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The Big Picture: Higher US rates to last longer with rising fiscal dominance

宏观视野: 财政扩张将支持美债利率保持高位

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Long-term US rates to stay high even though Fed hikes are drawing to a close. We expect US economic resilience to continue, supported by an improved private sector balance sheet and solid capex on the back of industrial policies. The resilience of the economy and likely higher neutral rates will reduce the scope for the Fed to cut rates in coming years. As disinflation continues, we expect a modest 50bp interest rate cut next year, and long-term interest rates to hover around 4% in the next two years. Policymakers will continue to use liquidity support rather than large rate cuts to counter any credit stress, in our view.

US fiscal deficit will continue to add to demand and support elevated rates. Fiscal expansion since the pandemic has seen the real interest rate catching up with potential growth, in line with our earlier expectations. In coming years, large interest payments will increasingly add to the fiscal deficit and to fiscal debt, keeping rates high but giving rise to uncertainty over terms of growth and debt sustainability.

Dollar to weaken albeit gradually. While higher rates will support the dollar in the near-term, we expect the dollar to weaken gradually from narrowing interest rate differentials with other countries and deteriorating fiscal positions. We maintain our expectation of modest RMB appreciation as the Chinese economy recovers and sentiment improves in 2H.

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美国财政赤字和债务将继续上升，支持利率高位。疫情以来的财政扩张、安全资产供应上升，促使美国实际利率趋向其潜在增长，与我们之前的预期一致。未来几年，财政利息支出将进一步增加财政赤字和政府融资需求，支持利率保持高位。近期的债务上限协议达成后减少了短期的财政紧缩压力，但中期增长和债务可持续性仍面临风险。

美元短期维持坚挺，中期预计继续回落。美国利率上升在短期内会对美元形成支撑，但我们预计随着联储加息见顶，以及财政赤字加大，美元将逐渐下行。随着下半年国内经济复苏和情绪改善，我们维持人民币小幅升值的预期。

US long-end yields have marched towards cyclical highs, notwithstanding a potential peaking of Fed hikes. In our view, higher yields were underpinned by the greater prominence of rising fiscal deficit and economic resilience. In this piece we examine the factors contributing to higher yields and highlight the rate outlook.

US government deficit and fiscal debt set to rise, adding to higher rates

We anticipate that the large DM fiscal expansion during the Covid-era would mark a fundamental shift in macro policy, and that an increase in government debt would reverse the safe asset shortage in the years following the GFC, implying higher rates (see *The Big Picture: Global macro landscape post coronavirus and China's options*, 15 May 2020). The suppressed real rates in post GFC years have normalized towards trend growth (Fig 1), as we previously predicted.

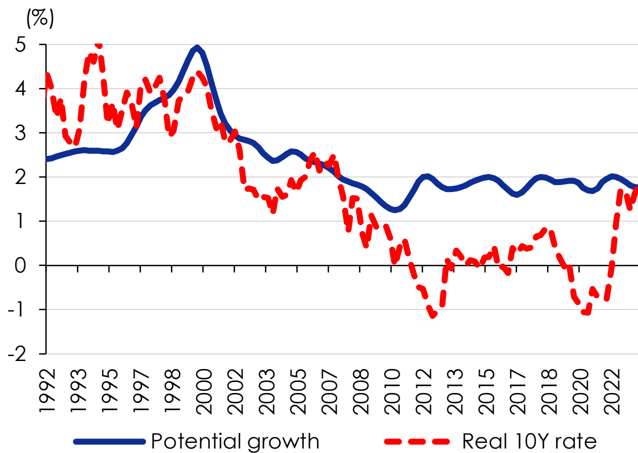
This fiscal deficit is likely to remain large. The debt deal reached in early June between the Republican Party and the Biden administration was largely a win for the government. As the two sides agreed to suspend the nation's borrowing limit for two years, the debt deal allowed the government to continue borrowing money and pay its bills on time. In exchange, the government committed to modest spending cuts. While the deal reduced the immediate downside growth risks from sharp spending cuts, long-term fiscal issues remain prominent and, indeed, may have become more pressing with the curbs on government borrowing in the coming two years removed. Thus, already bloated government debt is set to grow even more.

