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UNITED STATES

The quality of U.S. debt could be an issue under Trump

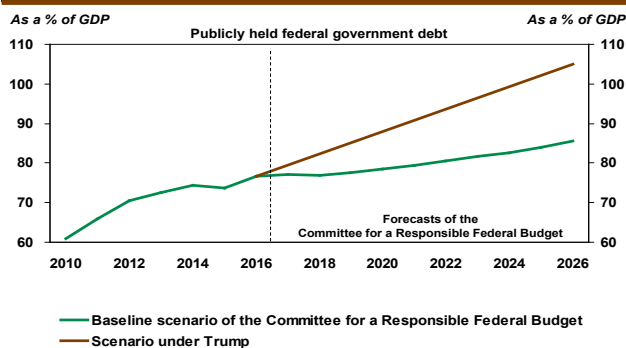
Since the presidential election of November 8, the 10-year U.S. Treasury yield is up by almost 50 basis points. After such a sizeable movement in such a short period of time, one may wonder whether a reversal is in sight. As it stand, a return to pre-election yield level is difficult to imagine.

Some argue that the surge in inflation expectations that is behind the yield climb is overdone, along with hopes of a dramatic impact from Donald Trump's economic policies on growth. However, the 10-year inflation expectations have only returned to 2.0%, a level corresponding to the Federal Reserve (Fed) target. Thus, markets are not so much indicating a disproportionate fear of an inflationary surge, but a little less difficulty for the Fed to defend its target. Recall that 10-year inflation expectations had spent much of the year 2016 around 1.5%. Even without the Trump effect, this level appeared too low, especially in view of the fact that inflation expectations largely responded to realized inflation. The latter has been plagued by the drop in energy prices in recent years, but this effect on the annual change in price indices has now almost entirely dissipated, something that markets had not really adjusted to before the election. One can see in the election of Donald Trump a healthy kick to expectations that were misaligned.

The U.S. debt is another factor that seems to limit the risk of a significant fall in interest rates. Under Trump's policies, which rely on substantial tax cuts, some estimates point to an increase in the U.S. federal debt held publicly to 105% of GDP by 2026, from a level of about 75 % currently.

Coupled with rising borrowing costs, the consequence would be a larger debt servicing burden, only accentuating deficits. This would not mean default per se, but it may be that Moody's and Fitch, the two credit rating agencies that still attribute a AAA rating to U.S. debt, believe it deserves a lower status. Fitch said that the literal implementation of Trump's promises would be detrimental to the solvency of the United States. If downgrades were to occur, some

Donald Trump's proposals could increase public debt considerably



Sources: Committee for a Responsible Federal Budget, Congressional Budget Office and Desjardins, Economic Studies

investors such as pension funds, foreign reserves and financial institutions, which are required to hold high quality debt securities, may see U.S. bonds as less attractive.

Implications: In the medium term, the trajectory of U.S. debt could be among the factors prolonging the rise in borrowing costs. That said, no definitive conclusions can be drawn at this stage. From electoral promises to concrete measures, there is a large step, especially since some Republicans of Congress are unlikely to endorse a slippage of public finances.

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