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OPINION

Any setback for Treasuries should be seen as buying opportunity

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Markets Insight

Long-term debt and political concerns might lead to more volatility but this is outweighed by the unique financial status of the US

US Treasuries have rallied strongly in recent months as investors look towards interest cuts. Yields on the benchmark 10-year note have dropped around a percentage point since April with prices moving inversely higher.

But that strong rally has still not allayed longer-term worries among some investors about this cornerstone asset for financial markets — mainly questions about the rising debt burden of the US and whether geopolitical tensions will see some foreign investors scale back purchases of Treasuries.

Washington cannot simply run up budget deficits indefinitely and some investors have grown jittery ahead of US elections, worried that neither candidate for the presidency has a convincing plan to address the sustainability of the US federal debt, which reached 124 per cent of GDP in 2023 and is projected to grow to 129 per cent by 2033. By 2028, interest expenses will represent over 60 per cent of the US federal deficit. Therefore, a possible tipping point for US debt sustainability could occur when additional borrowing is required mainly to cover interest servicing costs.

The wrong US foreign policy could also undermine confidence. The sustainability of US debt depends — until Washington balances its books — on the country's ability to maintain its privileged position in the global financial system. In addition, it requires that the rest of the world both create sufficient surpluses and be willing to then transfer them to the US through the purchase of financial assets.

Countries like China will continue to find it difficult to find alternative places to park their huge surpluses. But geopolitical fragmentation and increased demands in the rest of the world for domestic investments — in infrastructure and green energy — still threaten to diminish the surpluses available for funnelling into US markets. This raises the stakes for the strength and stability of US international alliances, which support its central role in the world economic order.

Washington cannot afford to alienate too many countries in the short- to medium-term when it needs foreign capital to fund its debts, even if it intends to balance the budget in the medium to longer term and reduce its reliance on foreign capital to fund its deficits.

Already, US foreign and economic policies are out of kilter. Faced with a frosty US trade stance, China has forged closer ties with emerging markets, creating a loose trading bloc that is increasingly conducting trans-

Top 15 foreign portfolio holdings of US assets by country, $bn

Country	Total	Equities	Long-term debt	Short-term debt
Australia	572.25	474.09	84.64	13.52
Belgium	983.73	85.58	825.85	72.30
Canada	2054.89	1459.13	565.81	29.94
China	1432.37	309.29	1117.91	5.18
France	676.68	362.92	292.20	21.56
Germany	623.37	411.56	198.88	12.94
Ireland	1478.01	841.90	486.34	149.77
Japan	2496.23	836.82	1590.13	69.28
Luxembourg	2098.75	1087.39	883.06	128.31
South Korea	585.19	386.78	186.34	12.05
Netherlands	477.92	319.99	153.94	4.00
Norway	693.84	510.73	181.83	1.38
Singapore	664.82	408.37	247.30	9.15
Switzerland	1086.77	682.70	340.99	63.04
UK	2621.60	1457.60	1065.24	98.75

All countries with total assets above $500bn are included plus the Netherlands. Figures as of end of June 2023. Source: Pictet Research Institute actions in non-dollar currencies. This eats away at the dollar's dominance — an issue that risks growing more serious if other trading partners lose trust in the US.

For now, however, such concerns are outweighed by the unique financial status of the US — part of what former French president Valerie Giscard d'Estaing famously called the "exorbitant privilege" accorded to the country.

Under this equilibrium, the rest of the world owns 28 per cent of US gross debt and 40 per cent of US public and private equities. This system is effectively the "glue" that sustains the current financial system. The rest of the world is invested across the capital structure of USA Inc, and would have a lot to lose should the system come unstuck. This gives the official sector in the rest of the world a major incentive to hold the existing system together, or at least to reduce its US dependency slowly.

Political tensions may make some foreigners sceptical about investing further in US markets but the country's investment proposition is unmatched. Its leadership in innovation translates into highly attractive equity returns that act as reassurance for debt investors of the country's tax-raising capacity.

Markets are likely to remain vigilant about public debt, experiencing episodes of volatility, elevated yield levels and higher exchange rate movements. But against the broader backdrop, any weakness in US Treasuries may present buying opportunities.

The outcome of the US elections in November will not fundamentally alter the existing equilibrium or the US capacity to be a producer of safe assets. And despite longer-term concerns, the US remains an investment beacon. The US knows its rivalry with China is existential and that to retain its privileged position it needs to remain a leader in innovation. It is doing that with its semiconductor investments dwarfing rivals. Such dynamism helps the US generate superior equity returns, making it a safer borrower and securing Treasuries' haven status — for now, at least.

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