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US Treasury credibility risks

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Summary

- Policy uncertainty has pushed US Treasury yields higher
- Risks come not only from inflation, the budget deficit and foreign capital
- A confidence crisis could undermine the factors that keep yields so far in check notably Fed Treasury holdings

The tariff announcements by the US administration on April 2nd and the subsequent escalation of tariff hikes between the US and China as well as the recent standoff between US President Trump and Fed Chair Powell have pushed US Treasury yields higher.[1]

Based on our econometric US Treasury model, we show the different channels through which we view policy could impact yields, notably inflation expectations, the budget deficit and foreign capital flows.

The biggest risk we see, however, would be a loss of confidence in government debt sustainability as well as in the Fed's independence and commitment to low inflation.

Fed Treasury holdings depress the 10-year Treasury yield by nearly 200 basis points, based on our estimates. A confidence crisis could diminish that impact or, worse, turn it into the opposite if debt monetization is suddenly seen as inflationary by the market.

In our view, the recent rise in Treasury yields reflects mostly position adjustment, especially by leveraged investors, and is not yet a sign of an unfolding confidence crisis.

We also view business, household and financial sector balance sheet conditions as solid and unlikely to foster a financial crisis. However, the credibility of the government and the Fed as ultimate stability anchors in a crisis situation may no longer be assured.

Growth and inflation imply higher yield

Last year, we introduced our econometric macro model for 10-year Treasury yields and argued that yields are likely to stay higher for longer.[2]

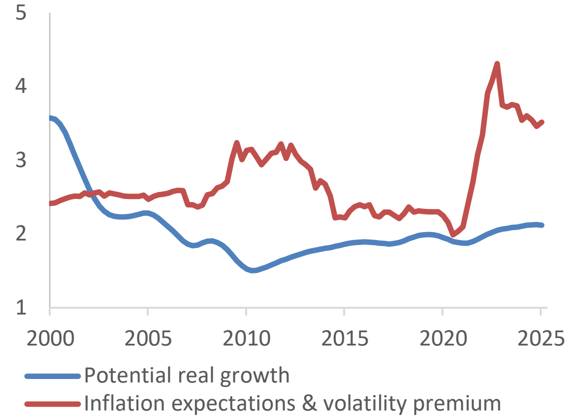
The model separates nominal yields into inflation expectations and real yields, with the latter regressed on potential growth, inflation volatility, the government balance, domestic private net savings, foreign capital flows, the real Fed funds rate and Fed Treasury holdings.[3]

Building on this analysis, we divide the macro factors into three groups: 1) growth and inflation, 2) flow-of-funds and 3) Fed policy operations.

Chart 1 shows the contribution of the growth and inflation group to the 10-year US Treasury yield through the first quarter 2025; the contribution from real potential growth has been on a gradually upward moving trend since the financial crisis, while the contribution from inflation (expectations and volatility premium) spiked in 2022 and has since then declined but remains elevated.

Chart 1: ZAIS estimate of growth & inflation contributions to 10-year Treasury yield

Percentage points per quarter annual rate



Source: ZAIS estimates.[4]

Until recently, we expected that the growth contribution would stabilize due to trends in demographics, and that the inflation contribution would decline further but not come back down to the lows seen between 2015 and 2021, with tighter labor market conditions and no more disinflation from deleveraging and globalization.

Now, we think that the growth contribution may moderate as the trade and immigration policies of the new administration undermine supply conditions.

On the other hand, we think the inflation component is unlikely to decline further and may rise again due to the inflationary impact of the government's trade, immigration and fiscal policy agenda. Overall, we believe the balance of the growth and inflation contributions to Treasury yields is biased to the upside.

It is interesting to us that the estimates of the growth and inflation components alone imply 10-year Treasury yields of well above 5% for the first quarter of this year. In other words, the flow-of-funds and Fed components must have a depressing impact and offset part of the growth and inflation component.

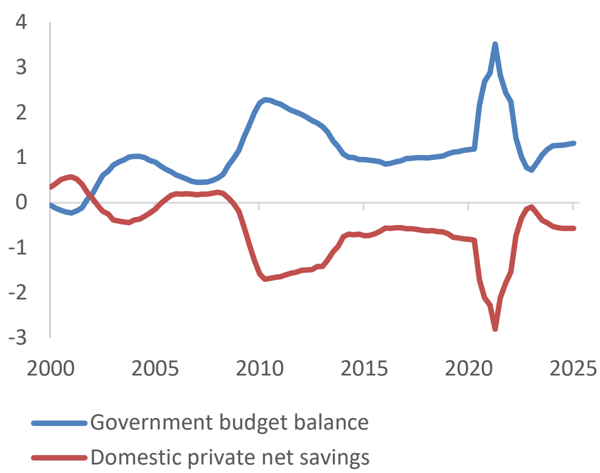
Flow-of-funds depress yields slightly

Chart 2 shows the contributions from the government budget balance and domestic private net savings on the 10-year US Treasury yield. The yield-contribution of the government budget is positive given the persistence of deficits for more than 20 years.

