RESEARCH TEAM

WHIT DAVIS
STEPHEN HALKOS
HOWELL HOLLIS, CAIA®
STUART HUSTON
HARRY JONES
BRENDAN KEELAN
ELIZABETH MACKIE, CPA
JACOBI PADGETT
DENNIS SABO, CFA®
WILL SKEEAN, CFA®

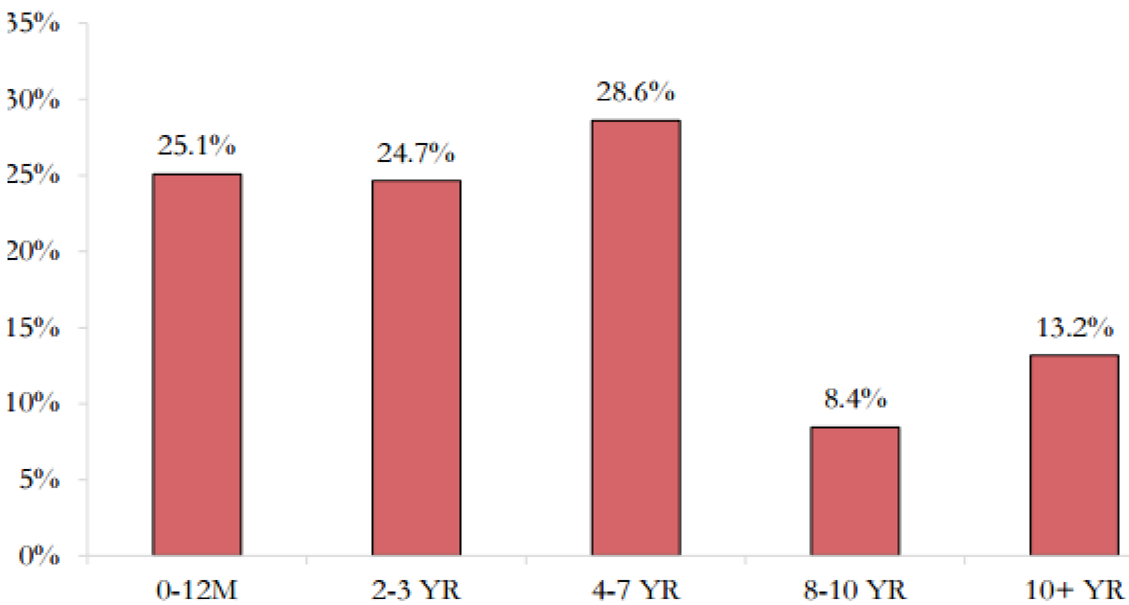
The Need for Longer-dated US Debt

EDGE RESEARCH INSIGHTS | DECEMBER 2016

For the last several years, historically low interest rates have provided the US government an attractive option to extend the average maturity of US Treasury obligations, saving taxpayers billions of dollars. Two weeks ago, the Federal Reserve raised not only their target Federal Funds rate, but also their expectations for the number of rate hikes in 2017. Before the Fed initiates additional hikes, and before inflationary pressures push market rates higher, the US Treasury should consider extending the average maturity of US debt through the issuance of longer-term debt or by weighting upcoming issuances to the longer end of the spectrum.

The current average maturity of US marketable obligations is 68 months (or 5.7 years), with issuances weighted towards the short-term side of the maturity schedule (Figure 1). With the recent increase in interest rates and the flattening of the yield curve, the opportunity cost for the US Treasury to extend the average maturity remains low, however this window is closing. We will explore this potential decision and its implications to our national debt against reasons why the government may not leverage the opportunity.

Figure 1: U.S. Outstanding Marketable Sovereign Debt
(by Maturity Timeline)

