recent budget, you have a spending boost of a little bit more than 1 percent of GDP, a tax increase of a similar size. I think probably all else equal, you would have a slight increase in the deficit. Though my guess is, between the two scenarios, probably a little bit more of an increase on the Republican side.

But the main thing is that in those scenarios, they can essentially do what they want to do. Whereas under a divided government scenario, it just becomes very difficult to do very much. And because you have some fiscal restraint built into the law, so as an example, tax cuts are set to expire. You have spending caps in place. Etcetera, etcetera. Doing nothing actually, surprisingly, probably results in a slightly smaller deficit than the other scenarios.

Allison Nathan: Interesting. But we're talking around the edges here, if I understand correctly, in that scenario.

Alec Phillips: Well, I mean I think the big change would be if we saw some kind of reform to the major entitlement programs. So, Medicare, Social Security. Or some commitment to raise net taxes for purposes of deficit reduction.

And right now, nobody is talking about any of that. As I mentioned, neither party is really talking about any major entitlement changes. And on the tax side, the tax discussion is usually couched in terms of how do we fund the new things that we want to spend money on?

Allison Nathan: Right. So, that all seems pretty far. Jonny, when you speak to the leaders of companies who are raising money in the debt markets or are considering doing that, how are they viewing all of this?

Jonny Fine: So, they're obviously looking at what the end result is of intersection of monetary policy and Treasury financing. And that intersection means high yields. We have very tight credit spreads right now. So, almost everyone that I speak to, they love the spread environment. They don't particularly like the yield environment.

But at the same time, I do think we've moved into a camp where the majority of clients that we speak to are just making peace with the higher for longer regime. And therefore, more elevated financing costs as a result. When you kind of think about what the behavior was in the first quarter of the year from a financing perspective, the first quarter in IG, investment grade financing markets in the US was the busiest quarter that we've ever seen. Now, a lot of that was driven by what I think is liquidate risk management, knowing there's an election at the back end of the year. A lot of companies looked at the market and said, "I've got financing to do. If I've got it to do at some point this year, let's go ahead and do it and not roll the dice and see what things look like in October and November." And history will tell you and data will tell you that's probably a good decision. And so, that was a significant driver of activity.

Look, companies, they're refinancing the debt that they have coming due. There's more limited expansion of their debt portfolios because the marginal cost of debt is that gets allocated to capital expenditure products or M&A. It makes it harder to hurdle in a higher interest rate environment. Really, the only entity that's really incurring significantly larger amounts of marginal debt is the US government. And I would say a lot of clients that I speak to are kind of scratching their head a little bit at that behavior.

Allison Nathan: Right. So, what are you watching in the markets, in the economy, Jonny, Alec, that would make you more or less concerned about the supply/demand balance in treasuries?

Jonny Fine: Well, I'm going to answer it slightly differently because I don't think-- look, at the end of the day we'll get moments in time where people will be concerned about deficit financing and Treasury issuance and things will have a long tail in auctions and so on and people will get concerned. And that will ebb and flow. I don't think we're going to get in the near term to a significant market correction as a function of this.

What I am looking at if I kind of think about the things that are out there that are worth following and spending some time focusing on. Obviously, employment's held up really well. Corporate earnings have held up really well. The US consumer has held up really well also, demonstrating, I think, pretty darn good resilience in the face of higher interest rates. Or maybe an insensitivity to higher interest rates.

Now, that can't last forever. And at some point, it will bite. I'm looking at the state of health of the US consumer and the indicators that I'll look at there generally come from bank earnings. We've seen a growth in consumer credit. We now have consumer credit above that which it was prior to COVID. The affordability is pretty good because wage prices have grown nicely. But that can change quickly.

In a high yield environment, right, the market both on corporate side as well as the consumer side, I think is quite highly levered now. And so, as this starts to bite, I think it could bite fairly quickly and then create an environment where the Fed has to take corrective action pretty dramatically.

Allison Nathan: And Alec, what are you watching? You've laid out a pretty concerning fiscal trajectory. What are you most focused on ahead?

Alec Phillips: One thing would be, obviously, as we get closer to the election whether we see either candidate propose substantial new fiscal measures that actually would expand the deficit. It's been in some ways a little bit surprising that if you look at what both of them have talked about, there hasn't been more of a promise of doing something that would have negative fiscal implications.

I mean, the other, sort of along the lines of what Jonny was saying, is if one wanted something to worry about beyond what we were just talking about on the fiscal side, consider that most of the debt that gets added to the US debt burden gets added during or shortly after recessions. So, if you take those periods out of the history of the last, you know, several decades, you wouldn't really have much of an increase in the debt load. And that's the case again now, right, where you basically saw a jump of around 20 percentage points during 2020, during sort of peak COVID. And then after that, sort of flat.

And so, you know, I think the big question for the fiscal side ultimately is, actually, when does the next recession occur? What is the fiscal response to that? And do we end up adding another, call it, 20 to 25 percent of GDP to the debt load as we did in the last two recessions?

Allison Nathan: So, what I'm taking away from both of you is that the fiscal trajectory is no doubt concerning. But I like the way you put it, Jonny, that a sharp market correction is unlikely to be the result of any issue in the debt auctions, per se. But that the biggest concern to really watch is, ultimately, the economy. The consumer and the broader economy. And, you know, if we have a recession, there'll be a lot more to talk about.

Jonny Fine: Yeah. I'd agree with that. But I'd also say there'll be bumps along the road. Like, there will be times where we likely have an auction that has a big tail. The market doesn't like it. We get a sell off. A lot of headlines. A lot of focus. A lot of attention to it. I think it'll be short lived. But those are the kinds of bumps in the road that I'd expect that we sustain.

Allison Nathan: Jonny, Alec, thanks so much for joining us.

Jonny Fine: Thank you for having us.

Alec Phillips: Thank you.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Wednesday, April 24th, 2024. I'm your host, Allison Nathan.

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