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Treating the symptom, not the problem

Last week, following a sharp rise in long-term bond yields, the US Treasury announced it would double the size of its buybacks of longer-dated bonds to at least US$4 billion per operation, with Bessent subsequently indicating it could do even more.

Source: CNBC Markets

At first blush, the logic is straightforward. Long-term Treasury yields had risen sharply, with the 30-year yield moving above 5%. Higher government borrowing costs eventually flow through into higher mortgage rates, corporate borrowing costs and tighter financial conditions more generally. They also add to the already considerable cost of servicing US government debt.

Treasury Secretary Scott Bessent clearly didn't like what he was seeing. His view was that the bond market had got ahead of itself, so Treasury stepped in.

And it worked. Well, for 24-hours. Long-term yields fell. But the rally was short-lived and yields subsequently moved back towards, in some cases beyond, where they had been before the announcement.

This shouldn't surprise anyone. Bessent was trying the age-old policy faux pas of treating the symptom rather than the problem.

As has become well understood, the rise in long-term US bond yields isn't primarily a market-functioning problem. It reflects some very real fundamental concerns. The US continues to run extraordinarily large fiscal deficits at a time when the economy is not in recession. Government debt has continued to rise and the amount of new debt the market is being asked to absorb remains enormous. At the same time, inflation remains above target, oil prices are elevated and the outlook for monetary policy remains uncertain.

Investors understandably want more compensation for lending to the US government for 20 or 30 years. That's the market doing exactly what markets are supposed to do!

Of course, Treasury buybacks aren't new. They have traditionally been used to improve liquidity in older, less frequently traded securities. But the context matters. Increasing purchases immediately after a sharp rise in yields, and then explicitly arguing that the market has overshot, makes this look rather different. It looks like exactly what it is – a futile attempt to influence the price of long-term money.

The strategy (and I use the term loosely) had more than a passing resemblance to the Federal Reserve's old "Operation Twist". Treasury is effectively issuing relatively more short-term debt while buying longer-dated securities, thereby reducing the amount of duration the private sector has to absorb.

Mr Bessent, meet Mr Warsh

One of the defining features of Kevin Warsh's early tenure at the Federal Reserve has been his desire to reduce the Fed's footprint in financial markets. Less forward guidance and less pretence that policymakers can fine-tune markets, a smaller balance sheet over time and more emphasis on price stability and allowing markets themselves to determine financial conditions.

For now, it seems to me that just as Warsh is trying to get the Fed out of markets, Bessent appears to be getting Treasury into them.

That creates an intriguing tension. The Fed may decide that inflation requires monetary policy to remain tight, or perhaps even tighter, while Treasury simultaneously attempts to reduce longer-term borrowing costs. One arm of government could therefore be trying to tighten financial conditions while another is trying to ease them. That's hardly a recipe for policy clarity.

The bond market is sending a message to Washington

The uncomfortable reality for the US Administration is that higher long-term yields are telling policymakers something. The problem for the Administration is it's not a message they want to hear - the US fiscal position is unsustainable over the longer term.

That doesn't mean a fiscal crisis is imminent. The US retains enormous economic strengths; the dollar remains the world's dominant reserve currency and US Treasury securities remain at the centre of the global financial system.

But none of that means the price of borrowing is irrelevant. Large structural deficits require enormous amounts of debt issuance. Investors need to be persuaded to hold that debt. And if they become less confident about inflation, fiscal sustainability or the future value of the dollar, the price of persuading them rises. That price is the bond yield.

Buying some long bonds might temporarily suppress that signal. Issuing more bills might shift some of the financing burden towards the short end of the curve. Neither changes the underlying fiscal arithmetic.

Indeed, there is a risk that attempting to suppress the signal actually makes the problem worse. Investors may reasonably ask why Treasury feels the need to intervene. They may also begin to wonder whether policymakers are becoming increasingly unwilling to tolerate the market consequences of their own fiscal decisions. That sets up an intriguing political….and market….conundrum.

Fiscal dominance

I've written a bit about the rise of fiscal dominance recently. Fiscal dominance doesn't necessarily arrive with a dramatic announcement that monetary policy has overnight become subordinate to the needs of government. It can happen much more gradually.

Governments run increasingly large structural deficits. Debt rises. Interest costs increase. Higher bond yields then make the fiscal arithmetic even more difficult. Eventually, the level of interest rates required to contain inflation or appropriately price fiscal risk becomes increasingly uncomfortable for governments.

At that point, the temptation to influence those interest rates becomes stronger. That influence can take many forms. Governments can change the maturity profile of their borrowing. They can issue more short-term debt and less long-term debt. They can buy back longer-dated securities. And, ultimately, political pressure can build on the central bank to run monetary policy in a way that makes the government's debt burden easier to manage.

None of that means the US has suddenly entered an era of fiscal dominance. Bessent's buybacks are far too small to warrant that conclusion. But the direction of travel is worth watching.

For much of the past few decades, monetary policy has been dominant. Central banks set policy according to their inflation and employment objectives, while governments broadly accepted the interest-rate consequences.

Fiscal dominance turns that relationship around. Monetary and financial conditions increasingly have to accommodate the consequences of fiscal policy. That is why the contrast between Bessent and Warsh is so intriguing.

Warsh appears to want a Federal Reserve that intervenes less, communicates less and allows markets to play a greater role in determining financial conditions. Bessent has just looked at one of the most important prices in global financial markets, the long-term US government bond yield, concluded that the market had got it wrong, and intervened.

Those two philosophies can coexist for a while. Bessent may well succeed in smoothing periods of poor liquidity. Treasury can also sensibly manage the maturity profile of its debt issuance. Those are legitimate functions of debt management. But if fiscal pressures continue to build, at some point they may collide.

If the objective is ultimately to engineer structurally lower long-term interest rates, buybacks aren't going to solve the problem. There are really only two durable ways of achieving that. One is lower inflation. The other is a more credible fiscal trajectory.

Setting the stage for Jackson Hole

This is all setting the stage for the annual gathering of central bankers at Jackson Hole, with the main event likely to be Federal Reserve Chair Kevin Warsh's first keynote address at the symposium.

I expect we will be silent on the immediate outlook for monetary policy with the focus the most likely to be on his thinking about the framework for monetary policy. Since taking over at the Fed, he has argued for less forward guidance, a smaller central-bank footprint in financial markets and greater reliance on markets themselves to determine financial conditions. Jackson Hole gives him an opportunity to explain that philosophy more fully.

That would have been interesting enough in its own right. But Treasury Secretary Scott Bessent's intervention in the bond market last week gives Warsh's speech an added dimension. Just as Warsh is arguing that the Fed should intervene less in markets, Treasury has stepped in to try to ease pressure on long-term yields.

I would be surprised if Warsh directly criticised Bessent. But listen for any emphasis on market price discovery, central-bank independence and the distinction between monetary policy and debt management. A strong restatement that the Fed's job is to deliver price stability, rather than manage Federal Government borrowing costs or particular levels of bond yields, would be significant.

There is a certain irony in all this. Jackson Hole has become famous as an occasion on which markets hang on every word from the Fed Chair. Warsh's message may ultimately be that they should stop doing so!!!!!