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Trump and the Bond Market

Why a Flight From U.S. Treasuries Is Unlikely

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KEVIN LAMARQUE / REUTERS

U.S. President Donald Trump and Treasury Secretary Steven Mnuchin at the Treasury Department in Washington, April 2017.

Donald Trump's presidential campaign frightened bond market investors around the world. Trump pledged to slash federal income taxes and spend up to $1 trillion upgrading the United States' infrastructure. Investors worried that his victory would lead to massive federal deficits and runaway inflation, eroding the value of their holdings. The title of an April 2016 article in Forbes captured the mood: "President

Donald Trump Would Destroy the Bond Market."

The anxiety was particularly acute among foreign investors, who own around 40 percent of the $14 trillion worth of outstanding U.S. Treasury securities. When Trump hinted during the campaign that he would "make a deal" with creditors to reduce the value of their Treasuries, pundits asked whether the Chinese and Japanese central banks would begin to sour on the U.S. debt they had been stockpiling as part of their foreign exchange reserves.

To be sure, foreign confidence in U.S. Treasuries had wavered long before the 2016 election. In recent years, budget deficits, quantitative easing, and the political dramas surrounding the debt ceiling and other fiscal issues had put the creditworthiness of the U.S. federal government in doubt. Still, the prospect of Trump's victory introduced a new dynamic altogether, leading some observers to fear that a panicked selloff of Treasury securities could be around the corner.

The stakes were high. The U.S. Treasuries market is the largest and most liquid financial market in the world, and as the world's premier low-risk assets, U.S. Treasuries are a benchmark against which most other assets are priced. U.S. regulators require banks to hold Treasuries as part of the safe assets on their balance sheets, and investors turn to Treasuries as safe havens in uncertain times. Treasuries have also been the linchpin of U.S. global financial power: steady foreign demand for them has allowed the United States to cheaply finance big deficits.

In the week after the November 8 election, around $1 trillion was wiped off of global bond markets as investors moved away from U.S. and other government debt. But that was no panic, and for a few reasons, U.S. Treasuries will probably remain the world's premier risk-free asset. The first is a lack

of attractive alternatives from other governments: the U.S. bond market is the best of a questionable batch. The second is that the big companies and superwealthy families in the United States hold a disproportionately large share of the country's domestically owned public debt and would resist policies that would disrupt the bond market.

Jonathan Ernst / REUTERS
U.S. President Donald Trump celebrating with Congressional Republicans after the U.S. Congress passed a tax overhaul, Washington, December 2017.

NOWHERE TO RUN

The U.S. economy can seem dysfunctional. But investment decisions are always relative, and compared with the alternatives, U.S. Treasuries look like beacons of stability. There are two challengers that might supplant U.S. Treasuries in the long term—eurozone government debt and Chinese government debt. Neither is especially attractive.

Eurozone bond markets are still reeling from the sovereign debt crisis in southern Europe, driven by Italy's broken banking system and the prospect of a Greek default. The United Kingdom's decision to leave the European Union has

cast further doubt on the future of the European project and the monetary union it supports. And unemployment, slow growth, and inequality have created the potential for another populist wave on the continent, which would compromise the security of eurozone government debt.

If not the eurozone, then what about China? As part of its recent financial reforms, Beijing has sought to open up foreign access to China's interbank bond market. The reforms are meant to promote the international use of the renminbi (RMB) and increase China's global financial influence. In November 2015, the International Monetary Fund announced that it would include the RMB alongside the U.S. dollar, the euro, the yen, and the pound sterling in the basket of international currencies used to value the Special Drawing Right.

Yet China has a long way to go before it can rival the United States as the world's top source of safe assets. Investors still fret over China's opaque institutions, its slowing economic growth, its volatile stock market, its use of capital controls, and its growing piles of private and public debt. The size of the Chinese bond market, which is worth about $4 trillion, pales in comparison with that of the U.S. Treasuries market, and foreign ownership of China's public debt remains very low. And despite Beijing's efforts, the RMB's use in international transactions fell between 2015 and 2016 by almost 30 percent. All of this uncertainty reinforces the relatively safe status of the U.S. Treasuries market.

As emerging markets drive global growth in the coming years, the value of the dollar will probably undergo a gradual fall. Central banks in Beijing and Tokyo could limit their losses by selling some of their U.S. Treasuries now. But that too is unlikely, thanks to a dynamic that the economist Eswar Prasad has called the "dollar trap." By selling their Treasuries, Beijing and Tokyo could set off a panicked flight

from the Treasuries market—and that would be bad news for big exporters such as China and Japan, since it would further weaken the value of the dollar and make U.S. exports more competitive.