The yield contribution of domestic private net savings is basically an inverse image of the government budget, which shows the government stepping in when private-sector savings rise in crisis periods as well as the crowding out effect of government deficit spending.

Chart 2: ZAIS estimate of government budget & domestic private net savings contributions to 10-year Treasury yield

Percentage points per quarter annual rate



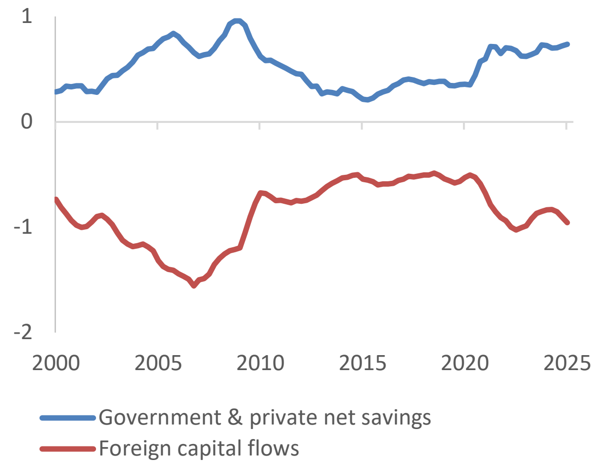
Source: ZAIS estimates. [5]

Chart 3 completes the flow-of-funds impact on 10-year Treasury yields by adding foreign capital flows.

The contribution of government and private net savings together on Treasury yields is positive but more than offset by the impact of foreign capital inflows.

Chart 3: ZAIS estimate of flow-of-funds contribution to 10-year Treasury yield

Percentage points per quarter annual rate



Source: ZAIS estimates. [6]

In 2006, at the peak of the international reserve accumulation boom, the impact of foreign capital inflows on 10-year Treasury yields more than offset the impact of government and private net savings by 90 basis points.[7] In the first quarter of 2025, that net impact had declined to 20 basis points.[8]

Until recently, our expectation was that the government deficit would stay high and potentially rise further, while we thought that domestic net private savings would decline due to higher investment needs and less savings related to demographics. We believed that foreign capital inflows would remain strong, but probably not enough to offset the yield-raising bias from government and private net savings.

Our outlook for the government deficit has not changed but we think that the domestic private sector will become more cautious and raise net savings due to increased policy uncertainty. On balance, that could be an improvement, but only if foreign capital inflows remain strong, which is questionable given the rise in policy uncertainty.

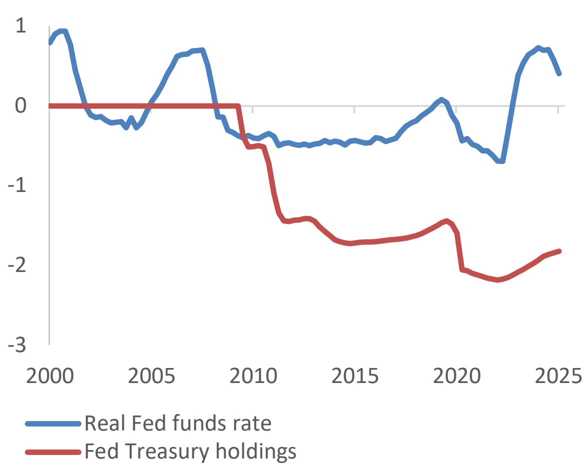
US financial markets have massively outperformed the rest of the world over the last few years[9] and we think this has resulted in large overweight positions in US assets by international investors that apparently are now being rebalanced. However, whether this could lead to a structural de-dollarization is less clear to us as we see no obvious replacement to take the role of the USD.[10]

Fed Treasury holdings hold yields down

As we pointed out before, we believe yields would be well above 5% now based on the growth and inflation contributions. The flow-of-funds contribution closes that gap only marginally, which implies that the main yield depressing factor must be Fed policy. Chart 4 shows the contribution of the real Fed funds rate and Fed Treasury holdings to 10-year Treasury yields.

Chart 4: ZAIS estimate of Fed policy contributions to the 10-year Treasury yield

Percentage points per quarter annual rate



Source: ZAIS estimates [11]

The chart shows the contribution of the real Fed funds rate varies between positive and negative depending on the interest cycle and short-term inflation expectations but was still positive by about 40bps in the first quarter of this year. That leaves Fed Treasury holdings as the main yield-depressing factor.

