RIVERFRONT INVESTMENT GROUP

Weekly View

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SUMMARY

- Deficit will have a minimal near-term impact on the Treasury market, in our opinion.
- The Treasury market's strength is its size, depth, and diversified pool of investors.
- Potential US bank buying can help offset any pullback from foreign investors.

06.10.25

Deficit Pressures Treasuries… But No Crisis

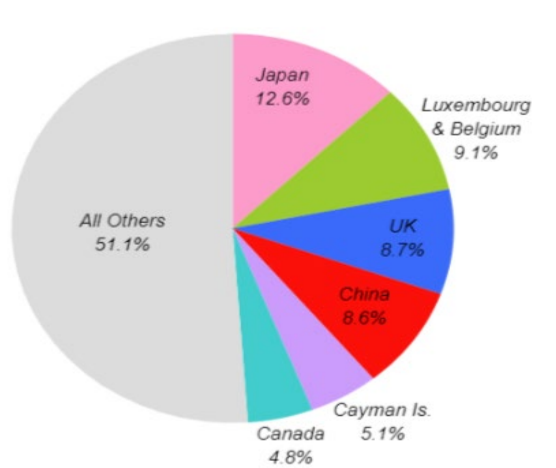
US Treasury Market Is 'Too Big to Fail'

The first half of 2025 has been driven by headlines that have caused volatility in both the stock and bond markets. While tariff negotiations have commanded the most attention, we are now pivoting to the federal budget deficit, which feels like a perpetual headline over the last 15 years. Now that the House of Representatives have passed its version of the Trump Administration's spending bill, we will have to wait to see the Senate's preferences. The ultimate spending bill is still far away from completion, but the preliminary version increases the federal budget deficit over the next decade by $3.8 trillion, according to the Congressional Budget Office (CBO).

We think the size and growth of the federal budget deficit is worthy of its' own standalone publication. However, we would prefer to write on that after bill passage, when the ultimate size and scope of the budget is better known. Rather, today's *Weekly View* will instead focus on the impact that the current deficit will have on the US Government's ability to issue more debt. We will specifically zero in on the Treasury market, given that it is the primary tool the government uses to finance its operations outside of tax collection. Through a traditional 'SWOT' (Strengths, Weaknesses, Opportunities and Threats) analysis, **we will explore the Treasury market and why we believe that it will remain the world's most relevant sovereign bond market.**

Strengths of the US Treasury Market: Sheer Size and Scale

At the end of the first quarter, the US Treasury market had $28.6 trillion outstanding, according to SIFMA. We expect the Treasury market to grow as the US government refinances existing debt and borrows to fund future budget obligations. The Treasury market has grown by 8.4% since the end of 2023 when it had $26.4 trillion outstanding. To put the size of the US Treasury market into perspective, we compare it to both the overall US bond market and the global bond market. As of the end of 2023, the US Treasury market represented just under 48% of the overall US bond market and nearly 19% of the global bond market.



Source: LSEG Datastream, RiverFront. Data weekly as of March 31, 2025. Chart shown for illustrative purposes only. Past performance is no indication of future results.

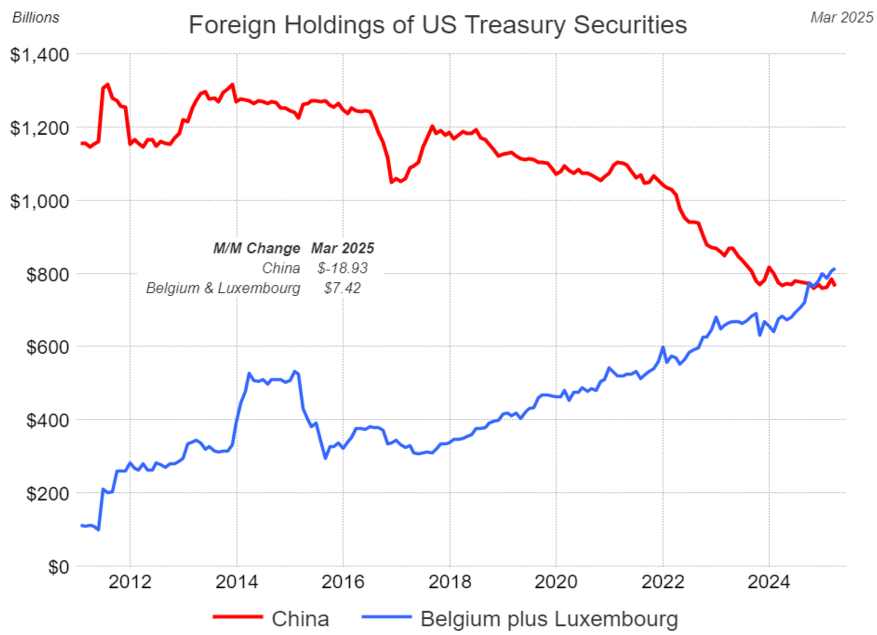
The US Treasury market alone was larger than the entire fixed income capitalization of all other countries in 2023. There is nothing that leads us to believe that this dynamic will change, as the US holds the distinction of having the world's reserve currency in the dollar. Why is this important? Given that the dollar is the reserve currency of the world, most trade is done in dollars… leading countries to need dollars for trade, and in turn investing their excess dollars into the Treasury market. **To this point, global debt issued in US dollars now represents about half of all developed economy currency debt, according to NDR Research.**

