AquilaFlash

Fiscal Dominance

The Event

On Wednesday, 19 August, US Treasury Secretary Scott Bessent announced that buybacks of government bonds with maturities of 10 to 30 years would at least double. The ceiling per buyback operation rises from USD 2 billion to USD 4 billion. With seven such operations scheduled before 4 November, this adds roughly USD 14 billion of buyback capacity over the life of the programme.

That figure deserves a moment's attention. Not all US government debt is tradable: of the USD 40 trillion in gross debt, some 7 to 8 trillion consists of securities the government holds in its own social security trust funds. These are not traded and are not eligible for repurchase. That leaves around 32 trillion in private hands, of which roughly 5.3 trillion sits in the long maturities Bessent is targeting. The increase therefore amounts to just over a quarter of one percent of the relevant segment.

The instrument itself is neither new nor an invention of this administration. Janet Yellen established the buyback programme in 2024 and set the ceilings that applied until last week: USD 4 billion per operation for maturities up to ten years, USD 2 billion for anything beyond. Bessent has kept that architecture and has simply raised the lower of the two limits to match the higher one. The long end now gets what the rest of the curve has had for two years. Nor does the schedule reflect a spur-of-the-moment decision: the seven operations between 9 September and 4 November have been in the calendar for years.

So anyone looking for a turning point in monetary policy will not find one here. And yet this announcement occupied markets for a full week. That is the genuinely interesting finding: the effect lies not in the amount, but in the signal.

The Market Reaction and Its Half-Life

The trigger was the yield on the 30-year US Treasury. It has held above 5.2 percent for weeks, climbed above 5.3 percent on Monday, 17 August, and continued to drift higher. That is the highest level since 2007. Two trading days later, Bessent stepped in.

The immediate reaction was pronounced. The 30-year yield fell by around 10 basis points, the dollar weakened against every G10 currency, the dollar index lost 0.8 percent, gold gained more than 4 percent, and equity markets firmed. By the following day, the move in the bond market had been fully reversed. The 30-year yield stood at roughly 5.26 percent again, essentially where it had started, and the ten-year had returned to around 4.7 percent.

When an authority intervenes in a market, it gets tested. Such interventions rarely remain isolated events, because they create a dynamic in which the authority has to defend its position again and again. Here the test came within 24 hours, and the result was unambiguous. What is notable is what was not reversed. The dollar kept its decline, down 1.8 percent against the Swiss franc. Gold held its gain. Put differently: the bond market rejected the intervention, while the currency market and precious metals accepted it. When interventions cannot durably suppress yields, the pressure to adjust shifts into the currency and into real assets.

Why an intervention of this size became necessary at all, and why it achieved so little, only becomes clear once you look at the balance sheet behind it.

The Budget Behind the Bonds

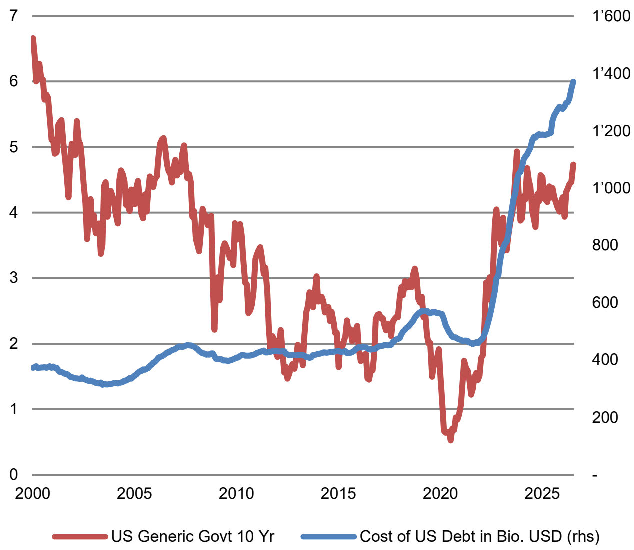
On 18 August, gross US federal debt passed USD 40 trillion, around 123 percent of annual economic output and roughly USD 117,000 per inhabitant. Ten years ago the figure stood at 19.4 trillion.