Where Fed policy will go from here is much debated. The Fed's current own projections imply a decline of the Fed funds rate by 50 basis points in 2025 and a continued gradual unwind of the Treasury holdings.[12] The net impact of that could be a wash.

In our view, the Fed may soon end its unwinding of Treasury holdings, pointing to the need for a large balance sheet to maintain the Ample Reserve Regime.[13] We also think the Fed remains more sensitive to negative unemployment surprises or systemic financial stress than persistent inflation pressures.

10-year yield heading towards 5% …

The table summarizes our outlook for the different 10-year Treasury yield components. On balance, we calculate that the trend points to higher 10-year US Treasury yields approaching 5% by the end of this year (see Chart 5 on next page). That would also imply a steeper curve based on our view that the Fed will probably ease by the end of the year.

Table: ZAIS outlook for 10-year US Treasury yield components

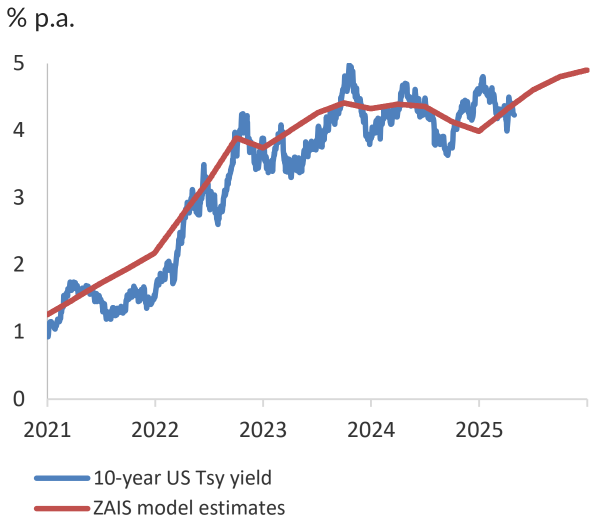
Component	Outlook	Yield impact
Potential growth	Moderating	Down
Inflation expec. & vola. premium	Elevated to rising	Up
Budget deficit	Elevated to rising	Up
Dom. prv. net savings	Stable to rising	Down
Foreign cap. flows	Declining	Up
Real Fed funds rate	Stable to falling	Down
Fed Tsy. holdings	Stabilizing	Stable

Source: ZAIS outlook and estimates [14]

… but a loss of confidence in policy credibility could push yields much higher

However, such model-based outlook projections require that the relationships observed in the past hold in the future. The risk is that a massive loss of confidence in US policy credibility could adversely change the relationships going forward.

Chart 5: 10-year US Treasury yield and ZAIS model estimate



Source: Board of Governors of the Federal Reserve System and ZAIS estimates [15]

In our view, a loss of confidence in US government debt sustainability as well as Fed independence and commitment to low inflation could trigger such a regime shift, with damaging implications for the US Treasury market.

We believe a deterioration of government debt sustainability would probably impact the parameters of the flow-of-funds component the most and raise the yield premium that investors require to hold government debt.

The budget reconciliation process in Congress is still ongoing but the government debt projections by the Committee for a Responsible Federal Budget suggest that debt sustainability is a serious concern.[16]

A loss of confidence in the Fed's independence and commitment to low inflation would, in our view, primarily undermine the yield-depressing impact of Fed Treasury holdings.

In a worst-case scenario, when combined with a loss of confidence in government debt sustainability, monetization of government debt could be seen by the market as inflationary and reverse the impact of Fed Treasury holdings from yield depressing into yield compounding.

Policy credibility is precious

To be sure, we think the recent volatility in the Treasury market, although caused by policy uncertainty, which triggered position adjustments especially by leveraged investors, is not yet a sure sign of an inevitable confidence crisis. In contrast to prior stress situations, especially the financial crisis, we also view business, household and financial-sector balance sheet conditions as solid and unlikely to foster financial stress.

However, our analysis highlights the importance of policy credibility for the Treasury market. In particular, the credibility of the government and the Fed as ultimate stability anchors in a crisis situation may no longer be assured if the government and not the private sector becomes the source of financial instability.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

[1] Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/DGS10

The New York Times; Trump Says He Won't Fire Powell. His Fed Battle May Not Be Over Yet. April 23, 2025.

https://www.nytimes.com/2025/04/23/us/politics/trump-jerome-powell-fed.html

[2] ZAIS Insight: Adjusting to Higher for Longer; June 2024.

https://www.zaisgroup.com/adjusting-to-higher-for-longer.html

[3] Same as footnote 2.