According to the Congressional Budget Office, the US federal budget deficit is forecast to rise to 5.8% of gross domestic product (GDP) this year, up from 3.7% of GDP in 2022. Assuming some consolidation of the primary deficit, the total deficit will stabilize between 5.1% and 5.8% of GDP in the next few years. Rising interest payments, however, will cause total debt to climb quickly post 2027F. Total federal debt held by the public is projected to climb from 98% of GDP this year to 108% in 2029. We expect rising interest payments and ballooning federal debt to compound one another, with no stabilization in sight (Fig 2).

CBO estimates may still be on the conservative side. Fitch estimates that the general government deficit will exceed 6% of GDP in the next three years, reflecting cyclically weaker federal revenues, new spending initiatives, and a higher interest burden. Fiscal consolidation will be small. Reflecting the expected fiscal deterioration in the next three years and high and growing government debt, Fitch announced in early August that it was downgrading the US sovereign rating from "AAA" to "AA+", helping to crystalize the pressure of public finances in the US. Around the same time, the US Treasury Department announced a larger-than-expected increase in its refinancing plans for the August-October quarter following three quarters of relatively minor changes. Furthermore, the US Treasury's comments suggest issuance supply is likely to increase further in coming quarters.

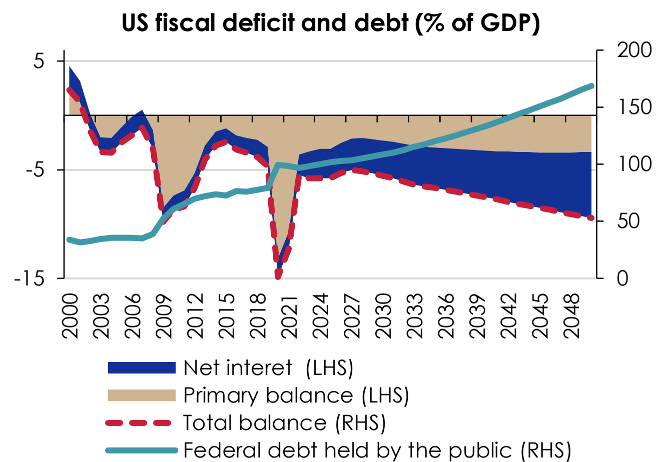
So far, the large increase in Treasury supply has been absorbed by the market with no apparent market stress. The bid-to-cover ratio, a proxy for demand for 10-year Treasuries has largely kept stable (Fig 3). In addition, the Bloomberg US Treasury Liquidity Index, a measure of prevailing liquidity conditions in the US Treasury market with remaining maturity of one year or longer, points to adequate overall US Treasury market liquidity. However, sharply larger supply may have added upward pressure on Treasury yields. While long-term bond yield was relatively stable so far this year on the back of steady Treasury bond issuance, the 10-year yield surged following the announced increase of bond issuance (Fig 4). By maturity, the planned increase in Treasury supply in the August-October quarter was across the curve with greater concentration on the short-end, but supplies of all maturities increased notably relative to the outstanding debt stock, contributing to rising yields.

Fig 1: Real rates are catching up to potential growth, as we previously anticipated



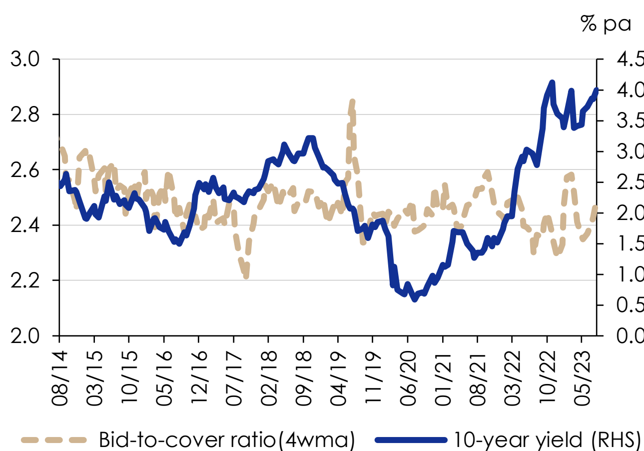
Source: Fed, Bloomberg, CCBIS

Fig 2: Long-term fiscal pressure: increasing interest payments and government debt



