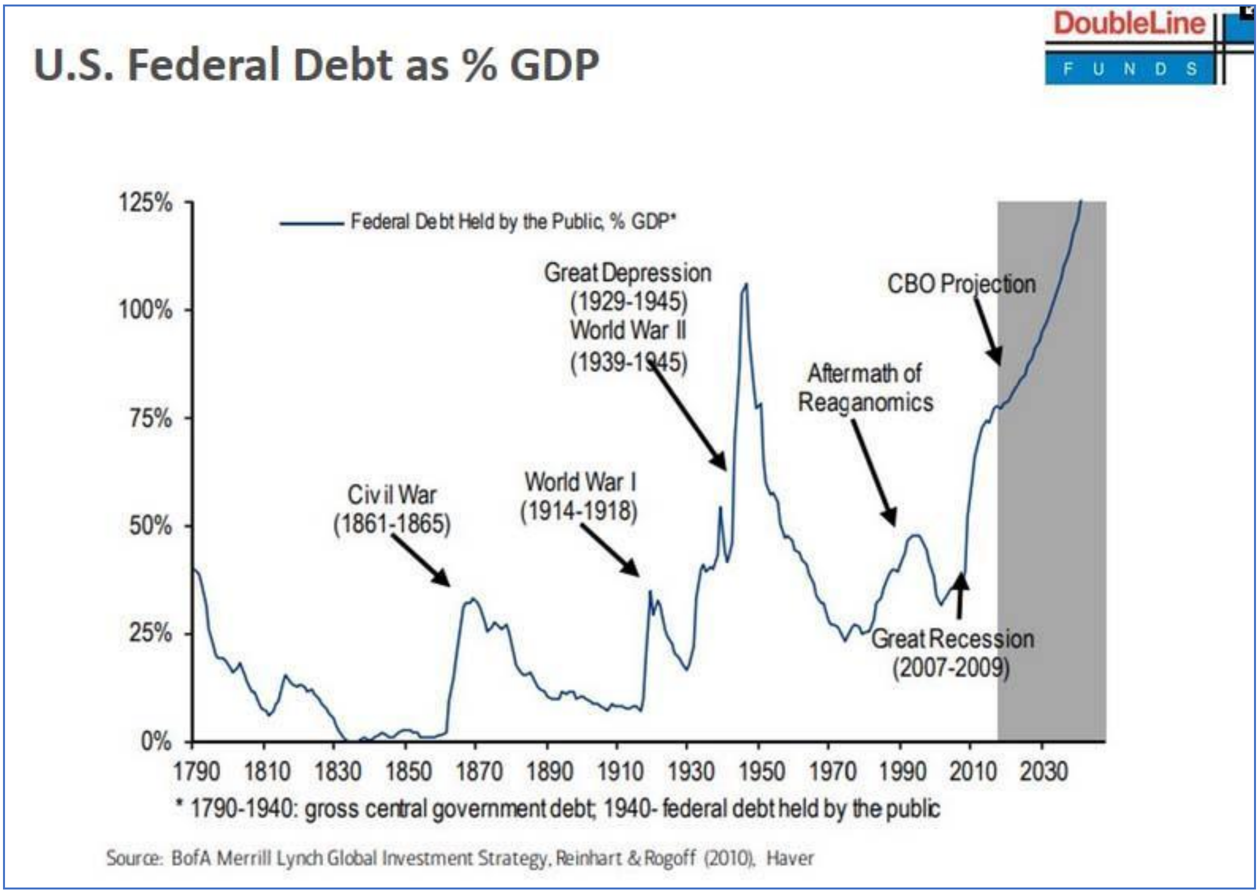
To get the economy humming, President Trump has instigated a fiscal stimulus package that is unprecedented outside periods of war or recession, and after an economic expansion that is, by historical standards, already long in the tooth. Based on current fiscal projections, the US will run budget deficits of around 5% of GDP as far as the eye can see. This, in turn, will send US debt as a percentage of GDP into the stratosphere as shown in the chart below.