This reserve currency benefit has helped fuel the growth of the Treasury market. The sheer size and depth of the Treasury market, along with its pool of diversified investors (retail, institutional, and foreign investors) highlight the strengths of the market.

Weaknesses Within the Treasury Market: Dependence on Foreign Investors

Ironically, the US dollar's designation as the reserve currency has not only fueled the growth of the Treasury market but has simultaneously created a foreign investor dependence. It is often stated that nothing in life is free, and this rings true with the interdependent relationship that the dollar and the Treasury market share with foreign investors. As previously mentioned, foreign investors often use their excess dollars to invest in Treasuries, so when the dollar is weak there is less incentive to own Treasuries and when the dollar is strong there is more of an incentive to own Treasuries.

As of June 2024, foreign investors owned 33% of US Treasuries according to the Fed. The countries with the largest exposure to the Treasury market are Japan, China, Luxembourg, and Belgium as shown in chart to the right. Economists believe that the holdings of Luxembourg and Belgium are proxies for China, as China uses both countries as conduits to purchase Treasuries 'under the radar'. Given the size of foreign holdings, there has been concern that the Treasury market has become too dependent on foreign investors. The concern could come to fruition sooner rather than later if trade negotiations go awry and turn into a war. Economists concede that international investors – and in particular, a geopolitical adversary like China – could sell their Treasuries or at the very least abandon future purchases to retaliate against the US during a trade war.



Source: LSEG Datastream, RiverFront. Data weekly as of March 31, 2025. Chart shown for illustrative purposes only. Past performance is no indication of future results.

While we acknowledge that such a scenario would not bode well for the government as it seeks to roll existing debt maturities and fund future spending, we put a low probability on a huge 'dumping' of Treasuries actually happening. For instance, China's decline of Treasury holdings over the past decade or so (see red line in the chart above) is well-publicized and helps to serve this public narrative. However, under these headlines we believe that China is likely using small, opaque financial conduits like Belgium and Luxembourg (blue line on the chart above) to indirectly route enough Treasury purchases to largely negate this public drop. This suggests to us that China is not comfortable trimming Treasuries as much as their policymakers would have you believe.

Another issue that the Treasury market faces is that institutional investors use the market to hedge their portfolio risk. Institutional investors view Treasuries as a risk-free asset, despite the US losing its triple A rating recently, after Moody's downgraded its sovereign debt. Institutional hedging could create selling pressure on the market, causing Treasury yields to move higher and thus increasing the borrowing cost for the US government when it attempts to roll or issue debt. However, we view the recent Moody's downgrade as a non-event, considering the other two rating agencies had long ago dropped US debt ratings.

Opportunities: US Banks Could Potentially Become Large Treasury Holders Again

While there is a significant part of the US Treasury market owned by foreign investors and institutional investors that use the market to hedge their portfolio risk, banks are the one segment of investors that are underrepresented. After the Global Financial Crisis (GFC) in 2008, regulators required banks to maintain higher capital levels to ensure that they were adequately capitalized relative to their overall leverage, which included both on and off-balance sheet items. The post GFC regulation required the systematically important banks to maintain a 3% Supplemental Leverage Ratio (SLR) regardless of the composition of their assets.