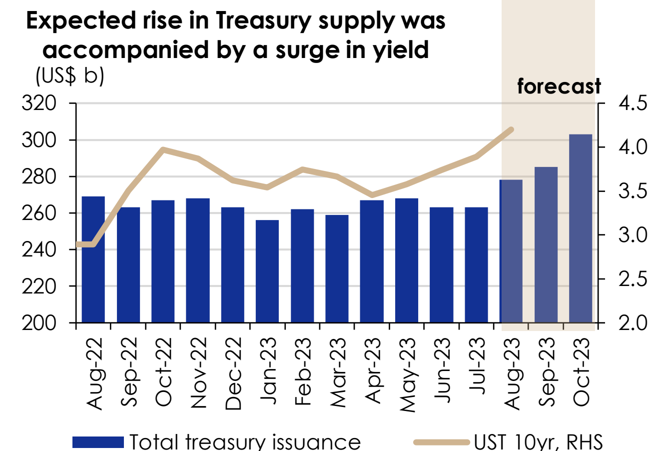
Source: CBO, CCBIS

Fig 3: Treasury demand remains solid despite higher yields



Source：Bloomberg, CCBIS

Fig 4: Rising issuance supply added upward pressure on yields

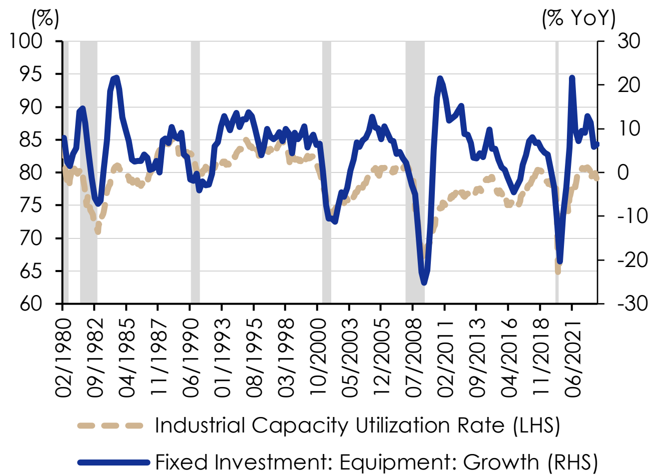


Source: Bloomberg, CCBIS

Economic resilience implies shallower Fed rate cuts

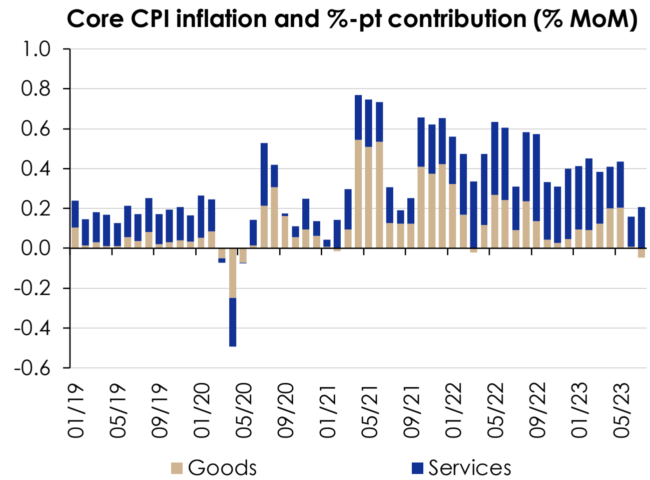
Better-than-expected economic resilience in the US suggests that the coming economic downturn is likely to be mild, reducing rate cut expectations and supporting a steepening of the US Treasury curve. Despite rapid monetary tightening, the US economy has proven resilient. Growth beat expectations and accelerated from 1Q, with robust consumption and a resilient labour market. Business investment, which tends to weaken substantially before each recession of past cycles, has stayed remarkably strong of late (Fig 5). Although improved supply chains helped ease goods prices early this year, contributing to disinflation (Fig 6), solid services inflation points to still-strong domestic demand. The Atlanta Fed's GDPNow model estimates the pace of growth accelerated in early August.