The pace tells us more than the level. Getting from 39 to 40 trillion took the government 154 days. Getting from 19 to 20 trillion, a proportionally larger step, took 588. The annual deficit runs at around 2 trillion, or 5.8 percent of economic output, and in July alone the shortfall came to 432 billion, the highest monthly figure in more than five years. Consolidation is nowhere in sight: the administration is expanding spending, does not intend to raise taxes, and the war in the Middle East is adding further costs. On top of that comes a burden nobody had planned for. After the Supreme Court ruled the tariffs unlawful in February, Washington now has to refund an estimated 165 to 175 billion in tariff revenue.

The Number That Matters Is the Interest Due

To understand why the long end of the yield curve has suddenly become politically relevant, look not at the level of debt but at the cost of servicing it.

The US government's interest bill currently runs at around USD 1,370 billion a year on a gross basis. In 2021 it was 450 billion. That works out at roughly USD 3.7 billion in interest every single day. The item now exceeds the entire defence budget, and it continues to grow: over the first ten months of the current fiscal year it rose 10.6 percent against the same period a year earlier.



Source: Bloomberg Finance L.P.

The chart shows why this is only becoming visible now. Between 2000 and 2021 the debt grew substantially, yet the interest burden stayed almost flat. The reason lies in the red line: as long as yields were falling, maturing bonds were continuously replaced at lower rates. Falling rates offset rising volumes. Since 2022 both forces have pushed in the same direction, and the blue line has turned almost vertical.

That is the heart of the problem, and it is strikingly simple. Around a third of tradable debt matures within twelve months. In addition, some 6.1 trillion comes due in 2027 and 2028, most of it issued at rates well below today's. Every one of those refinancings makes the debt service more expensive. And the shorter the government's funding profile, the faster every move in rates feeds through.

Why This Reinforces Itself

What emerges is a feedback loop worth spelling out once. Higher yields raise the interest bill. A higher interest bill widens the deficit. A wider deficit forces additional bond issuance. And more issuance means private investors have to absorb still more duration risk, for which they demand greater compensation. The circle closes.

The structure of spending makes this worse. Social security and health programmes, interest and veterans' benefits together already absorb around 105 percent of federal revenue, and that with revenue close to an all-time high. These obligations are growing at roughly 7.5 percent a year, revenue at 4. Nor are they commitments that can be argued away: pensions, medical benefits and veterans' entitlements are written into law, driven by demographics and politically untouchable. Around half of federal revenue comes from taxing labour, which leaves the revenue side exposed to the business cycle.

Not a Purely American Problem

What is happening in Washington is happening everywhere. Long-term yields reached multi-decade highs last week in Germany, the United Kingdom, France and Japan at the same time. France pays 4.12 percent on ten-year bonds, its highest rate since October 2008, and will spend some EUR 77 billion on debt service in 2026, up from 66 billion the year before. Ten-year German Bunds yield 3.25 percent, the highest level since 2011.

The pattern is the same everywhere. Public finances are deteriorating, debt volumes are growing, and because the level of interest rates has risen, the interest burden is growing faster than the debt itself. At the same time markets are demanding a higher term premium, meaning a larger premium for tying up money over long horizons. Yield curves are steepening. Switzerland remains the exception. High stability, low inflation, little debt, and no breakout in long-term rates. Financial markets rarely come this close to a controlled experiment.

Our Reading

We do not see the buybacks as an isolated event, but as one element in a closer working relationship between the Treasury and the central bank. There is a term for this constellation: fiscal dominance.

What it describes is a shift in priorities. An independent central bank orients its policy towards the price level. Under fiscal dominance it orients it, in practice, towards the government's ability to service its debt. Formally, independence remains intact; in practice, the room for manoeuvre shrinks. Raising rates high enough to break inflation decisively would overwhelm the budget. The United States is the largest case here, but not the only one.

