CAPITAL MARKETS ECONOMICS

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Special Report: Why The US Can Accommodate Less Bond Buying

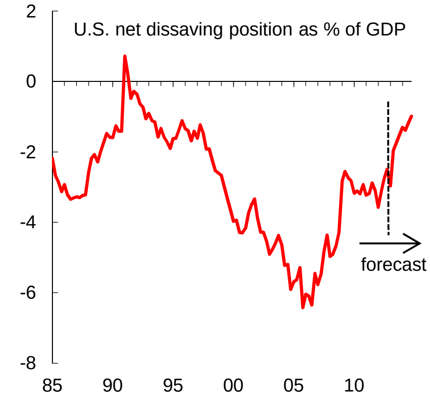
- **The US net borrower status is close to an end.**

Who will buy all the debt being issued by Treasury and the private sector when the Federal Reserve eventually cuts back on its purchases and ultimately stops them? This complex question plagues asset markets and there are no easy answers as foreign creditors question the value in Treasuries, while domestic households, banks, pensions, life insurers and shadow investors already collectively sit atop high ownership of fixed income products.

One more sanguine perspective is that the US will need foreign creditors much less so over the next two years. This perspective is offered in terms of how reduced Treasury issuance relates to the broad improvement in the imbalance between savings and investment across the entire US economy. By the end of next year, in fact, we are forecasting that all sectors of the US economy combined will be 'dissaving' to the least extent since the Clinton administration. This reflects the fruits of years of deleveraging as well as emerging fiscal repair. As a result, it is possible that within a few short years the US economy may well come very close to putting an end to its status as a net borrower in world markets compared to peak rates of dissaving that equaled about a whopping 6½% of GDP by late 2005 and should go from 3% of GDP now to 1% or even outright balance by the end of next year (chart 1). If this happens, then it would at least ensure a relatively orderly debt market compared to more alarmist concerns regarding what happens in the wake of the Fed's injection of massive volumes of bond purchases.

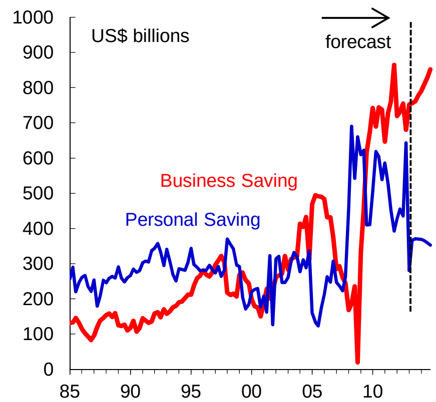
To get to this understanding, we need to make a reasonable attempt at forecasting the net saving and investment position of the US economy. This is tricky because it entails forecasting many variables including outright saving or dissaving by households, businesses including through retained earnings, and combined levels of governments. It also involves forecasting investment flows by households primarily in real estate, businesses in equipment, structures and software, and governments in the same said categories. In essence, we are forecasting the components embodied within table F8 in the Federal Reserve's *Financial Accounts Of the United States*.

Chart 1 **US Dissaving Is Rapidly Improving**



Source: Financial Accounts of the United States, Federal Reserve, Scotiabank Economics.

Chart 2 **US Personal and Business Saving on an Upswing**



Source: Federal Reserve Flow of Funds, Scotiabank Economics.

The problem is probably somewhat less complex than it sounds, however, since the two biggest potential swing factors that entail the greatest sensitivities are government deficits and total investment and we'll come back to these two variables in a moment. One of the guiding assumptions on the rest of the variables includes an assumption that the profit cycle probably has not peaked as an economic recovery unfolds with greater private sector momentum into next year. That should guide higher business retained earnings over our forecast horizon but at a slower rate of growth than the past. We also assume that the personal saving rate will be gradually rebuilt from the distorted lows in 2013Q1 that resulted in spending the unanticipated income surge in 2012Q4 that was partially guided by brought-forward dividend pay-outs. We have erred conservatively in this regard, assuming only a gently higher pace of personal saving over this

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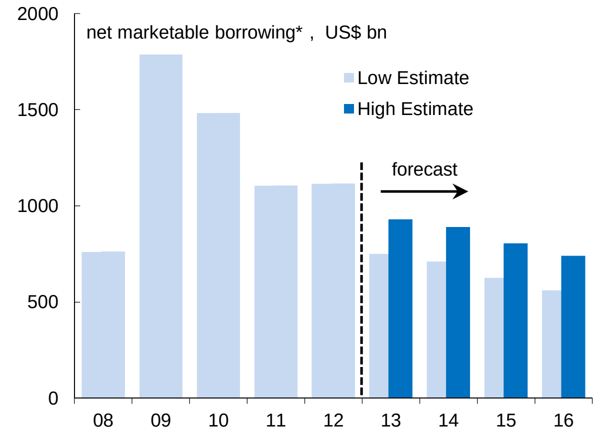
year and next. These two guiding assumptions are reflected in chart 2 into the end of next year. They are not, however, the most sensitive variables in our projections.

