FT.com
FINANCIAL TIMES

Watch out for tail risks hanging over Treasuries

By Gillian Tett
Published: May 19 2011 14:54 | Last updated: May 19 2011 14:54

Three years ago, investors received a brutal lesson in why it can be risky for banks or other financial institutions to fund long-term holdings with short-term debt. But could it be time for investors to relearn that concept in relation to sovereign debt?

That is a question hovering over the $14,300bn US Treasuries market as the political fight about US fiscal policy intensifies.

In recent months, the atmosphere in the Treasuries market has been eerily calm, so much so that this week 10-year yields dropped to their lowest level this year.

That is striking, given that the Treasury technically hit the debt ceiling this week (the limit to how many bonds it can legally issue), and could even tip into a technical default in August if Congress fails to reach a deal to raise that debt ceiling by then.

But while it is reassuring to see that investors are continuing to gobble up US debt, even amid this political uncertainty, investors and politicians would do well to look also at what type of debt the US is selling today – and, more importantly, what it has sold in the past.

The issue revolves around the average maturity of the Treasuries market, or how frequently the government needs to sell new bonds to replace expiring ones.

This average maturity is now about 61 months, meaning around a ninth of the stock must be replaced each year.

By the standards of recent US history, this does not look too odd.

Since 1980, the average maturity has moved between 45 and 70 months. In 2008 it fell as low as 48 months, because the US government issued a large quantity of short-term debt to calm the financial markets.

However, when viewed with a wider lens, this US pattern looks unusual and unnerving.

In the UK, for example, the average maturity of sterling government debt is 13 years. While the UK is somewhat extreme in its duration, even in much of continental Europe the maturities are between seven and nine years.

The Treasury is keenly aware that this pattern makes the US something of an outlier, and unsurprisingly has been trying to extend the maturity profile.

It has already had some success, at least compared with 2008.

Indeed, these days T-bills – the shortest form of debt – account for less than 20 per cent of outstanding marketable debt, the lowest proportion since the 1960s.

But do not expect the Treasury to push out maturities too much further, too fast.

One problem is that US officials think it important to maintain the health of the T-bill market for overall financial stability, and thus are committed to continued hefty issuance there.

They also want to ensure that the 10-year bond market remains well supported, since this is central to the structure of US housing.

Doubts abound on whether there is even much investor appetite for ultra-long-term US debt. Although non-US investors have been buying a higher proportion of long-term debt, domestic institutions do not have the same appetite as, say, in the UK.

This creates at least two potential risks.

The most dramatic, and less likely, danger is that the short average maturity profile means the government could find it hard to keep rolling over its debt at a reasonable price – if at all – if there was ever a full-blown collapse of confidence.

The more subtle and likely problem is that the US government could also see the cost of financing the debt rise sharply if inflation surges, because it will need to roll over its debt at (rising) market rates.

The Congressional Budget Office, for example, recently projected what would happen to the US debt to gross domestic product ratio if inflation rose by 3 percentage points.

It concluded that this would fall from 72 per cent in 2012 to under 70 per cent in 2020, if bond rates remained stable (and all else remain unchanged). However, if rates rose by 2 percentage points, the debt burden rises to 76 per cent.

Inflation, in other words, will not "fix" the US debt burden, or not unless the government finds a way of forcing market rates down with controls.

Right now, this does not matter. Those 10-year bond rates are still laughably low, meaning financing costs are cheap. But if sentiment ever swings violently, there could be a nasty wake-up call.

That is a sobering thought at a time when Washington is also living with a form of political "rollover" risk, namely the danger that Congress keeps staving off any stable, long-term debt deal and resorting to short-term, temporary budget fixes, which like those bonds need to be continually renewed in a peculiarly hand-to-mouth way.

gillian.tett@ft.com