Jason Lee / REUTERS
The headquarters of the People's Bank of China in Beijing, June 2013.

MONEY TALKS

There is another reason that U.S. Treasuries will likely retain their safe status: their powerful domestic owners will seek to protect them.

In recent years, domestic ownership of the United States' public debt has become increasingly unequal: the richest American families and the biggest financial corporations have acquired a disproportionate share of U.S. Treasuries. Among U.S. households, the share of public debt held by the richest one percent climbed from around 20 percent in 1969 to 56 percent in 2013. Meanwhile, in the corporate sector, the top 2,500 companies' share of the debt jumped from 65 percent in the period between 1977 and 1981 to 82 percent in the period between 2006 to 2010. Highly concentrated mutual funds

have expanded their holdings of U.S. Treasuries as pension funds, which are more widely held, have lost some of their share. All of this has aligned the interests of the richest Americans with those of the biggest financial firms.

This concentration of public debt is the result of the four-decade evolution of what the economic sociologist Wolfgang Streeck has called the "debt state." In the case of the United States, rising federal spending and stagnating federal revenues—themselves a result of increasingly regressive tax policies—have produced ever-deeper levels of public debt. The United States' wealthies families and biggest companies have waged a successful political battle to reduce their tax burdens; they now pay less tax relative to their income than they did a few decades ago. That has produced more inequality—and more savings for the rich to invest in rising public debt. In effect, the federal government is borrowing from powerful domestic groups instead of taxing them. If Trump ever seriously threatened he safe status of U.S. Treasury securities, these powerful domestic owners would probably rise up in opposition.

At this point, there are few signs that Trump will try to disrupt the debt state. To the contrary: the tax reforms backed by his administration could add up to $1.5 trillion to the deficit over the next decade. Because the bulk of the tax cuts will benefit top earners, the reforms would further entrench the power of domestic groups with interests in a stable Treasuries market.

IN THE LONG RUN

This assessment applies only to the short term. In the longer run, a financial crash, a natural disaster, domestic unrest, or a major war could quickly bring about systemic changes, unraveling the global financial order and ending the U.S. Treasury market's role as a safe haven. More optimistically,

Trump could deliver a sustained economic recovery, reducing the U.S. deficit and placing the onus on other governments to supply the global financial system with safe assets. Wouldn't that, too, disrupt the position of U.S. Treasuries?

Perhaps. But there is reason to be skeptical of Washington's ability to produce such an outcome. First, Trump's proposals for recovery have hinged mainly on his pledge to increase infrastructure spending. With such large tax cuts in the offing, however, it is unlikely that Republicans will throw their support behind an expensive infrastructure plan. Second, Trump's fiscal strategy appears to contradict the other component of his blueprint for growth: a weaker dollar. Increased deficit spending could lead to rising interest rates, which attract capital inflows. To the detriment of U.S. exporters, those inflows would strengthen the dollar and widen the current account deficit far more than the tax cuts would on their own.

Nor is this all. The political economists Shimshon Bichler and Jonathan Nitzan have shown that since the 1940s, rising employment rates tend to be followed by falling pretax corporate profits and falling stock prices relative to wages. Unemployment is already falling, and if Trump delivers on his promises to create even more jobs, profits and the stock market would fall even further than they would otherwise. Having appointed the wealthiest cabinet in U.S. history, Trump will likely be reluctant to aggressively pursue policies with such potentially detrimental consequences for the superrich.

> *Domestic ownership of the United States' public debt has become increasingly unequal.*

Bichler and Nitzan identify yet another factor that might dampen enthusiasm for a Trump-style recovery: the effect of

employment growth on interest rates. Since the 1960s, they note, "employment growth has become a nearly perfect five-year leading predictor for interest rates." As employment rose in the 1960s and 1970s, interest rates climbed; since the early 1980s, both employment growth and interest rates have fallen. Substantial growth in employment today could send interest rates soaring and bring an end to the bull market that cheap credit has encouraged.

Trump's election made investors justifiably nervous. But a mass exodus from the U.S. Treasuries market is unlikely, both because the United States remains the most relatively safe investment option in a perilous world and because Trump's policies will entrench the power of the superrich owners of Treasuries. The existence of an influential bloc of domestic owners should offer some solace to foreign investors rattled by the new administration's nationalist rhetoric. But perhaps the main lesson for the holders of U.S. Treasuries is that the inertia in the global financial system is strong—even in the face of a change like Trump.

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