BRAY FARM
INCOME ADVISORY

Week of April 22, 2025

Help! Help! I'm being repressed! While the world's focus remains on trade and the global flow of real goods, we need to discuss the global flow of financial capital. By accounting definition, a country's current account – its balance of payments for real goods and services – is equal to its capital account – the flow of financial goods. Since 2006, our current account has slid to a $1 trillion deficit. To settle payment, the United States sends dollars to the exporting nation. Now, the exporting manufacturer and its nation's central bank have an excess of United States dollars. What's the best – historically – and easiest thing to do with US dollars? Invest in US dollar denominated financial assets. The largest demanded asset has been Treasury securities[1], but foreign investors can also allocate to corporate debt, public equities, and real assets.

As displayed on Liberation Day, the Trump administration views bilateral trade imbalances as inherently bad. Mathematically, if we narrow our current account deficit, we will narrow our capital account deficit. Foreign investment in US dollar denominated assets *must* fall, and Treasuries will be the most impacted asset class. The short-term effect is an increase in structural yield levels, and the long-term effect is a much more expensive debt balance[2].

President Trump and Secretary Bessent have iterated repeatedly that a key goal of theirs is to lower the yield on 10-year Treasuries. With yields rising due to global demand shifts, a bloated government debt weighing on balance sheets, and political pressure to manage costs, the Administration may be left with one option. *Financial Repression.*

Financial repression is a scary term for a spectrum of regulatory policies aimed at artificially managing interest rates and debt through the banking sector. On the extreme side, governments can explicitly cap interest rates – like during World War II – or place restrictions on demand deposits – Regulation Q banned interest on demand deposits and imposed caps on other deposits. On the subtler side, the Fed could carve out Treasuries from capital requirements or large quantitative easing aimed at capped yield targets. In the short run, financial repression provides a tool for deficit reduction. The stated goals of the administration would lead them right to this option.

I think it's almost certain that the first tool would be changing leverage and liquidity requirements on domestic banks. Dealers complain that the supplementary leverage ratio (SLR) – the ratio of bank equity to total assets – is the main impediment to participating in auctions. Current bank regulation requires banks to have 3% – or 5% for the global systematically important banks – of their total assets in cash reserves. The Fed, Office of the Comptroller of the Currency, and Federal Deposit Insurance Company could do this *tomorrow.* Changing the SLR calculation has already been a topic of lobbying and pressure from the banking industry, so the political and industrial will is there already!

For bond yields, this sort of intervention detaches yields from pure macroeconomic fundamentals, at least initially. The path I expect is an initial increase in bond yields as foreign buyers retreat from the primary market, followed by a one-time decrease in yields driven by this policy implementation. As long as inflation remains relatively capped, I expect a downward level shift of 10-15 basis points for the 10-year Treasury, based on similar actions taken during COVID. If hard data begins to show economic slowdown or if volatility remains structurally relevant, we may see yield decreases of 15-25 basis points.

However, in the long run, by increasing leverage in the banking sector, the Fed will be trading a temporarily lower yield for a hotter financial sector with larger systemic risk. Concerns over the basis trade and the ability of the repo market to provide liquidity may start to show cracks in the event of turbulent conditions in the credit market. Furthermore, artificially lower yields may push extra credit creation and deterioration in incentives to save, leading to structurally higher inflation.

1.) The current mix for 2024 flows is $477 billion for Treasuries (40%), $295 billion for corporate debt (25%), and $312 billion for US equities (27%).

    U.S. Department of the Treasury. Treasury International Capital System, U.S. Long-Term
    Securities Held by Foreign Residents. https://ticdata.treasury.gov/resource-center/data-chart-center/tic/Documents/slt_table1.txt

2.) I don't know if I can get into all the impacts of the US not being able to issue debt at the level it's accustomed to. In short, I think our consumptive, service-based economy has been centered on America's unique ability to offer consistently low-cost debt.

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