Fig 5: Capex remains strong



Source: CEIC, CCBIS

Fig 6: US disinflation on track, service inflation still points to solid demand



Source: CEIC, CCBIS

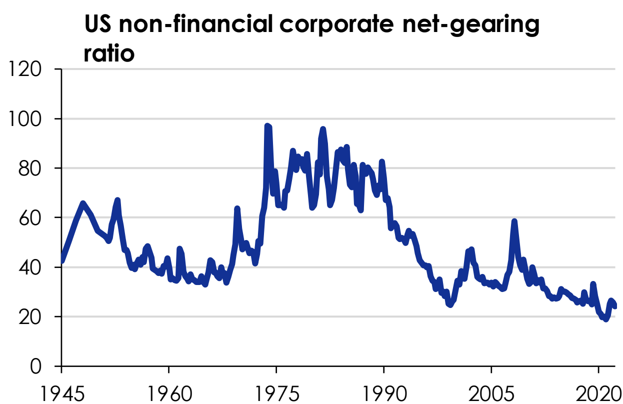
Economic resilience, against the backdrop of rapid monetary tightening, may reflect several factors

First, the private sector's balance sheet is robust. To the extent that borrowing conditions have tightened, the corporate sector as a whole has been cushioned as it maintains a relatively low net leverage ratio, helping to reduce the sensitivity of business investment to monetary tightening (Fig 7). Despite rate hikes and US banks continuing to tighten their lending criteria, the corporate credit spread has been largely benign and financial conditions have loosened somewhat. Government policy has also eased some of the contagion risk of US bank fallouts in April.

In addition, consumer spending has felt little pressure from elevated interest rates because of low effective mortgage rates and the strong job market. New mortgage applications have fallen sharply amid rising mortgage rates. However, many borrowers have locked in very low rates for long-term fixed rate mortgages. The effective rates on outstanding mortgages remain very low at below 4%, as pointed out by a recent Fed study. It would appear that monetary policy transmission has been blunted in this cycle.

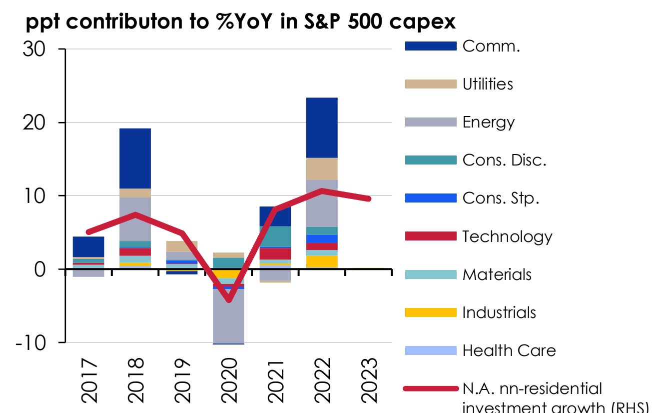
Second, long-term industrial plans support business investment. The US has enacted three pieces of legislation to support investment in infrastructure, the green transition, and advanced manufacturing. Robust demand from these structural themes supported investment in energy, industrial, and other related sectors last year and is likely to continue (Fig 8). Some of the initiatives, however, imply a continued burden of fiscal spending and borrowing from the future. In total, we estimate these legislations will increase the budget deficit by US$1trillion (or about 0.3-0.5 of US GDP each year) through 2031F, jeopardizing the stable primary fiscal deficit in the CBO forecast.