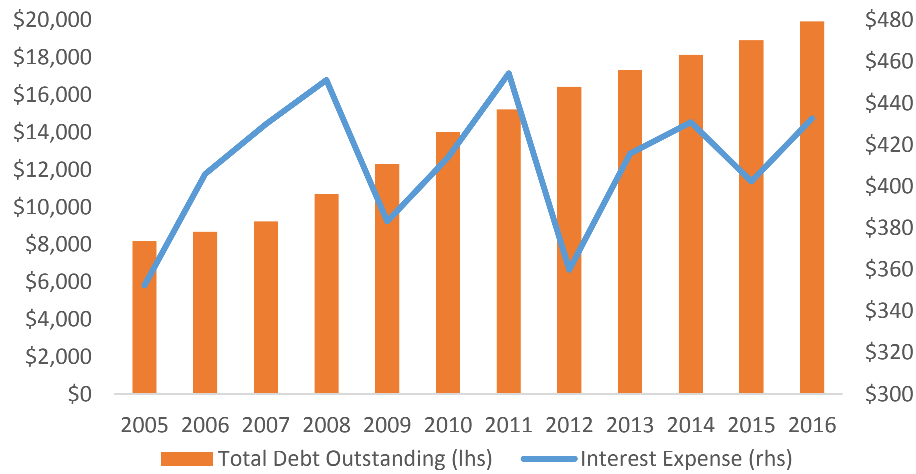


Source: Strategas Research

As of November 30, 2016, the United States had $19.9 trillion of outstanding debt (Figure 2), with $13.9 trillion held by the public (non-government owners) and the remaining $6 trillion held by over 240 individual federal government accounts and agencies. According to Strategas Research Partners, “the weighted average coupon of US Marketable debt outstanding is 1.75%” and the average interest rate on all US debt outstanding is 2.2%.

While you try to absorb exactly how staggering the total debt figure of almost $20 trillion is (and rising), carefully observe the following two core points of this paper: **(1) 58% of outstanding US debt will mature in the next four years, with 79% maturing within the next 10 years; and (2) US government bond yields remain near all-time historic lows.**

Figure 2: Total US Debt Outstanding and Annual US Interest Expense ($bn)



Note: The data above is courtesy of TreasuryDirect for fiscal years ended September

When Treasury debt matures, new bills, notes, and bonds are issued at the current market interest rate for each level of maturity. Said another way, the US’s liabilities are being extended, not paid off, primarily through the underwriting of new debt. It just so happens that these new issuances are weighted heavily towards shorter-term debt. As rates increase, so does the interest expense on newly issued debt.

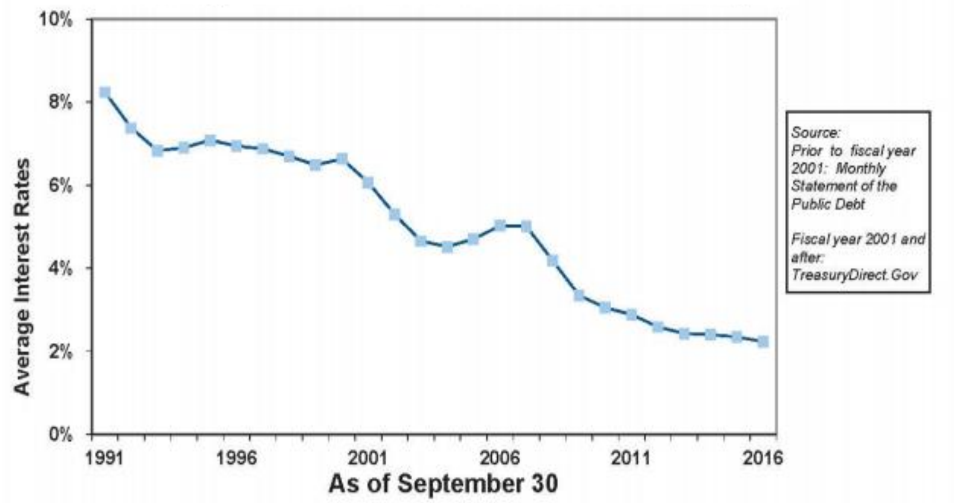
To give you a sense of the magnitude of our government’s interest burden, let us take a look at recent history. Over the past 10 years, the US Government’s average annual interest expense is $416 billion to its bond holders (Figure 2, above), up from an annual amount of $318 billion in the 1990s, even though the average interest rate over the last decade has decreased. The increase in payments is due to the debt-fueled spending that has been undertaken here in the US, while the decrease in interest rates is courtesy of the Fed. Since the financial crisis, interest rates paid by the Treasury have fallen substantially (Figure 3), presenting an attractive opportunity to lock-in and extend the maturity.

The question then becomes, what is allowed? The Duties & Functions of the US Department of the Treasury state that the Treasury’s basic functions are to, “Manage Federal finances,” among other things like “collecting taxes and investigating and prosecuting tax evaders.” The Congressional Research Service states that in regards to managing federal finances and the country’s debt management, that the Treasury should “finance the government’s borrowing needs at the lowest cost over time.” As recently as 2015, the US Treasury Committee debated extending the debt maturity to take advantage of lower rates, but the above statement ultimately tethered the Committee to its longstanding behavior.

