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Big Deficits Stir Risks in Bond Market

CAPITAL ACCOUNT

By Greg Ip

Note

The Federal Reserve isn't in the bailout business, Chairman Kevin Warsh told Congress this past week, especially not for the biggest debtor of all, the U.S. Treasury.

He did, though, append an escape clause: "In periods of crises like the 2020 pandemic and the 2008 crisis, central banks by design [need] to step into markets to create a fair price."

He was wise to flag an escape clause. He may need it.

Note

Near-record peacetime budget deficits mean the U.S. government must issue roughly $2 trillion a year in additional Treasury bills and bonds. Meanwhile, the Treasury market is changing shape: Patient investors are making way for faster-moving opportunistic players dependent on potentially fragile funding. It's combustible.

Superficially, the Treasury market looks healthy. Turnover, at $1.2 trillion a day, is up 11% this year from last. At auctions, there are roughly $2.30 to $2.50 of bids for every $1 of bonds for sale. The market withstood a jump in yields during last year's trade war and this year's war with Iran.

Note Note

Beneath the surface, things look more worrisome. The 30-year Treasury yields a half percentage point more than the 10-year, up from 0.2 point in early 2025. The relatively steeper rise in 30-year yields means investors are more wary of future deficits, inflation or random shocks.

The International Monetary Fund has found that on auction days, the 30-year yield has moved much more since 2022 than in the prior eight years.

Note

In 2010, dealers routinely bought 40% to 50% of Treasurys at auction (end-users such as foreign central banks and pension funds bought the rest). This year, they only bought 10% to 15%, according to JPMorgan Chase data. Maybe end-users just love Treasurys; or maybe dealers are reluctant to risk their own capital.

Note who?

Another red flag is a shift in who owns Treasurys. "Price insensitive" investors—central banks, sovereign-wealth funds, the Fed, commercial banks—owned 75% of all outstanding Treasury debt in 2007. Now, they own 52%.

The balance is in the hands of price-sensitive investors, who are quicker to buy or sell.

Most prominent: between 2023 and last September, hedge funds' share of Treasurys jumped from 4.5% to 8.5%, a Fed study found. These funds aren't typically betting on the direction of yields. Rather, they're doing arbitrage, such as buying a bond while selling an equivalent futures contract.

These hedge funds finance their bond buying with short-term "repo" loans from banks, collateralized by the bonds. This is a potential weak link. "A small number of dealers account for the bulk of repo lending to leveraged hedge funds," the Bank for International Settlements recently noted. Imagine if banks pull back those loans because of stress elsewhere on their balance sheets.

Repo rates would then surge, hedge funds could liquidate Treasury positions en masse, and yields would gyrate.

Note

Something like that unfolded in March 2020. It took massive lending and Treasury purchases by the Fed to calm the maelstrom.

High public debt in combination with these changes in market structure makes a bond market malfunction more likely, BIS research has found. But the Trump administration, rather than reducing deficits, is tinkering with the market itself. It has dialed back bank capital requirements, encouraging dealers to hold more Treasurys, with some success. It's pushing the adoption of stablecoins, which in turn spurs demand for Treasury bills as backing.

More controversially, it's holding down issuance of bonds in favor of Treasury bills, which have gone from 15% of total debt in 2019 to 22% now. Absent bigger bond auctions, that will hit 25% in 2028, according to Treasury's private-sector advisory committee, well above its recommended 20%. Above 20%, the rapid rollover of so much debt exposes the federal government to sudden jumps in borrowing costs.

"We know the administration has a stated goal of lowering long term rates," said Jay Barry, head of global rates strategy at JPMorgan. Declining to expand bond sales so far could be seen as an effort to keep long-term rates down, "knowing the midterms are coming up."

But starting in the next two years, a slug of debt issued during the pandemic will need to be refinanced, and Treasury's borrowing capacity, without expanded bond auctions, will fall roughly $1 trillion short of annual budget deficits, Barry calculates. Treasury at some point will have to expand sales of long-term debt.

Ramped-up bond issuance ups the risk something goes wrong. Disruptions can come out of the blue: a ransomware attack crippled one Treasury dealer in 2023. Last month, a customer error at Depository Trust & Clearing Corp. delayed payment on billions of dollars worth of trades.

Would the Fed similarly come to the rescue if bond trading breaks down? It did in March 2020. So did the Bank of England in 2022, when a proposed tax cut by then-Prime Minister Liz Truss triggered a surge in yields.

Barry says the market does assume the Fed would step in. This makes sense: If the Fed bails out private market players to save the financial system, surely it should do the same for Treasury. But what if bond buying crosses the line from crisis prevention to helping Treasury borrow? That's called "fiscal dominance," which compromises the central bank's independence.

That line can blur during a crisis. Warsh himself has long criticized the Fed for continuing to buy bonds after the crisis had passed in both 2008 and 2020. It wouldn't hurt for the Fed to spell out now where the line is, and how it plans to stay on one side in some future crisis.

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