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The Incredible Shrinking Deficit: Implications for U.S. Treasury Issuance

Karthik Ramanathan
SVP and Director of Bonds, International

KEY TAKEAWAYS

- Quietly and behind the scenes, increased tax revenues and decreased spending are leading to a rapid improvement in the U.S. fiscal deficit.
- Lower Treasury issuance implies reductions in bill supply and potentially in the issuance sizes of other securities; moreover, the Treasury debt portfolio may shift in terms of composition and maturity profile.
- While deferring the debt ceiling debate, hopes of a broader deficit deal to address long-term structural issues may be fading. As a result, deficits in the coming years are likely to deteriorate once again unless action is taken.

Staring into the abyss

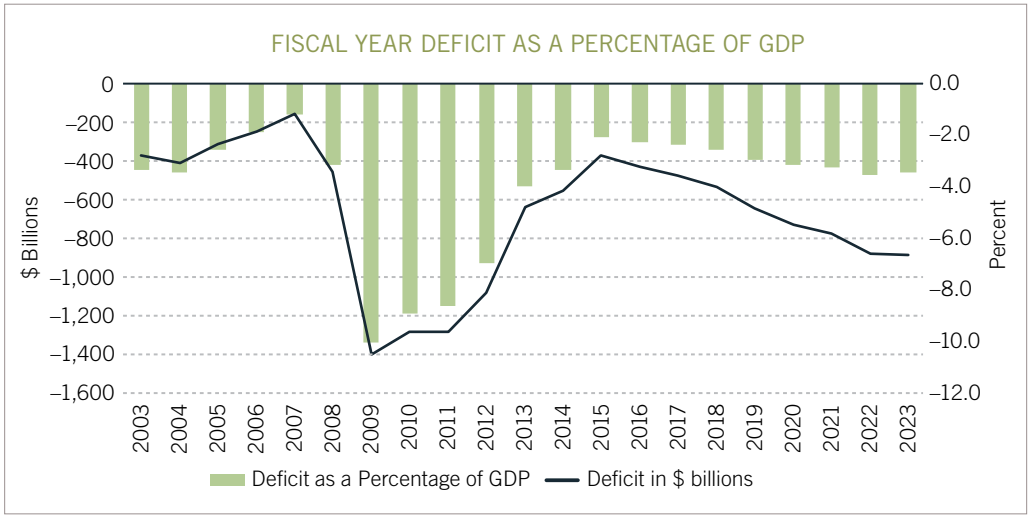
At the end of fiscal year 2009, following the depths of the economic crisis, the United States registered a ratio of fiscal deficit to gross domestic product (GDP) of more than 10%, nearly five times higher than in 2007. The fiscal deficit approached $1.4 trillion as revenues fell 17% versus fiscal year 2008. Concern among investors was elevated as debt sustainability and the potential for higher financing costs resulting from such large deficits came to the forefront. Comparisons with heavily indebted nations such as Japan, and even peripheral Europe, were common.

This nadir was soon followed by further market concerns when Congress fiercely debated and delayed increasing the debt ceiling until the last minute, resulting in the downgrade of the U.S. credit rating from AAA to AA by Standard & Poor's credit rating service. The subsequent market volatility and inability of Congress to resolve even short-term fiscal issues produced investor consternation. This concern was reflected in significant market volatility in equity and bond markets in the third quarter of 2011.

The turnaround

The situation appeared dire in 2011. Since then, however, the U.S. fiscal deficit has significantly recovered and should rapidly improve in the coming years (see Exhibit 1). Since most investors seem focused on Federal Reserve monetary policy actions this year, the dramatic improvement in the fiscal situation has not been on the radar of many investors. Marking this improvement, as recently as May 2013, the Congressional Budget Office revised its estimates for the 2013 deficit downward to $642 billion from $845 billion.[1]

EXHIBIT 1: The deficit is expected to be nearly half the level of 2009.



Source: Congressional Budget Office, as of May 2013.

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Four key factors, which are driving this reversal in fortunes in the coming years, include:

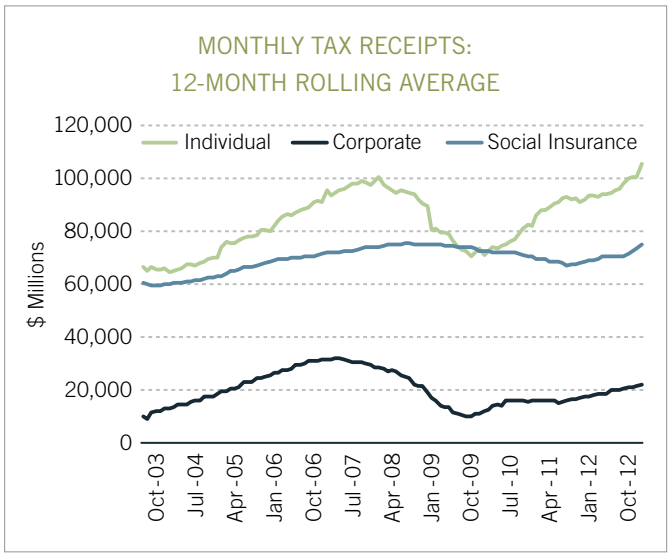
1. **Increased tax revenues.** The federal government has seen a surge in tax revenues since the beginning of 2013 (see Exhibit 2), partly due to enactment of the American Taxpayer Relief Act of 2012. The Act increased rates on upper-income marginal income taxes and investment income taxes that were rolled back in the 2011 payroll tax cut, and phased out certain tax deductions. Importantly, many individuals chose to shift income into 2012 given the prospective tax increase. As a result, this most recent tax period saw a boost in tax revenues, albeit likely temporary. In April 2013—the peak month for U.S. tax revenues—the federal government saw a 28% increase in overall tax revenue versus April 2012.