The Need for Longer-dated US Debt

For the last 35 years, the 10-Year Treasury, a widely quoted benchmark yield, has for the most part, been decreasing. From the highpoint of 15.8% in 1981, the 10-Year yield has declined to 1.37% - the low-point which occurred earlier this year. Since the trough, the 10-year yield has advanced to 2.55% (as of December 22, 2016).

Figure 3: Average Interest Rates of Federal Debt



Over the last few decades, it made fiscal sense to maintain a shorter maturity schedule as new debt can be repeatedly issued at lower and lower rates. If we are at an inflection point, now is the time for the US government to reverse behavior and extend the maturity schedule to later years. Otherwise, as rates begin their move up, the interest expense paid each year by the United States could swoon as rolled-over debt is issued at higher and higher interest rates.

At this critical juncture, we believe it is important to consider reasons why the US government may not change its long-held behavior. First, and arguably the most important reason why short-term paper is needed, is due to the demand from institutional investors, such as money market funds and other buyers. New requirements mandated by the SEC regarding more-stringent liquidity and capital requirements have increased the demand for short-term Treasuries, thereby, providing a natural buyer and strong demand for the market to absorb shorter issuance. Because of the strong demand at the front-end of the yield curve, there can be less support for longer-dated maturities, thereby, limiting issuance at the back-end of the curve.

The Treasury also has an eye on balancing the maturity of its liabilities with the government's collection of revenue that is used to support a large percentage of the nation's debt burden. Selling a 30-year bond at the current rates makes sense if forecasts call for higher rates, but it does have the offset of adding a long duration liability to the government's balance sheet that may not be offset through a matching asset. This mismatch can create long-term issues for the government and likely limits the amount of issuance that can be allocated.

The final motive for not extending the average maturity of US debt could be attributed to softer investor demand and the inability for government to issue substantial levels of debt that can effectively shift the maturity schedule. For example, most issuances of 40, 50, and 100 year paper have been small relative to the Treasury's issuances of long-dated debt. In 1996, China sold $100 million "century bonds" or bonds maturing in 100 years; in 2010, Mexico issued their own century bonds, raising $1 billion. In 2013, Panama issued $750 million in 40-year bonds. Belgium, France and the UK, to name a few developed nations, have recently taken advantage of low interest rates to issue debt due in as much as 100 years.

The UK has over $4.3 billion of debt outstanding that is due in 30 years or more. This compares to the US who currently has $174 billion maturing in 2046 alone and a total of $946.7 billion maturing between 2042 and 2046. For reference, this represents less than 5% of the total outstanding US public debt.

Time may not be on the side of the government. Interest rates have risen sharply since the 2016 election as President-elect Donald Trump’s policies are seen likely to be inflationary, and expansionary, both of which create the possibility of a rising-rate environment. And as stated, the government is set to roll 79% of its debt over the next decade, meaning that 79% of the total outstanding debt will be issued with future market interest rates. This strategy of weighting issuances towards the short-end of the spectrum may have made sense in the past, as governments are not in position to “guess” the direction of rates set by the free market and no politician wants to be on the hook for locking in a high interest rate when rates could be falling. Through the current lenses, the tables seem to have turned.

The demand for government bonds has arguably never been greater and will likely never be lesser, as newly-implemented regulations increase financial institutions’ capital requirements and corresponding demand for government-backed debt, and as uncertainties around the world such as Brexit create instabilities and further demand for safe-haven government bonds.

The fiscal stability from either issuing longer-dated debt or extending the average maturity of US Treasury obligations has the ability to provide a foundation for long-term economic growth, as uncertainty about a possible future US debt crisis may be viewed as remote and government obligations would be viewed as being well managed and under control. The debate on whether or not one or both of these changes will take place will be in Washington, not in this paper. However, an argument can be made both for a policy change, as well as against it. While time will tell if a true bottom has already been reached for interest rates, the clock is ticking, one basis point at a time, for the largest treasury department in the world.

ABOUT THE AUTHOR

Richard Pearce, CFP®
Associate

Richard Pearce is an Associate and Portfolio Manager in Edge Capital’s Charlotte office, where he evaluates investment strategies and performs asset allocation analysis to propose and implement suitable portfolios for clients.

ABOUT EDGE CAPITAL

EDGE Capital is an independent financial firm whose objective advice helps individuals and institutions realize their goals in the areas of investment management and corporate finance. The Edge Research Team's thoughtful and timely reports are based on extensive independent research and analysis of firms, financial developments and macroeconomic trends.
For more research and commentary, visit us online at http://www.edgecappartners.com/.

CONTACT EDGE

1380 West Paces Ferry Road
Suite 1000
Atlanta, GA 30327
Phone: 404-890-7707
Email: info@edgecappartners.com