There are four ways to reduce a debt burden. You can cut spending, which is politically all but impossible. You can raise taxes, which is equally unpopular. You can stop paying, which a government that borrows in its own currency has no need to do, since it can print that currency if it comes to it. Or you can erode the debt over time by holding interest rates below the rate of inflation. The technical term is financial repression, and it is the only one of the four routes that requires no act of parliament and that those affected barely notice. The United States took it once before, between 1942 and 1951, capping the ten-year yield at 2.5 percent. Bond investors were left with negative real returns for years afterwards.

So anyone trying to understand the buybacks should not start with the buybacks, but with the question of what Washington is actually aiming for. The answer lies less in what the Treasury is doing than in what the central bank has been saying. Fed Chair Warsh was described by many commentators as unclear after his most recent press conference. We think his message reads perfectly well once you set two statements side by side.

First: he accepts rising yields at the long end. The economy is growing strongly, and the bond market is expected to adjust to that. In his own framing, markets should do part of the tightening work the central bank would otherwise have to do. Rising long-term rates slow construction, investment and consumption without the Fed having to raise the policy rate and thereby increase the government's own cost of borrowing.

Second, and this is usually overlooked: he is at the same time explicitly maintaining an ample supply of liquidity. Anyone genuinely tightening drains liquidity from money markets. That is precisely what is not happening.

The objection is obvious, and it is a fair one: the minutes of the July meeting read as restrictive. Three members voted for a hike, others favoured tightening should inflation fail to come down, and Warsh has reaffirmed the two percent target in unambiguous terms. We think the contradiction can be resolved. The rhetoric is aimed at the short end and at inflation expectations; the balance sheet decisions concern the long end.

If the long end is allowed to rise while the short end stays anchored by ample liquidity, the result is a steeper yield curve. It slows the economy where slowing works, namely in long-term financing. At the same time it keeps short-term rates low, and short-term paper is now where the government does most of its borrowing. And this is exactly where the buyback fits in.

Operation Twist (Again)

The government buys back long-dated paper and funds that through short-dated issuance. Afterwards it has exactly as much debt as before, but a different maturity profile. The risk is redistributed along the curve, not reduced. Anyone who switches a mortgage from ten years to two does not have less debt. They simply have another conversation with the bank sooner. A note in passing: Bessent was sharply critical of this very instrument in 2024, when Yellen deployed it. We make no moral judgement of that. Someone who adopts a tool he once condemned rarely does so out of conviction.

Interest rate policy is only one half of the picture. The other is the spending side, and it follows a discernible logic. Bessent has spelled it out himself: after Wall Street has had its day, it is now Main Street's turn. In practice that means targeted fiscal spending rather than broad stimulus. Defence procurement, strategic alliances, critical raw materials, energy infrastructure. These are programmes designed to generate domestic orders, create jobs and strengthen the industrial base. One may argue about how well targeted they are. About the scale, one may not. A deficit of around 6 percent of economic output is a substantial stimulus, and it comes at a point when the economy is growing anyway and unemployment is low. That explains part of the strength many observers currently admire in the US economy, and it explains at the same time why inflation is not returning to 2 percent.

Is America Going Bankrupt?

The question is an obvious one, and it can be answered more precisely than the debate suggests. The debt ratio alone is no guide. Russia defaulted in 1998 at a ratio well below 100 percent, Argentina in 2001 likewise. Japan has lived with more than 200 percent for years. There is no threshold at which a state tips over, and anyone looking for one will be disappointed.

What actually predicts sovereign debt crises is the relationship between the real interest rate and real economic growth. As long as an economy grows faster than the real rate it pays on its debt, the debt ratio falls even if the government merely balances its budget before interest. Once that relationship inverts, the self-reinforcing dynamic described above sets in. Every major sovereign default of recent decades, Greece, Argentina, Russia, Venezuela, Sri Lanka, shared this feature, and did so irrespective of the debt ratio.