[4] Estimates are based on the ZAIS 10-year US Treasury model (see also footnote 2 for reference). The model first subtracts 10-year inflation expectations from the nominal 10-year yield to determine the real 10-year yield. Subsequently, we estimate the real yield level as a linear function of the following variables with coefficients (standard errors in parenthesis) based on a quarterly regression from 1990-Q1 to 2025-Q1.

0.699 * Potential real GDP growth (0.042)

0.692 * 5-year inflation volatility (0.097)

-0.202 * Gov. net savings % GDP (0.069)

-0.190 * Private net savings % GDP (0.075)

-0.251 * Foreign net lending % GDP (0.051)

0.246 * Real Fed funds rate (0.037)

-0.718 * Natural log of Fed Treasury holdings

linked to QPMs since 2009 % GDP (0.052)

Note that the Fed Treasury holdings impact real yields in our analysis in level terms and not in flow terms but with a diminishing scale factor expressed through the natural logarithm. The following data sources were used for the regression.

The following data sources have been used for the regression analysis.

Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis [GS10], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/GS10

Federal Reserve Bank of Philadelphia; Survey of Professional Forecasters; 10-year CPI Inflation Rate (CPI10); Median Responses; April 23, 2025.

https://www.philadelphiafed.org/surveys-and-data/cpi10

Potential real GDP growth (% oya):

U.S. Congressional Budget Office, Real Potential Gross Domestic Product [GDPPOT], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/GDPPOT

5-year inflation volatility (% 5-year standard deviation of quarterly CPI % over year ago):

U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis; , April 23, 2025.

https://fred.stlouisfed.org/series/CPIAUCSL

Net government savings (% of GDP, 4-quarter average, 1 quarter lagged):

U.S. Bureau of Economic Analysis, Net Federal Government Saving [FGDEF], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/FGDEF

U.S. Bureau of Economic Analysis, Net State and Local Government Saving [SLDEF], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/SLDEF

U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/GDP

Net private savings (gross savings minus investment % of GDP, 4-quarter average, 1 quarter lagged):

U.S. Bureau of Economic Analysis, Gross Private Saving [GPSAVE], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/GPSAVE

U.S. Bureau of Economic Analysis, Gross Private Domestic Investment [GPDI], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/GPDI

U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/GDP

Net foreign lending (% of GDP, 4-quarter average, 1 quarter lagged):

Board of Governors of the Federal Reserve System (US), Rest of the World; Net Lending (+) or Borrowing (-) (Capital Account), Transactions [RWLBACQ027S], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/RWLBACQ027S

U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/GDP

Real Fed funds rate (% p.a.):

Board of Governors of the Federal Reserve System (US), Federal Funds Effective Rate [FEDFUNDS], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/FEDFUNDS

Accumulated Fed Treasury holdings starting from 2009Q2 (% of GDP, 4-quarter moving average):

Board of Governors of the Federal Reserve System (US), Assets: Securities Held Outright: U.S. Treasury Securities: All: Wednesday Level [TREAST], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/TREAST

Board of Governors of the Federal Reserve System (US), Assets: Securities Held Outright: Mortgage-Backed Securities: Wednesday Level [WSHOMCB], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/WSHOMCB

[5] Same as footnote 4.

[6] Same as footnote 4.

[7] See Chart 3 again.

[8] See Chart 3 again.

[9] The MSCI US rose 97.3% in the five years until the end of 2025 while the MSCI World ex US rose only 31.6%.

https://www.msci.com/documents/10199/255599/msci-usa-index-gross.pdf

https://www.msci.com/documents/10199/255599/msci-world-ex-usa-index.pdf

[10] In particular, we think there is no other financial market that comes close to the US market in terms of size, liquidity and return potential. In our view, Europe is too fragmented, Japan too domestic and China too controlled.

[11] Same as footnote 4.

[12] Board of Governors of the Federal Reserve System; Summary of Economic projections; March 19, 2025.

https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20250319.htm

[13] Board of Governors of the Federal Reserve System; Plans for Reducing the Size of the Federal Reserve's Balance Sheet; May 4, 2022.

https://www.federalreserve.gov/newsevents/pressreleases/monetary20220504b.htm

[14] Based on ZAIS outlook for the individual variables and the model based impact on 10-year US Treasury yields (see also footnote 4).

[15] Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis [GS10], retrieved from FRED, Federal Reserve Bank of St. Louis; April 23, 2025.

https://fred.stlouisfed.org/series/GS10

ZAIS model estimates are based on the same model as described in footnote 4.

[16] Committee for a Responsible Federal Budget; 2025 Reconciliation Resources.

https://www.crfb.org/blogs/2025-reconciliation-resources

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