2. **Decreased spending.** The enactment of the sequestration in 2013 resulted in modest reductions in spending by government agencies and is expected to have a greater impact on spending in 2014 and 2015. Since the sequestration, year to date, appears to have minimally impacted the economy, a rollback of the spending cuts and caps doesn't seem likely, and the pace of expenditures should slow.

3. **"Windfall" profits.** Fannie Mae is expected to remit close to $50 billion in dividend payments to the Treasury following several profitable quarters. Freddie Mac is also expected to remit a significant amount to Treasury later this year.[2]

4. **Economic growth.** While still sluggish, the economy continues to grow, leading to additional employment and corporate earnings, which help fuel additional revenue inflows.

EXHIBIT 2: Social Security and individual income taxes have seen large increases.



Source: U.S. Treasury, as of May 2013.

These factors imply that the fiscal deficit will decline more rapidly than anticipated. In May 2013, the Congressional Budget Office noted that the deficit-to-GDP ratio could decline to 5%, almost one percentage point lower than they had forecast in January. If economic growth picks up the second half of the year, this ratio could be even lower.

To highlight this turnaround, on June 10, 2013, Standard & Poor's revised its debt rating outlook for the United States from "negative" to "stable" to indicate its current view that "the likelihood of a near-term downgrade of the rating is less than one in three."[3]

Two years ago many investors likely could not have imagined such a turn of events. The short-term improvements in the fiscal situation have been positive. Moreover, often, the pace of deficit reduction overshoots expectations and could result in an even greater improvement. As a result, the Treasury needs to be prepared to adjust supply in a timely manner.

Implications for Treasury issuance

As the deficit declines, the U.S. Treasury will likely need to consider curtailing its debt issuance. In May 2013, the Treasury stated:

> Depending on how the fiscal situation develops, the *Treasury may decide to gradually decrease coupon auction sizes*. [emph. added] Treasury will continue to provide guidance to market participants regarding any changes in the fiscal outlook that might impact the government's financing needs.[4]

When the Treasury chooses to decrease issuance, it normally begins by 1) reducing Treasury bill issuance, 2) lowering the sizes of note or bond offerings, beginning with its longer-dated securities, because they normally incur higher interest rates, 3) curtailing the number of auctions for a particular security and, finally, if confident, 4) lowering issuance of specific securities.

The last two options are not currently feasible. However, the Treasury has begun to aggressively reduce Treasury bill issuance given its lower borrowing needs. In fact, the Treasury anticipates paying off $35 billion in debt in the second quarter of 2013—the first such payment since 2007. Moreover, estimates for borrowing in the first quarter fell almost $140 billion versus previous estimates by Treasury in February 2012.

The Treasury tries to maintain some minimum size of Treasury bill offerings, because smaller sizes could influence market liquidity. The next step by the Treasury, if bill issuance cannot decline below this floor, would be to cut coupon sizes.

Historically, the Treasury begins by making cuts to its longer-dated securities. If cuts to coupon issuance were to occur, the 30-year bond or 10-year Treasury may first see small initial issuance cuts.

However, if the pace of fiscal consolidation increases more rapidly than expected, shorter dated two- and three-year securities could be adjusted more nimbly to reduce supply. Longer-term structural issues may require the continued issuance of long-dated securities versus shorter-dated securities.