This requirement made it cost-prohibitive for banks to hold US Treasuries because they were having to pledge the same amount of capital for a risk-free asset as a riskier asset. Hence, banks pulled back from stepping in and supporting the US Treasury market during volatile times from a market maker perspective and as an investment. **However, there is a proposal by the Trump Administration to exempt the SLR requirement on US Treasuries, which would bring a large investor base back to the US Treasury market if enacted. We believe that this will help to mitigate the potential void if foreign investors pull away from the Treasury market.**

Threats: Rate Differentials, Hedging Costs Make Treasuries Less Attractive to Foreign Investors

Foreign investors have a lower incentive to buy Treasuries as yields are rising in their countries. Additionally, international investors must factor in hedging costs that occur when they must sell their respective currency to buy dollars to purchase Treasuries. Currently, the hedging costs erode the entire yield advantage that the US Treasuries have over their foreign counterparts. For example, the 10-year German sovereign bonds yield 2.57%, which is 194 basis points less than the 10-year Treasury. However, it costs a German investor 2.39% to hedge its currency for three months. Hence, German investors would be better off investing in their home sovereign bonds. This dynamic was not in play over the last decade as international investors increased their allocation of US Treasuries. However, now that the mathematical economics do not make sense, there will have to be a different catalyst to propel additional growth of their Treasury holdings.

Conclusion: Deficit Will Have Minimal Near-Term Impact on the Treasury Market

The budget deficit is not getting any smaller based on the initial bill put forth by the House of Representatives. While the Senate has yet to put its stamp on the proposal, the one thing that is certain is that the government will have to turn to the US Treasury market to finance any shortfalls in revenue. We believe that because the budget deficit timing is running parallel with trade negotiations, there could be upward pressure on Treasury yields if negotiations go poorly given the large presence of international investors in the market. However, it is important to remember that size of the Treasury market will help mitigate the threat of a particular country pulling away from the market as trade negotiating leverage. Furthermore, the US government can create additional buyers for Treasuries simply by changing the rules for banks via the SLR.

While we continue to believe that Treasury yields will end the year higher than they are currently, we do not envision a scenario where the government cannot roll or issue new debt. Negotiations are fluid both with the deficit and trade, but the US Treasury market will not overreact even in a negative outcome scenario. Hence, we believe that the 10-year Treasury will trade in range between 4.25% and 4.75%, with fair value being 4.5%.

Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time and have experienced increased volatility in recent years due to global and domestic economic events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.

Important Disclosure Information

The comments above refer generally to financial markets and not RiverFront portfolios or any related performance. Opinions expressed are current as of the date shown and are subject to change. Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.

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All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

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. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

In a rising interest rate environment, the value of fixed income securities generally declines.

Index Definitions:
Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:

Bank Loans are an amount of money loaned at a floating interest by a bank to a borrower, usually on collateral security, for a certain period of time.

The Congressional Budget Office (CBO) is a federal agency within the legislative branch of the United States government that provides budget and economic information to Congress. Inspired by California's Legislative Analyst's Office that manages the state budget in a strictly nonpartisan fashion, the CBO was created as a nonpartisan agency by the Congressional Budget and Impoundment Control Act of 1974.

A SWOT analysis identifies a company's strengths, weaknesses, opportunities, and threats.

The Securities Industry and Financial Markets Association (SIFMA) is a United States industry trade group representing securities firms, banks, and asset management companies. SIFMA was formed on November 1, 2006, from the merger of the Bond Market Association and the Securities Industry Association. It has offices in New York City and Washington, D.C.

The 2008 financial crisis, also known as the global financial crisis (GFC), was a major worldwide financial crisis centered in the United States. The causes of the 2008 crisis included excessive speculation on housing values by both homeowners and financial institutions that led to the 2000s United States housing bubble, exacerbated by predatory lending for subprime mortgages and deficiencies in regulation. Cash out refinancings had fueled an increase in consumption that could no longer be sustained when home prices declined.

The Supplementary Leverage Ratio (SLR) is a measure of capital adequacy that applies to financial institutions with more than $250 billion in total consolidated assets. It measures a bank's ability to take losses on its assets in percentage terms, and the formula is SLR = (tier 1 capital)/ (total leverage exposure). The SLR requires banks to hold a minimum ratio of 3 percent, with more stringent requirements for the largest and most systemic financial institutions.

The 10-year Treasury is a debt obligation issued by the U.S. government with a maturity of 10 years. It pays interest at a fixed rate every six months and pays the face value to the holder at maturity. The 10-year Treasury bond yield serves as a benchmark for other interest rates and reflects investor sentiment about economic conditions. Treasury notes are a low-risk fixed-income investment that pays a set interest rate every six months.

US Equities include stocks listed in the United States. Stocks represent partial ownership of a corporation. If the corporation does well, its value can increase, and investors can share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Small/mid-cap equities, MLPs, REITS and alternatives equities are types of US Equities and assume further risks described below.

When referring to being "overweight" or "underweight" relative to a market or asset class, RiverFront is referring to our current portfolios' weightings compared to the composite benchmarks for each portfolio. Asset class weighting discussion refers to our Advantage portfolios.

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