Fig 7: Low corporate net leverage increases private sector resilience



Source: Fed, CCBIS

Fig 8: Strong investment supported by energy and infrastructure sector is likely to continue



Source: Bloomberg, CEIC, CCBIS

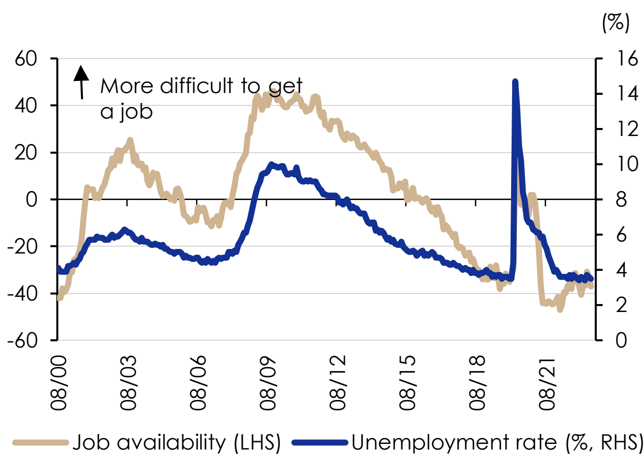
Higher rates to continue in the next few years

The analysis above suggests that central banks are not the only game in town, and an expansionary fiscal stance will play a bigger role in affecting global rates and financial conditions in coming years. In fact, a recent New York Fed blog estimates that the short-term r* may have increased by about 1ppt post pandemic. As a result, the current monetary policy setting may not be very restrictive, indicating less room to cut and greater economic resilience.

As inflation cools and the labor market moderates, we expect the Fed may have reached the peak of its current tightening cycle, although forthcoming cuts are likely to be slow and shallow. While a technical recession cannot be ruled out, it is likely to be mild. Our previous research suggests the Fed typically commences rate cuts only when an uptrend in the unemployment rate has been established. For now, leading indicators continue to suggest overall labor markets remain tight, though they are softening slowly (Fig 9). We anticipate the first cut in the Fed Funds rate will come in 2H24F with a cumulative 50bp cut in 2024F, which is smaller than our previous forecasts given continued economic resilience in the US, and lower than the 90-100bps cut anticipated by the market. Policy makers are likely to resort to liquidity measures rather than rate cuts to counter the credit stress during the economic slowdown, in our view.

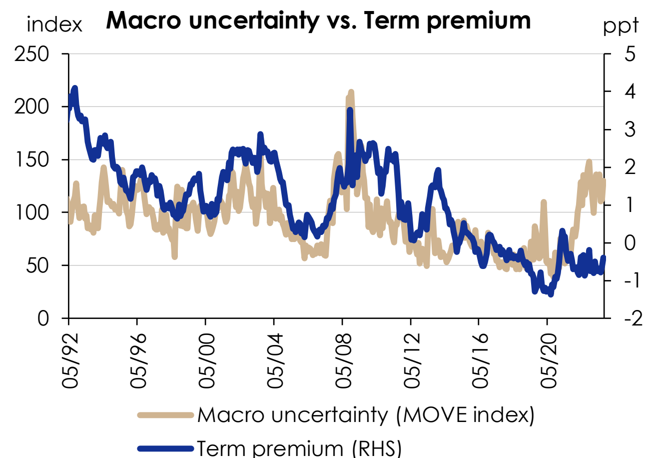
While upward pressure on yields may ease as the market absorbs the surge in Treasury supply in recent weeks, elevated yields will likely persist. We lift our 2-year and 10-year bond yield forecasts because of expectations of reduced interest rate cuts amid economic resilience, with a bigger increase in the 10-year bond yield. Consistent with the past monetary policy cycles since 1995, the yield curve inversion tends to decline following the peak of policy tightening. Any increase in term premium, in light of the persistent macro uncertainty, will add to the yield curve steepening (Fig 10).