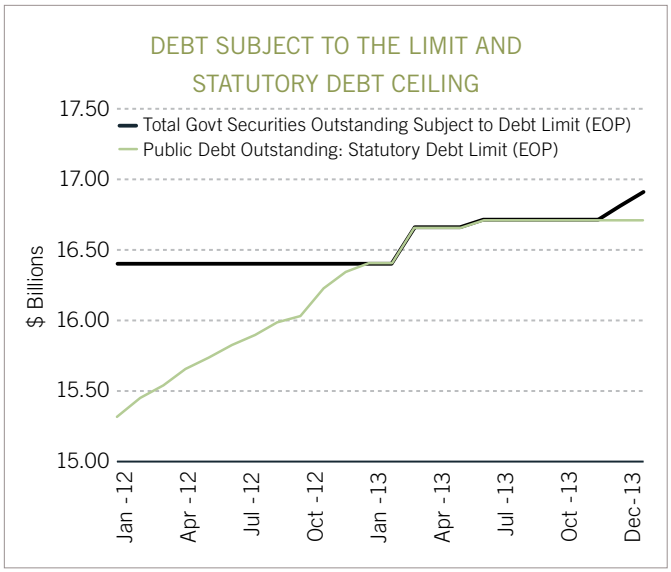
Waitlist the debt ceiling

On February 4, the "No Budget, No Pay Act of 2013" was passed, which suspended the debt ceiling until May 19, 2013. The new statutory debt ceiling would be based on debt outstanding as of that date, which turned out to be $16.99 trillion. Treasury began using its "extraordinary" tools totaling close to $250 billion, beginning on May 19, to continue borrowing and remain below the debt ceiling.

Initially, expectations were for these tools to provide enough borrowing capacity until August 2013. Congress would need to readdress the increase in the debt ceiling. Usually, these contentious debates lead to an eventual increase in the debt ceiling but are accompanied by market volatility and investor concern about rating agency actions.

Because of the improving deficit, the Treasury may be able to borrow longer than expected and potentially until late October or early November (see Exhibit 3, below). This means the debt ceiling debate will likely occur later than expected. If the pace of economic growth increases, resulting in additional revenues to the government in the second half of 2013, this debate could be delayed until the fourth quarter of 2013. While the delay may initially appear positive, it in fact creates less incentive for Congress to focus on the broader fiscal issues facing the United States.

EXHIBIT 3: Debt ceiling could be postponed until the third quarter of 2013.



Source: U.S. Treasury, Fidelity Investments estimates, as of June 2013.

Treasury portfolio Implications

The composition of the Treasury portfolio is likely to shift marginally as supply reductions potentially occur. Since 2008, the Treasury has been vocal about its desire to increase the average maturity of the debt to be more in line with other G-7 countries and to lower rollover risk. Currently, the average debt maturity is 64 months. The Treasury aims to increase the maturity closer to 80 months over the next decade.[5]

During the past four years, the issuance of monthly 30-year bonds and additional 30-year inflation-linked securities has rapidly increased the average maturity of the portfolio. Reducing bill issuance and shorter-dated coupons, such as the two- and three-year notes, could increase the average maturity of the debt slightly faster. These reductions are likely to be modest and, over a 10-year horizon, unpredictable.

Hold the applause

While the fiscal deficits should decline in the next two years, longer-term structural issues, such as tax and entitlement reforms, loom as significant unaddressed risks to the long-term fiscal health of the United States. On this point, Steven Hess, lead sovereign analyst for Moody's, said that the U.S. "rating outlook will likely be either moved back to stable or the rating downgraded during the course of this year," based on the results of ongoing negotiations, and that "more needs to be done on the policy front to address this rising debt ratio."[6]

As the fiscal deficit narrows, policymakers will likely have less incentive to focus on these difficult structural changes. Normally, the debt ceiling debate would offer an opportunity for Congress to focus exclusively on the fiscal situation for at least a short period. That debate, however, will likely occur later in 2013, or even early 2014, and may not be front and center in the public forum if the deficit has improved significantly.

Looking forward

On the back of increased revenues, reduced spending, and continued slow economic growth, the fiscal deficit in the United States is rapidly improving. While not sharing the center stage with the potential for Federal Reserve policy decisions in the coming months, the falling deficit has implications for the issuance of Treasury securities. Lower deficits mean lower borrowing needs and potential adjustments to security issuance sizes.

The Treasury has signaled that such adjustments may take place in the second half of 2013. Reduced Treasury issuance could delay the need to raise the debt ceiling. While positive in some respects, the falling deficit and postponement of the debt ceiling debate may mean hopes for a longer-term fiscal deal—or even incremental steps to addressing the nation's longer-term structural fiscal issues—may be fading, or at least put on the back burner.

Author

Karthik Ramanathan
Senior Vice President and Director of Bonds, International

Karthik Ramanathan, senior vice president and director of bonds, international at Fidelity Investments, is responsible for driving the growth of the institutional fixed income business on an international basis. Prior to joining Fidelity in 2010, Karthik served as acting Assistant Secretary for Financial Markets for the U.S. Department of the Treasury beginning in 2008.

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In general the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties.

Ratings are not intended as a recommendation and may change at any time.

Endnotes

[1] Updated Budget Projections: Fiscal Years 2013 to 2023, May 14, 2013, Congressional Budget Office.

[2] Reuters, May 9, 2013.

[3] U.S. 'AA+/A-1+' Ratings Affirmed; Outlook Revised to Stable, Standard & Poor's, June 10, 2013.

[4] Quarterly Refunding Statement, May 1, 2013.

[5] Treasury Borrowing Advisory Committee (TBAC) Discussion Charts, May 1, 2013, U.S. Treasury.

[6] Moody's, May 15, 2013, Steven Hess, Issuer Comment.

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