

## The Mother of All Debt Cliffs Mardjokic.com

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I remember hearing somewhere that if the government was run like a major corporation the CFO would be fired. I think now more than ever, most of you would agree with this statement. The national house is in disarray: unresolved deficits, an inflation-friendly monetary base, fast approaching debt ceilings, and hemorrhaging war costs come to mind first.

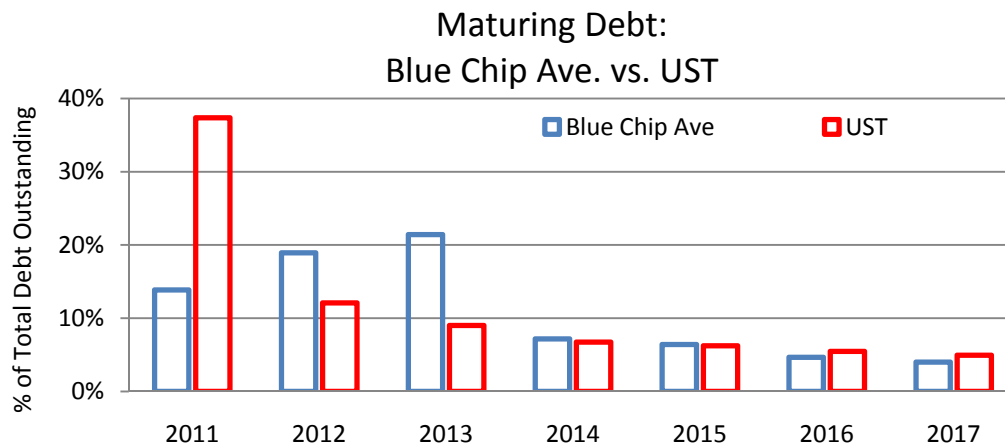
But as long as capital markets are open and willing to lend, the government hums along. Like a great many companies, the government must balance interest costs (which are real and reportable) with abstract and 'out-in-the-tail' risks like liquidity and rollover risk.

The battle is waged along the yield curve where the Treasury seeks to find bidders for its debt and like any good salesman widens its product offerings to capture many suitors.

The steepness of the yield curve dictates how expensive it is for the government to mitigate rollover risk by making it (relatively) more or less expensive to place long term debt. Today the steepness of the yield curve makes short term debt very compelling, but the government's behavior is more than just opportunistic. The US, since 1979, has been a chronic abuser of short term financing with average issuance in the 0-2Y space of 75%!

The best way to showcase what I mean is by looking at a debt maturity profile. It plots the amount of debt that is outstanding and coming due within the next few years. When debt comes in large blocks, people refer to it as a 'debt cliff'. Either you refinance the whole block at the same time or game over, you become insolvent.

Debt cliffs are most commonly seen in high yield issuers who have trouble securing long term financing and rely heavily on bank loans. But unlike high yield issuers, the US is creating a debt cliff by frontloading the nation's obligations on the short end, where yields are just 4bps.



*Source: Bloomberg, TreasuryDirect.gov*

The above graph plots the US debt maturity profile against a composite of 6 blue chip companies in the US. You notice the cliff I was referring to? Over 37% of US debt (or \$4.1T) is maturing this year while the blue chip average is 14%. The US is chronically exposing itself to rollover risk. Looking at it another way, the average maturity of US debt is just shy of 5Yrs (4.91Y) while the blue chip average is 6.25Yrs. This means the US is going to have to roll more debt over a shorter time period.

I know what you are may be thinking: treasury markets are some of the most liquid in the world, and more importantly, at present, dirt cheap. So why shouldn't the DMO (Debt Management Office) issue short duration? 3M Treasury bills yield just 4bps while a ten year treasury yields close to 3.5%. That's a yield spread of 3.46%, which is very rich. If you were a banker and I offer up a yield spread of 3.46%, you'd be picking up my dry cleaning and driving my kids to soccer practice.

I realize it's a hard argument to make. Over the last 4 years, following the actual debt issuance of the UST over the more fiscally responsible blue chip average has netted the UST over half a trillion in interest savings. (*See Appendix A for a breakdown*).

But these savings come at an implicit cost: it makes the US a defacto variable rate borrower, and one that is constantly rolling its debt into new money yields. The immediate risk isn't the same for the US government as it is for a corporate issuer. The market will lend to the US, but one day markets are going to wake up and realize they are unpaid for their services.

Moreover, how do we wean a government off artificially low short term rates that are the equivalent of a teaser rate to a subprime borrower? Debt loads are close to 100% of revenue and deficits forecasted out as far as the eye can see.

Appendix A:

<b>Proforma: Maturity Profile using Blue Chip Ave (Bn)</b>	<b>0-2Y</b>	<b>2-5Y</b>	<b>5-10Y</b>	<b>10Y-20Y</b>	<b>20-30Y</b>	<b>Grand Total</b>
2007	1.46	1.46	1.46	1.46	1.46	1.46
2008	2.22	2.22	2.22	2.22	2.22	2.22
2009	2.78	2.78	2.78	2.78	2.78	2.78
2010	2.76	2.76	2.76	2.76	2.76	2.76
2011	0.66	0.66	0.66	0.66	0.66	0.66
<b>Proforma: WA Coupon</b>	<b>0-2Y</b>	<b>2-5Y</b>	<b>5-10Y</b>	<b>10Y-20Y</b>	<b>20-30Y</b>	<b>Grand Total</b>
2007	4.38%	4.25%	4.01%	4.21%	4.84%	4.36%
2008	1.26%	2.06%	2.97%	3.05%	4.43%	1.46%
2009	0.18%	1.26%	2.75%	2.67%	4.16%	0.67%
2010	0.14%	0.97%	2.44%	1.95%	4.09%	0.63%
2011	0.13%	1.11%	2.48%	3.62%	4.11%	0.66%
<b>Proforma: Total Interest Payments (Bn)</b>	<b>0-2Y</b>	<b>2-5Y</b>	<b>5-10Y</b>	<b>10Y-20Y</b>	<b>20-30Y</b>	<b>Grand Total</b>
2007	0.06	0.06	0.06	0.06	0.07	0.06
2008	0.03	0.05	0.07	0.07	0.10	0.03
2009	0.01	0.03	0.08	0.07	0.12	0.02
2010	0.00	0.03	0.07	0.05	0.11	0.02
2011	0.00	0.01	0.02	0.02	0.03	0.00
						<b>1.41</b>
<b>Actual Interest Payments (Bn)</b>	<b>0-2Y</b>	<b>2-5Y</b>	<b>5-10Y</b>	<b>10Y-20Y</b>	<b>20-30Y</b>	<b>Grand Total</b>
2007	0.16	0.02	0.01	0.00	0.00	0.19
2008	0.07	0.01	0.01	0.00	0.00	0.10
2009	0.01	0.01	0.03	0.00	0.01	0.06
2010	0.01	0.01	0.03	0.00	0.01	0.05
2011	0.00	0.00	0.01	0.00	0.00	0.01
						<b>0.834</b>
<b>Net Savings (Bn)</b>	<b>0.5727</b>					
<b>**Note: Assumes WA Coupon does not chg given maturity shifts**</b>						