Where does the United States stand? The weighted average rate on outstanding debt is around 3.4 percent, annual inflation around 3.4 percent. In real terms, Washington is currently paying next to nothing. Against that stands trend real growth, which the Congressional Budget Office (CBO) and the central bank both put at roughly 1.8 percent. By this measure the situation is not yet alarming. What matters is that this gap does not invert on a lasting basis. It is a key reason the debt burden remains bearable today, and it only does so as long as real financing costs stay below real growth.

Of the 5.8 percent deficit, 3.2 percentage points go to interest, leaving a primary deficit of around 2.6 percent. Without a primary surplus the ratio keeps rising, and every year of higher interest costs narrows the room for everything else. The CBO expects the debt to reach around 136 percent of economic output by 2036, with interest costs over the same period climbing from 19 to 26 percent of federal revenue.

The analyst Lyn Alden has coined the apt phrase that “nothing stops this train”. She identifies six drivers: underfunded social security, high healthcare costs, high defence spending, the rising interest bill, political polarisation, and the dependence of tax receipts on financial markets. Four of these are political in nature and cannot be administered away, only decided. Those decisions are not being taken, and they will not be taken in the next legislative term either.

What we are observing, then, is not an impending bankruptcy but a state of affairs in which the debt burden no longer shrinks by itself and instead has to be actively managed, so as to keep the real interest burden low and, if possible, negative, with yield curve control as the blunt instrument of last resort. Judging by recent events, that management has already begun.

Why the Dollar Is Not Collapsing

If influence is being exerted on interest rates, the pressure shifts to the currency. Trillions of dollars in debt are outstanding outside the United States. Anyone who owes dollars needs dollars, regardless of what they make of American fiscal policy. That demand is fixed by contract and cannot be circumvented at short notice. It is the reason the dollar money supply can expand considerably without the currency losing its function.

Then there is the relative argument. Exchange rates do not measure absolute purchasing power; they measure one currency against another. When Japan, the United Kingdom, France and the eurozone face the same problems and respond with the same instruments, the exchange rate shows less of it than one might assume.

The erosion therefore becomes visible not in currency markets, except for the structurally strong Swiss franc, but against yardsticks that cannot be multiplied at will, i.e. real assets, gold above all.

A Thermometer and an Unknown Boiling Point

So how should this situation be read? Most aptly as a thermometer with a boiling point nobody can pinpoint. The temperature is rising measurably: debt is growing, and the interest burden is growing faster. All of that can be observed. What cannot be observed is the mark at which the system shifts into a different state. Our expectation is that the boiling point will never be reached. Politics will intervene before it is. We read last week's announcement as another step in that direction.

A steeper yield curve is being tolerated for now, but it is already being massaged through intervention. Should long yields rise too sharply from here, we consider some form of yield curve control the most likely next step: first unofficially, through more intensive buybacks, issuance management and interventions, then, if necessary, explicitly. Up to X percent and no further.

The next test comes at Jackson Hole from 27 to 29 August. The symposium is not a policy meeting, but it is the first coherent opportunity to read this Fed's reaction function.

Any remarks on inflation tolerance, on balance sheet policy or on the retreat from forward guidance could move the term premium directly.

All Quiet on the Western Front

For investors, the consequence matters more than the mechanism. A policy that caps nominal rates while inflation runs above them produces negative real returns. That is precisely the point, because it is the only way to work down a debt burden without cutting spending and without raising taxes.

Our positioning follows from this, and it is not a new one. Real assets benefit in this environment because they cannot be multiplied at will. Gold ranks first among them. Emerging market central banks understood this long ago and have been accumulating for years, not least to diversify their dollar reserves.

Our real asset strategy therefore remains intact, several years on. It was never a bet on collapse. It is a bet that governments will manage their debt burden through the erosion of their currency, because every other route is politically too expensive. The past few weeks have delivered nothing that calls our positioning into question.

How would we know we are wrong? If the ten-year yield were to rise sustainably without Washington reacting, our thesis would be damaged. It would mean the willingness to bear higher financing costs is greater than we assume.

Contact

Silvano Marchesi
Chief Investment Officer
+41 58 680 60 40

Christoph Sieger
Portfolio Manager
+41 58 680 60 56