Fig 9: Labour markets remain tight



Source: CEIC, CCBIS

Fig 10: Elevated macro uncertainties could push up term premium



Source: Bloomberg, CCBIS

Table 1: US eco and rate forecasts

	3Q23F	4Q23F	1Q24F	2Q24F	3Q24F	4Q24F
US GDP (% YoY)	2.3	1.9	1.5	0.8	0.7	0.9
US core PCE inflation (% YoY)	3.8	3.2	2.6	2.5	2.5	2.5
US Fed fund target range (EOP %)	5.25-5.50	5.25-5.50	5.25-5.50	5.25-5.50	5.00-5.25	4.75-5.00
US 2-year bond yield (EOP %)	5.1	4.7	4.6	4.5	4.3	4.3
US 10-year bond yield (EOP %)	4.3	4.0	4.0	4.0	4.0	4.0

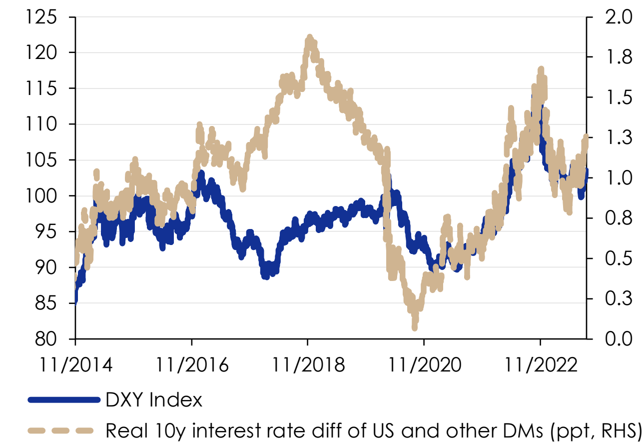
Source: Bloomberg, CEIC, CCBIS

Near-term dollar strength to persist, keeping the RMB under pressure, while Dollar to decline in the medium term

The impact of fiscal dominance on the dollar has been mixed. While the larger deficit is likely to be dollar negative, the interest rate differential and US economic outperformance are likely to support the dollar (Fig 11). However, as monetary tightening may have peaked, we see limited dollar strength going forward and expect the dollar to resume its decline.

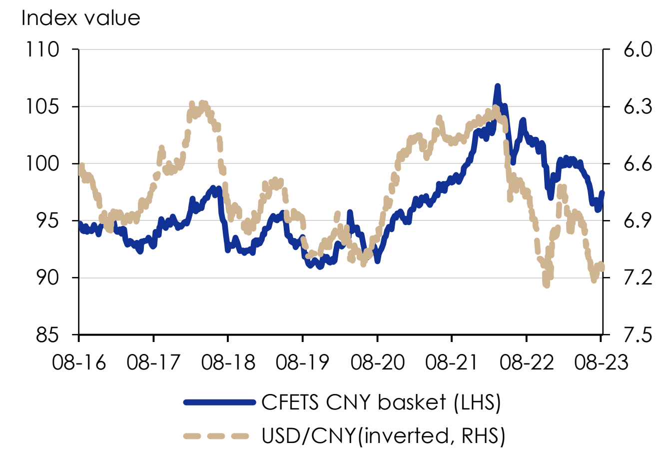
The recent CNY weakness has reflected both a strong dollar and soft Chinese data that prompted domestic monetary easing and dimmed market sentiment. While we expect monetary policy to stay accommodative, an increase in fiscal support is likely more supportive in lifting domestic demand. The recovery of the global manufacturing cycle is also expected to help Chinese industrial momentum and trade growth. We maintain our USDCNY rate forecast at 6.9 by the end of 2023F, as the Chinese economy gradually recovers and sentiment improves.

Fig 11: Interest rate differentials between the US and other nations may have peaked



Source: Bloomberg, CCBIS

Fig 12: CNY weakened against the dollar although the CNY basket remains above the pre-pandemic level



Source: Bloomberg, CCBIS

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