

Letter n°158

Causes and implications of tensions in the bond market in the United States and the world

“The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists.” Ernest Hemingway.

Hemingway, a Nobel Prize winner in Literature, was not an economist, but he was right on target. Trump’s election owed much to promises of lower inflation and increased purchasing power, but his policies have had the opposite effect. He is mismanaging the country, would like to lower rates to 1% to enable monetary inflation, and has chosen war without a clear strategy.

Fortunately, Kevin Warsh, recently appointed by Trump, has not yielded to Trump’s pressure, is striving to preserve the independence of the FED, and is raising rates as inflation is set to increase further.

Let us analyse the causes of tensions in long-term rates, followed by the outlook for short-term rates and their implications.

The factors driving tensions in long-term interest rates are numerous:

- The first factor is rising inflation, at 3.4% in August in the United States, or even 3.7% according to the PCE index followed by the FED. It is likely to continue rising in the coming months, as recent increases in oil and gas prices will be passed through and Trump’s tariff policy is also inflationary. Over the past 5 years, inflation has thus remained well above the 2% target, and the FED had to react.
- The second factor driving tensions is the particularly high level of the US budget deficit, at 5.9% of GDP in 2025 and 6.4% in 2024, despite the absence of a recession! Federal spending represents 23% of GDP, while revenues account for only 17%. Trump was counting on \$450 billion from his tariffs, but, rightly so, the Supreme Court invalidated this policy and refunds have begun at a rapid pace. According to the OECD, the deficit is expected to reach 7.5% this year, or \$2.1 trillion compared with \$1.8 trillion in 2025, as interest costs and the defence budget increase. The war against Iran has already cost \$38 billion and weapons stocks are significantly depleted. Trump’s initial ambition to abolish income tax, representing \$2.5 trillion in revenues, is unquestionably unfeasible and appears to have been forgotten. If Trump were able to distribute, as he promised, \$5,000 to every American in the event of a Republican victory in the mid-term elections, this would add \$1.2 trillion to the deficit.

According to Nobel Prize winner Stiglitz, one of the causes of this deficit is the lower contribution from corporate income taxes, at 1.3% of GDP, half the level of the 1970s, despite the share of profits as a percentage of GDP having doubled over the same period.

In other major countries, the deficit as a percentage of GDP is lower but no less problematic, as illustrated by the United Kingdom and France.

- The third factor driving tensions is public debt, a structural extension of the previous point. In the United States, it has already exceeded \$40 trillion, equivalent to 125% of a \$31.5 trillion GDP, and has increased by \$17 trillion since 2019, an amount equivalent to the debt accumulated during the 225 years of the United States’ existence. Federal debt alone exceeds 100% of GDP, compared with 32% before 2008, while the previous record, 106% of GDP, dated back to 1946 at the end of the war. According to the IMF, federal

government issuance combined with that of state and local entities exceeds 7.5% of GDP this year, a higher percentage than in any other major country.

- The fourth factor, and corollary of the previous one, is the financial cost of federal debt. It exceeds \$1 trillion, or 3.3% of GDP, compared with an average of 2.1% of GDP over the past 30 years. Interest payments on the debt are now higher than the defence budget and are exceeded only by healthcare and pension budgets.
- The fifth factor is the term premium, the idea that short-term rates will increase and therefore the demand for a premium for holding long-term bonds.
- The sixth factor driving tensions is increased volatility, the reduction in the Treasury portfolios held by foreign central banks to 31%, and the increase in the relative weight of hedge funds in Treasury holdings. China, which held \$1.3 trillion of Treasuries in 2013 and was the largest holder, is now the third-largest holder with \$600 billion, behind the United Kingdom, with nearly \$1 trillion, and Japan, with approximately \$1.2 trillion. In 2007, 75% of US debt was held by stable investors, central banks and sovereign wealth funds; today, only 50% is.
- Finally, the multiplication of bond issuance by technology companies is adding to this congestion in the bond markets. The phenomenon is new. Just two years ago, the GAFAM companies were boasting of being generators of Free Cash Flow and were increasing their share buyback programmes. The race to invest in AI, \$800 billion this year and \$1 trillion in 2027, has changed the situation, and markets are beginning to worry not only about this debt spiral, as reflected in the evolution of Oracle's CDS, but also about future massive impairments, or "write-offs", of investments, as competition is intense. In the first 7 months of the year alone, according to Dealogic, the 6 tech giants issued \$245 billion of bonds.

