Wall Street's 'Bond Vigilantes' Are at Battle as U.S. Debt Soars

The financial world has been debating if market appetite for U.S. debt is near a limit. Not everyone agrees this is something to panic about, but the ramifications for funding government priorities are immense.

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By Talmon Joseph Smith

For this article, Talmon Joseph Smith interviewed investors, traders and economists.

Typically, the esoteric inner workings of finance and the very public stakes of government spending are viewed as separate spheres.

And bond trading is ordinarily a tidy arena driven by mechanical bets about where the economy and interest rates will be months or years from now.

But those separations and that sense of order changed this year as a gargantuan, chaotic battle was waged by traders in the nearly $27 trillion Treasury bond market — the place where the U.S. government goes to borrow.

In the summer and fall, many investors worried that federal deficits were rising so rapidly that the government would flood the market with Treasury debt that would be met with meager demand. They believed that deficits were a key source of inflation that would erode future returns on any U.S. bonds they bought.

So they insisted that if they were to keep buying Treasury bonds, they would need to be compensated with an expensive premium, in the form of a much higher interest rate paid to them.

In market parlance, they were acting as bond vigilantes. That vigilante mind-set fueled a "buyers' strike" in which many traders sold off Treasuries or held back from buying more.

The basic math of bonds is that, generally, when there are fewer buyers of bonds, the rate, or yield, on that debt rises and the value of the bonds falls. The yield on the 10-year Treasury note — the benchmark interest rate the government pays — went from just above 3 percent in March to 5 percent in October. (In a market this large, that amounted to trillions of dollars in losses for the large crop of investors who bet on lower bond yields earlier this year.)

Since then, momentum has shifted to a remarkable degree. Several analysts say some of the frenzy reflected mistimed and mispriced bets regarding recession and future Federal Reserve policy more than fiscal policy concerns. And as inflation retreats and the Fed eventually ratchets down interest rates, they expect bond yields to continue to ease.

But even if the sell-off frenzy has abated, the issues that ignited it have not gone away. And that has intensified debates over what the government can afford to do down the road.

Federal debt compared with the size of the U.S. economy neared peak levels during the pandemic

Federal debt held by the public — the amount of interest-generating U.S. Treasury securities held by bondholders — relative to gross domestic product

Under current law, growing budget deficits increase the amount of debt the federal government must issue, and higher interest rates mean payments to bondholders will make up more of the federal budget. Interest paid to Treasury bondholders is now the government's third-largest expenditure, after Medicare and Social Security.

Inflation F.A.Q.

What is inflation? Inflation is a general increase in prices, which will cause a loss of purchasing power over time, meaning your dollar will not go as far tomorrow as it did today. It is typically expressed as the annual change in prices for everyday goods and services such as food, furniture, apparel, transportation and toys.

What causes inflation? It can be the result of rising consumer demand. But inflation can also rise and fall based on developments that have little to do with economic conditions, such as limited oil production and supply chain problems.

Is inflation bad? It depends on the circumstances. Fast price increases spell trouble, but moderate price gains can lead to higher wages and job growth.

Powerful voices in finance and politics in New York, in Washington and throughout the world are warning that the interest payments will crowd out other federal spending — in the realm of national security, government agencies, foreign aid, increased support for child care, climate change adaptation and more.

“Do I think it really complicates fiscal policy in the coming five years, 10 years? Absolutely,” said the chief investment officer for Franklin Templeton Fixed Income, Sonal Desai, a portfolio manager who has bet that government bond yields will rise because of growing debt payments.

“The math doesn’t add up on either side,” she added, “and the reality is neither the right or the left is willing to take sensible steps to try and bring that fiscal deficit down.”

Fitch, one of the three major agencies that evaluate bond quality, downgraded the credit rating on U.S. debt in August, citing an “erosion of governance” that has “manifested in repeated debt limit standoffs and last-minute resolutions.”

Yet others are more sanguine. They do not think the U.S. government is at risk of default, because its debt payments are made in dollars that the government can create on demand. And they are generally less certain that fiscal deficits played the leading role in feeding inflation compared with the shocks from the pandemic.

Joseph Quinlan, head of market strategy for Merrill and Bank of America Private Bank, said in an interview that the U.S. federal debt “remains manageable” and that “fears are overdone at this juncture.”

Samuel Rines, an economist and the managing director at Corbu, a market research firm, was more blunt — laconically dismissing worries that a bond vigilante response to debt levels could become such a financial strain on consumers and companies that it sinks markets and, in turn, the economy.

"If you want to make money, yawn," he said. "If you want to lose money, panic."

Interest payments for Treasuries have increased rapidly

Federal spending on interest payments to holders of Treasuries

The debate over public debt is as fierce as ever. And it echoes, in some ways, an earlier time — when the term "bond vigilantes" first emerged.

In 1983, a rising Yale-trained economist named Ed Yardeni published a letter titled "Bond Investors Are the Economy's Bond Vigilantes," coining the phrase. He declared, to great applause on Wall Street, that "if the fiscal and monetary authorities won't regulate the economy, the bond investors will" — by viciously selling off U.S. bonds, sending the government a message to stop spending at its heightened levels.

On the fiscal side, Washington reined in spending on major social programs. (A bipartisan deal had actually been reached shortly before Mr. Yardeni's letter.) On the monetary side, the Federal Reserve began a new series of interest rate increases to keep inflation at bay.