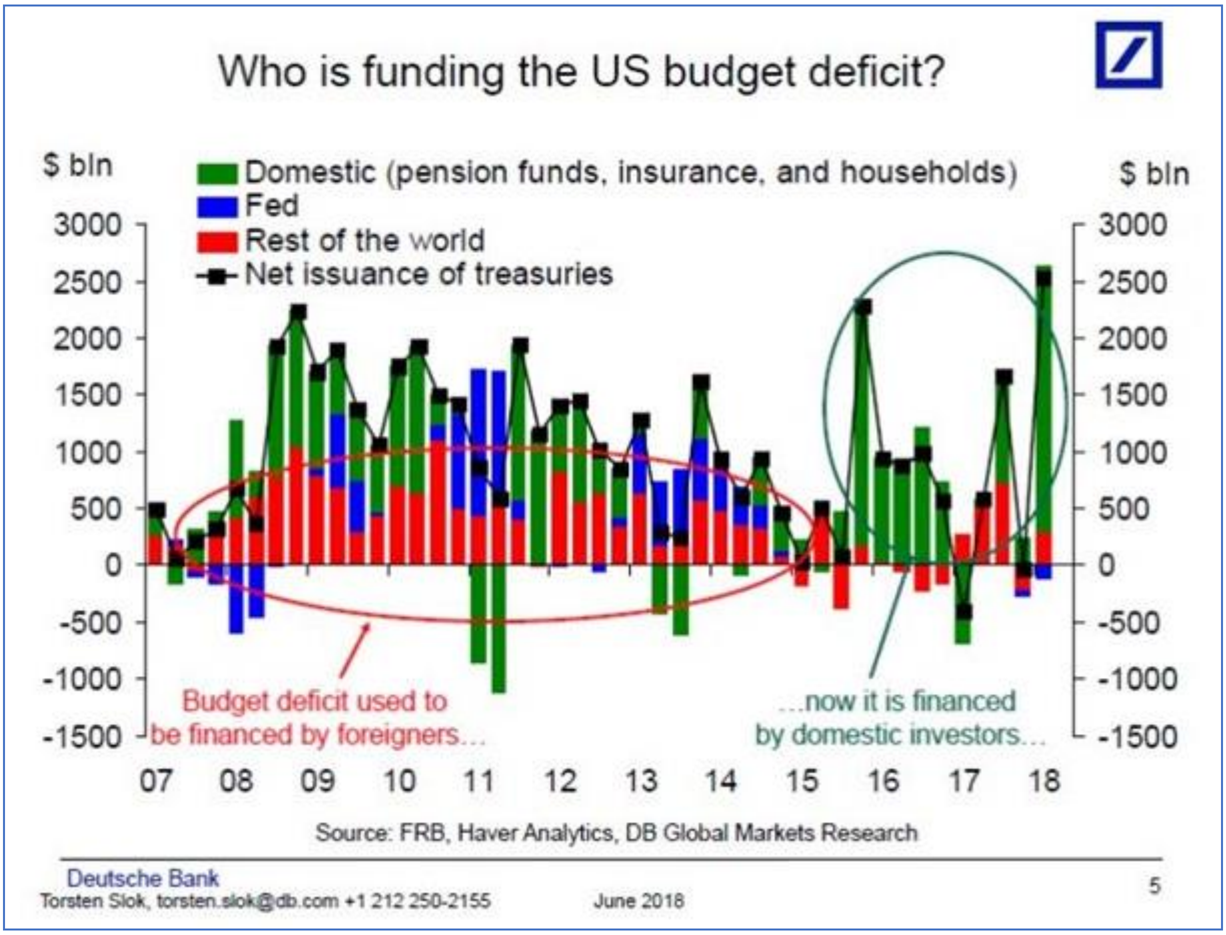
Source: Doubleline Funds, "Push Me, Pull Me" Webcast, June 2018.

This means that in the years ahead the US will be issuing a lot of treasury bonds. The obvious question for investors; who will buy them and at what price?

Historically the answer has been, to a large extent, foreigners in general and China in particular. In addition to the budget deficit depicted above the US has run a persistent and large trade deficit. In order for the Balance of Payments to balance, they must run a capital account surplus, whereby foreign capital flows into US assets such as treasury bonds.

This dynamic has persisted for a very long time, at least since the end of the Bretton Woods system in 1971 and arguably since the end of WWII. The reason is that in this period the US dollar has been recognised as the world's reserve currency creating a demand for US dollars that could only be satisfied by persistent US trade deficits. This is known in Triffin's paradox and meant for the lives of virtually every investor, US deficits didn't matter, in fact they were necessary. In the pre-war era period, this situation could not have happened due to the existence of a neutral reserve asset; gold. Persistent trade deficits would have seen an outflow of gold and a weakening of the currency.

The chart below breaks down how US budget deficits have been financed over the last 10 years.



Until 2015, roughly half of US deficits were financed by foreigners to help balance the current account deficit. Since 2015, despite persistent trade deficits, foreigners have made virtually no net purchases of US debt. They have stopped funding the US budget deficit.

Going forward, we know net issuance of treasuries is going to increase dramatically. Either foreigners must resume purchases, they must be bought by domestic individuals or institutions, or the Fed must print the necessary dollars and buy them.

Examining these options:

1. Foreigners resume purchases – Given Trump's belligerence on reducing the trade deficit, creditor nations are on notice that the US is no longer happy to be the consumer of last resort. Likewise, foreigners can see the ballooning entitlements programs and ever expanding fiscal deficits and are unwilling to continue to fund the unsustainable. It seems unlikely in the current environment that the old status quo will resume.

2. Domestic individuals or institutions step up – Much of the domestic demand that has filled the gap in recent years has been regulatory driven by directives affecting banks and money market funds. As net issuance increases this will suck demand out of the private sector through reduced consumption and private investment in a process known as 'crowding out'. This has the potential to turn the initial boost from the current fiscal stimulus to a drag in the years ahead.

3. The Federal Reserve prints money to finance the deficit – This is not the current direction of travel. The Fed is currently raising interest rates and reducing its balance sheet. However, as the current cycle reaches its conclusion, the pressure on deficits will intensify. Ultimately, the pressure on the Fed to fill the gap will be overwhelming.

How this all plays out over the coming years is of great significance to the global economy and the value of the US dollar. In the short term, there could be a squeeze on dollar funding which creates upward pressure on the currency and puts stress on those who require Eurodollar funding, such as many emerging markets. However, in the long term, option 3 would be extremely dollar negative, as the central banks of the creditor nations already know. While the destination may be clear, the path to it is extremely uncertain. Markets will continually try to game the outcome along the way.

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