Short-term rate increases are not over:

- In Europe, the European Central Bank has already raised its interest rates twice, now at 2.5%, while the Bank of England has kept its rate at 3.75% but is signalling a possible increase soon. Only the SNB appears capable of keeping its rates at 0, and this widening differential is one of the reasons for the Swiss Franc's relative weakness recently.
- In Japan, the central bank should continue raising its rates and move towards 2% as public debt is at a world record of 230% of GDP, net debt is at 130% of GDP, the inflation rate is close to 2%, the new Prime Minister, Ms Takaichi, wants to lower VAT, which nevertheless accounts for 20% of government revenues, and there is also the challenge of stabilising the currency, which has recently been at a historically low level.
- China, despite being highly indebted at 135% of GDP (public debt doubled between 2019 and 2024 to \$23 trillion) due to a budget deficit of 15% of GDP over the past 5 years, is not considering raising short-term rates and, in a context of weak credit demand, long-term rates are low at 1.6%. Nevertheless, the situation is concerning because total debt, when corporate and household debt are consolidated, stands at 350% of GDP. For \$1 of GDP, China needs \$6 of debt, and it has recently been necessary to finance a second \$54 billion bank recapitalisation plan.

China's financial situation, since the property crisis, is more concerning than that of Japan in the early 1990s following its property crisis. GDP per capita was then 108% of that of the United States, whereas China's is less than 20%.

In the United States, Kevin Warsh, chosen by Donald Trump to lower interest rates to 1%, had no choice but to raise them by 0.25% to 3.75-4%, for the first time since summer 2023. Unlike his predecessors, he does not want to give the market indications about his policy, but his credibility is at stake and the recent widening of the spread between 2-year and 10-year bonds is a good indicator of another increase by the end of the year. Many anticipate US rates between 4.25% and 4.5%, meaning another 2 rate increases by the end of the first quarter of 2027. The immediate effect of the increase in short-term rates was a slight rise in the 30-year Treasury yield to 5.35%.

If Donald Trump were to increase pressure on the Fed to slow the increases in short-term rates, tensions on long-term rates would only intensify.

Scott Bessent tried to stop the rise in long-term rates by selling short-term bonds and reinvesting the proceeds in long-term bonds, but he failed, and this attempt to manipulate rates against the fundamental trends of the market is unlikely to succeed.

A recession would interrupt this rise, but for now, it is not anticipated in the United States as the unemployment rate remains low at 4.1%, expectations for GDP growth stand at 2.3%, and recent strong employment figures have increased pressure on rates.

Conclusion: *“Inflation is the one form of taxation that can be imposed without legislation.” Milton Friedman.*

- As Milton Friedman wrote, inflation is harmful to the majority of economic actors. Kevin Warsh, as a disciple of Friedman, would like to reduce the FED's balance sheet, currently at \$6.6 trillion (\$900 billion in 2008 but \$9 trillion in 2022), but this would reduce liquidity and worsen tensions on long-term rates. Rising interest rates increase the cost of credit for businesses and individuals, thereby slowing investment, the property market (as 30-year mortgages now approach 7%), and consumer credit, particularly for automobile purchases. These are all sectors to be approached with caution in the stock market. The increase also worsens the refinancing cost of public debt and should ultimately affect GDP growth.
- Evidently, raising short-term rates is not the optimal response to inflation caused by a supply shock, in this case the rise in oil prices. Kevin Warsh would like to limit this increase in rates because he expects investment in AI to result in higher productivity and therefore higher potential growth, but it is premature to take a position on the validity of this thesis.
- Other causes of inflation, not developed in this Letter, include protectionist measures, the cost of reshoring, and the impact of geopolitical tensions on transportation costs.
- According to the OECD, debt in OECD countries averages 112% of GDP, 40 percentage points higher than in 2008. In the Eurozone, it is lower at 87%, but there is a wide contrast between Germany at 64% of GDP, Italy at 137%, and Greece at 146% of GDP and, according to the IMF, if European countries do not reverse the trend, debt in absolute terms will double over the next 15 years. In the United States, overall public debt exceeding 140% of GDP is feared as early as 2030.
- By comparison, emerging market debt, at 45% of GDP, appears more attractive, but the IMF, in its report, draws attention to more costly access to financial markets, more limited fiscal headroom, and stresses the need for selectivity, as 56 of these countries are in a critical situation.
- Global debt, at \$350 trillion, more than 3x global GDP, is constantly drifting higher. Few governments are reducing their deficits, and even fewer are in a position of fiscal balance. Between the effects of demographic ageing, slowing global economic growth and increased financing needs for defence, the energy transition, healthcare and pensions, there is nothing to suggest even a temporary improvement. It should be noted that there is no correlation between public spending and public debt, as the United States has high debt but low public spending as a percentage of GDP.
- In the markets, recent months have seen a divergence between bond markets and equity markets, with the former expressing concerns and the latter showing confidence, a widening spread between short-term and long-term rates but a narrowing spread between corporate bonds and government bonds. Two caveats, however: the rapid deterioration of private debt, now exceeding \$3 trillion, and default risks, as well as the weakening of the private equity market, but we do not invest in these two asset classes.

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