The Treasury bond sell-off continued into 1984, but by the mid-1980s, bond yields had come down substantially. Inflation, while mild compared with the 1970s, averaged about 4 percent in the following years, a level not tolerable by contemporary standards. Yet interest payments on government debt peaked in 1991 as a share of the U.S. economy and then declined for several years.

That sequence of events may be an imperfect guide to the Treasury bond market of the 2020s.

This time around, the Peterson Foundation, a group that pushes for tighter fiscal policy, has joined with policy analysts, former public officials and current congressional leaders to push for a bipartisan fiscal commission aimed at imposing lower federal deficits. Many assert that "tough questions" and "hard choices" are ahead — including a need to slash the future benefits of some federal programs.

But some economic experts say that even with a debt pile larger than in the past, federal borrowing rates are relatively tame, comparable with past periods.

According to a recent report by J.P. Morgan Asset Management, benchmark bond yields will fall toward 3.4 percent in the coming years, while inflation will average

2.3 percent. Other analyses from major banks and research shops have offered similar forecasts.

In that scenario, the "real" cost of federal borrowing, in inflation-adjusted terms — a measure many experts prefer — would probably be close to 1 percent, historically not a cause for concern.

Adam Tooze, a professor and economic historian at Columbia University, argues that current interest rates are "not a cause for action of any type at all."

At 2 percent when adjusted for inflation, those rates are "quite a normal level," he said on a recent podcast. "It is the level that was prevailing before 2008."

In the 1990s, when bond vigilantes helped prod Congress into running a balanced budget, real borrowing rates for the government were hovering higher than they are now, mostly around 3 percent.

Government yields were historically low before recent rise

The inflation-adjusted rate for the 10-year Treasury note, a key market measure of "real" government borrowing cost, jumped well above its 2010s levels this year.

In the broader context of the interest rate controversy, there is disagreement on whether to even characterize U.S. debt as primarily a burden.

Stephanie Kelton, an economics professor at Stony Brook University, is a leading voice of modern monetary theory, which holds that inflation and the availability of resources (whether materials or labor) are the key limits to government spending, rather than traditional budget constraints.

U.S. dollars issued through debt payments "exist in the form of interest-bearing dollars called Treasury securities," said Dr. Kelton, a former chief economist for the U.S. Senate Budget Committee. She argues, "If you're lucky enough to own some of them, congratulations, they're part of your financial savings and wealth."

That framework has found some sympathetic ears on Wall Street, especially among those who think paying more interest on bonds to savers does not necessarily impede other government spending. While the total foreign holdings of Treasuries are roughly $7 trillion, most federal debt is held by U.S.-based institutions and investors or the government itself, meaning that the fruits of higher interest payments are often going directly into the portfolios of Americans.

David Kotok, the chief investment officer at Cumberland Advisors since 1973, argued in an interview that with some structural changes to the economy — such as immigration reform to increase growth and the ranks of young people paying into the tax base — a debt load as high as $60 trillion or more in coming decades would "not only not be troubling but would encourage you to use more of the debt because you would say, 'Gee, we have the room right now to finance mitigation of climate change rather than incur the expenses of disaster.'"

Campbell Harvey, a finance professor at Duke University and a research associate with the National Bureau of Economic Research, said he thinks "there is a lot of misinformation" about current U.S. debt burdens but made clear he views them "as a big deal and a bad situation."

"The way I look at it, there are four ways out of this," Mr. Harvey said in an interview. The first two — to substantially raise taxes or slash core social programs — are not "politically feasible," he said. The third way is to inflate the U.S. currency until the debt obligations are worth less, which he called regressive because of its disproportionate impact on the poor. The most attractive way, he contends, is for the economy to grow near or above the 4 percent annual rate that the nation achieved for many years after World War II.

Others think that even without such rapid growth, the Federal Reserve's ability to coordinate demand for debt, and its attempts to orchestrate market stability, will play the more central role.

"The system will not allow a situation where the United States cannot fund itself," said Brent Johnson, a former banker at Credit Suisse who is now the chief executive of Santiago Capital, an investment firm.

That confidence, to an extent, stems from the reality that the Fed and the U.S. Treasury remain linchpins of global financial power and have the mind-bending ability, between them, to both issue government debt and buy it.

There are less extravagant tools, too. The Treasury can telegraph and rearrange the amount of debt that will be issued at Treasury bond auctions and determine the time scale of bond contracts based on investor appetite. The Fed can unilaterally change short-term borrowing rates, which in turn often influence long-term bond rates.

"I think the fiscal sustainability discourse is generally quite dull and blind to how much the Fed shapes the outcome," said Skanda Amarnath, a former analyst at the Federal Reserve Bank of New York and the executive director at Employ America, a group that tracks labor markets and Fed policy.

For now, according to the Treasury Borrowing Advisory Committee, a leading group of Wall Street traders, auctions of U.S. debt "continue to be consistently oversubscribed" — a sign of steady structural demand for the dollar, which remains the world's dominant currency.

Adam Parker, the chief executive of Trivariate Research and a former director of quantitative research at Morgan Stanley, says that concerns regarding an oversupply of

Treasuries in the market are conceptually understandable but that they have proved unfounded in one cycle after another. Some think this time is different.

“Maybe I’m just dismissive of it because I’ve heard the argument seven times in a row,” he said.

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