MV CAPITAL MANAGEMENT

Weekly Market Flash

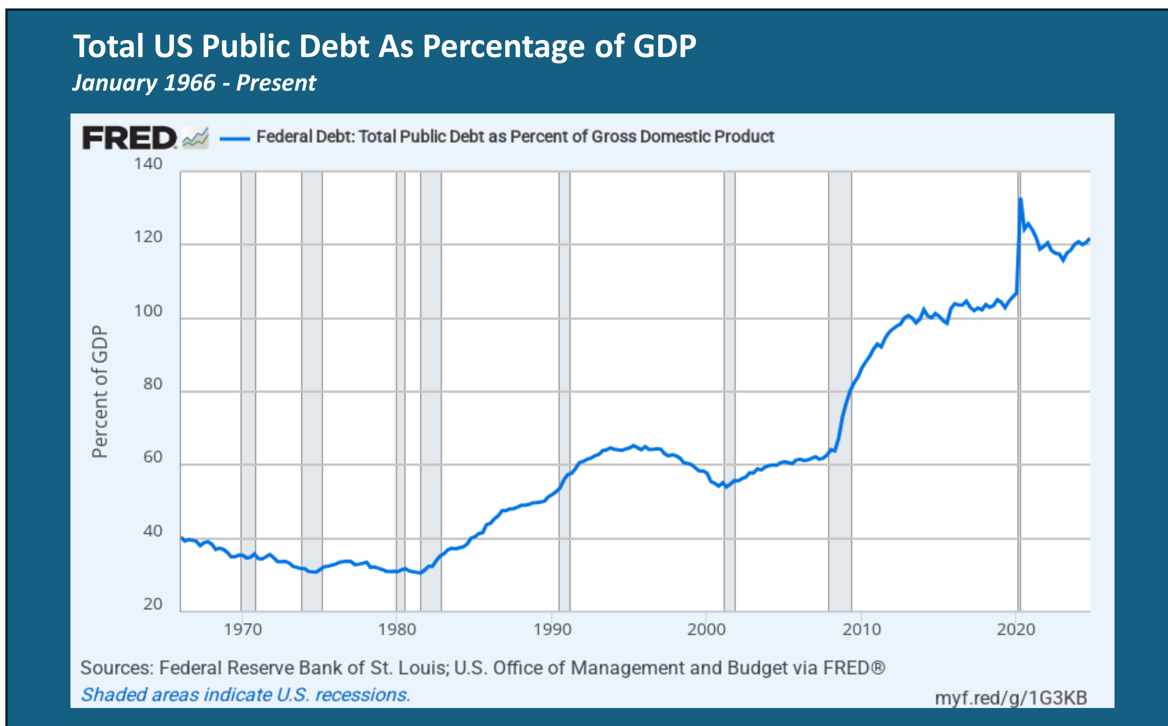
When Debts Come Due

April 25, 2025

All things considered, it has been a relatively good week. Springtime has settled in here in the nation's capital, and along with the pleasant weather we have seen a welcome pause in the chaos that has beset financial markets since the infamous "Liberation Day" antics of April 2. Dare we say, those market guardrails of which we spoke some time ago seem to have had some staying power. The bond market pushed back on the original tariff plan, the dire warnings of retail CEOs about empty Walmart shelves have added weight to the tariff pushback, and financial types not wanting to see their hard-earned (or inherited, or whatever) wealth collapse into a vortex of horror demonstrated some pull in getting Jerome Powell out of the administration's crosshairs. All of which could change – uncertainty remains the number one keyword for 2025 – but for now we'll take these manifestations of organic pushback as a win.

Meanwhile, On Capitol Hill

With the temporary reprieve from worst-case concerns about tariffs and trade, we turned our attention this week up the street from the White House to Capitol Hill, where Congress is in the process of cobbling together a remarkably irresponsible budget resolution. All talk of slashing costs and streamlining government notwithstanding, this current plan, which is on track for House and Senate approval and thus likely to come into effect, calls for $5.3 trillion in tax reductions and $517 billion in spending over the next decade. That's a $5.8 trillion addition to the deficit, and it comes at a time when total US public debt, as a percentage of GDP, is close to decades-long highs.



Source: Federal Reserve Bank of St. Louis, MVF Research

A few disclaimers here. We are old enough to remember when deficits, the "crowding out effect" of paying down interest on public debt and the like were hot topics back in the 1980s (when, as the above

chart shows, all that public debt accounted for just 40 percent, give or take, of GDP). The Cassandras of the time warned of chaos that never came, in no small part because the Cassandras of the 1980s did not fully grasp the implications of the globalization unfolding at the time, bringing new demand for US government debt from investors around the globe. Indeed, the ease of funding our increasing borrowing needs over the ensuing decades led to Vice President Dick Cheney's famous (for better or worse) observation that "deficits no longer matter."

Not Your Grandfather's Debt Market

Cheney made those remarks in 2002, noting that while national debt had tripled during the 1980s, the US economy had grown strongly, and bond yields had fallen. He had some facts on his side, in other words. But that was then. In 2002 the "Washington Consensus" – the neoliberal framework for a globalized economy of free trade and free capital movement, centered on the primacy of the US dollar – was in full swing. The 2008 global financial crisis was still six years away, and nobody imagined that the economy of the following decade would be entirely beholden to the tireless machinations of the Federal Reserve and its fellow central banks in preventing the wheels of global growth from coming off.

Today, America's borrowing needs continue to grow – see "irresponsible budget resolution" above – but the global appetite for American financial products, from Treasuries to the dollar itself – is not keeping pace. Where is the supply of funds going to come from as public debt grows? Just using today's tax and spending policies as a baseline, economists estimate that federal debt will grow to around 250 percent of US GDP over the next three decades, with interest obligations eclipsing every other budget item. Already, annual interest costs are higher than Medicare, Medicaid and defense obligations. So much for all that "government efficiency" we've been hearing about lately.

Ghosts of 1998

One likely answer to that question – where is the funding going to come from? – doesn't give us much comfort. A long and in-depth article in the Financial Times today titled "How the Treasury market got hooked on hedge fund leverage" notes that there is around $904 billion in hedge fund investments engaged in a variety of so-called relative-value trades, which use massive amounts of leverage to exploit small differences in value between Treasury instruments and interest rate derivatives.[1] When those value discrepancies depart from the statistical predictions of the models' algorithms, bad things can happen. We saw a (mercifully brief) example of this recently when Treasury yields shot up, and the dollar declined, a few days after the April 2 tariff announcements.

The point here is that some of the major players in the Treasury market are institutions running strategies that are vulnerable to unpredictable shocks. These are not the boring, dependable primary dealers whose presence has been a mainstay of what for most of the last eighty years has been an orderly market with a vast pool of liquidity. Essentially, they are modern versions of the strategies employed by Long Term Capital Management before that august institution got deep-sixed by the Russian debt default in 1998.

So Dick Cheney may have been partially right about the non-consequences of debt and deficits back at the turn of the millennium. A quarter century later, though, we need to be cognizant of the potential consequences and prepared for what could be a persistent level of volatility in what is supposed to be the world's safest asset. An in-depth review of fixed income allocation strategies and alternative scenarios is a good place to start.

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