1. US Treasury Issuance Set To Wane

We now turn to what we think are the more important swing drivers of the improvement in the US dissaving position starting with public sector deficits. To date, we have pointed out how rapidly improving US fiscal deficits should give way to lower net debt issuance requirements using high-low issuance numbers forecast by our fiscal policy specialist Mary Webb (chart 3). This was the theme we advanced in our piece titled *Treasury Supply Tapering Offsets Fed Tapering* back on June 21st. We have used that to argue that the Federal Reserve can move toward tapering asset purchases into 2014 alongside diminished new supply of Treasuries. Indeed, as soon as this October and at the start of Washington's next fiscal year, auction sizes are likely to begin being scaled back. The effects on the curve are likely to be mostly felt in reduced t-bill issuance, but we're assuming auctions will also begin to be curtailed in 2s through the belly of the curve. Most of this effect is likely going to be particularly felt as FY15 approaches after next September.

Chart 3 **Issuance Projected to Decline**

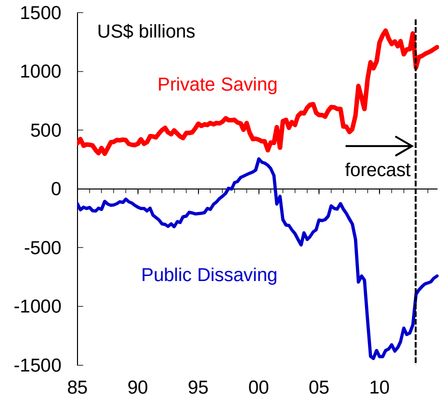


* Fiscal yr-end: Sept. 30. Source: US Department of Treasury, Scotiabank Economics.

This matters because it reflects the much faster pace of deficit repair than had been expected as recently as just the start of this year. The implication is a sharp forecast rate of improvement to public sector dissaving relative to private sector saving as illustrated in chart 4. We think governments collectively decrease net borrowing by over a half trillion dollars between the end of the US government's FY12 to the end of calendar year 2014. This improvement is too often not positioned in the broad context of the overall saving and investment position.

Chart 4

US Private Saving Offsetting Shrinking Government Deficits



Source: Federal Reserve Flow of Funds, Scotiabank Economics.

2. Bullish Housing and Business Investment Outlook

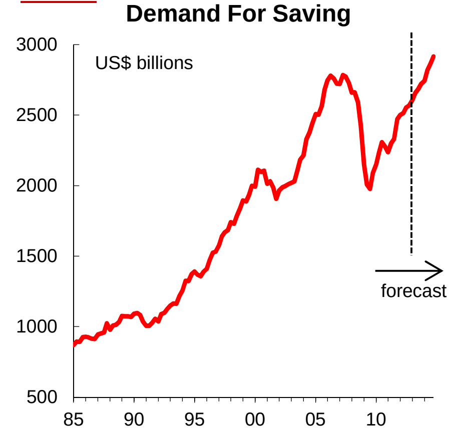
The second most sensitive variable in our projections for the saving and investment balance of the US economy is what happens to business investment. As chart 5 depicts, we're being conservative for present purposes by forecasting a rapid rate of growth in business investment. Conservative means risking overstating strength and thus understating the pace at which the US improves its net dissaving position. Whereas gross investment by all households, businesses and governments was about US$100 billion in 2012 and is about $600 billion higher since the trough in 2009, we're assuming a powerful acceleration in investment toward achieving a $350 billion rise over just the two year period from 2012 to 2014. That would take the sum total of investment flows across all physical assets in the US economy toward a record high.

Conclusion

Too often the deficit and tapering debates are not placed in forward-looking fashion within the proper context of the nation's overall sources and uses of saving within the global rebalancing theme. We feel that doing so through employing conservative assumptions yields a constructive backdrop for the country's bond markets and financial system going forward.

Of course, this does not negate the possibility that banks, nonbanks, households and foreign creditors might sell down Treasury and fixed income holdings in future through rotating into other assets. Two counter-acting forces to such a move, however, may well be that the stock of purchases held by the Federal Reserve won't go down for a long time yet while a diminished flow of needed purchases of net US debt can be accommodated in the context of the economy's broad saving and investment position.

Chart 5 **Rising Investment Demand For Saving**



Source: Financial Accounts of the United States, Scotiabank Economics.