

UNMASKING THE BOND VIGILANTES

Guardians of Fiscal Responsibility



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In November, the US Federal Reserve paused interest rates for a second time instead of hiking rates further. However, the US bond market did its own hiking, with yields on US government bonds surging across the board. The US 10-year Treasury yield brushed 5% — its highest level in 16 years.

The reason most widely cited for surging yields is the US economy's surprising resilience despite the Fed's rapid rate hiking cycle. But there is another explanation: the worsening of the US debt trajectory, a looming US Treasury supply glut and the return of the so-called bond vigilantes.

Economist Ed Yardeni originally coined the term 'bond vigilante' in the early 1980s. In a July 1983 paper he described how bond market participants can play a crucial role in enforcing fiscal discipline by influencing government borrowing costs and incentivising responsible fiscal policies. He wrote about them as follows: "So if the fiscal and monetary authorities won't regulate the economy, the bond investors will. The economy will be run by vigilantes in the credit market."

Monetary authorities in the US have stayed on course to lower headline and core inflation from their 2022 peaks — albeit not yet to target levels. Inflation soared after the US doled out three rounds of pandemic relief cheques to millions of Americans in early 2021 — fueling a consumer binge that caused prices to soar. The Fed responded (slowly at first) with one of the sharpest, most aggressive rate hikes in US history to tame the inflation beast. That same year, the US government successfully enacted fiscal spending programs — ironically under the Inflation Reduction Act — that have significantly degraded US budget deficit projections for the next decade.

The Fed's interest rate increases also mean far higher interest service costs for the US government, which is already spending more than it earns. The US federal deficit has

ballooned to \$2 trillion and is set to rise to over 6% of GDP this year — double that of 2022 — with worrying implications for future issuance.

When governments risk mismanaging their economies and undermining creditworthiness, bond vigilantes may react by actively selling bonds — driving down bond prices and pushing up yields. This makes government borrowing even more costly and acts as a signal to policymakers that their fiscal policies are unsustainable. In doing so, the vigilantes hope to help avert government spending sprees and resurgent inflation, which erodes the value of future debt interest and principal payments.

While it is difficult to precisely quantify how much of the recent spike in US Treasury yields was the result of vigilante activity, there is no doubt that the deteriorating US fiscal situation is of grave concern for bond investors — who may be grateful for the re-emergence of this mysterious group of market crusaders.



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