Tomorrow's Affairs
Analysis of today
Assessment of tomorrow

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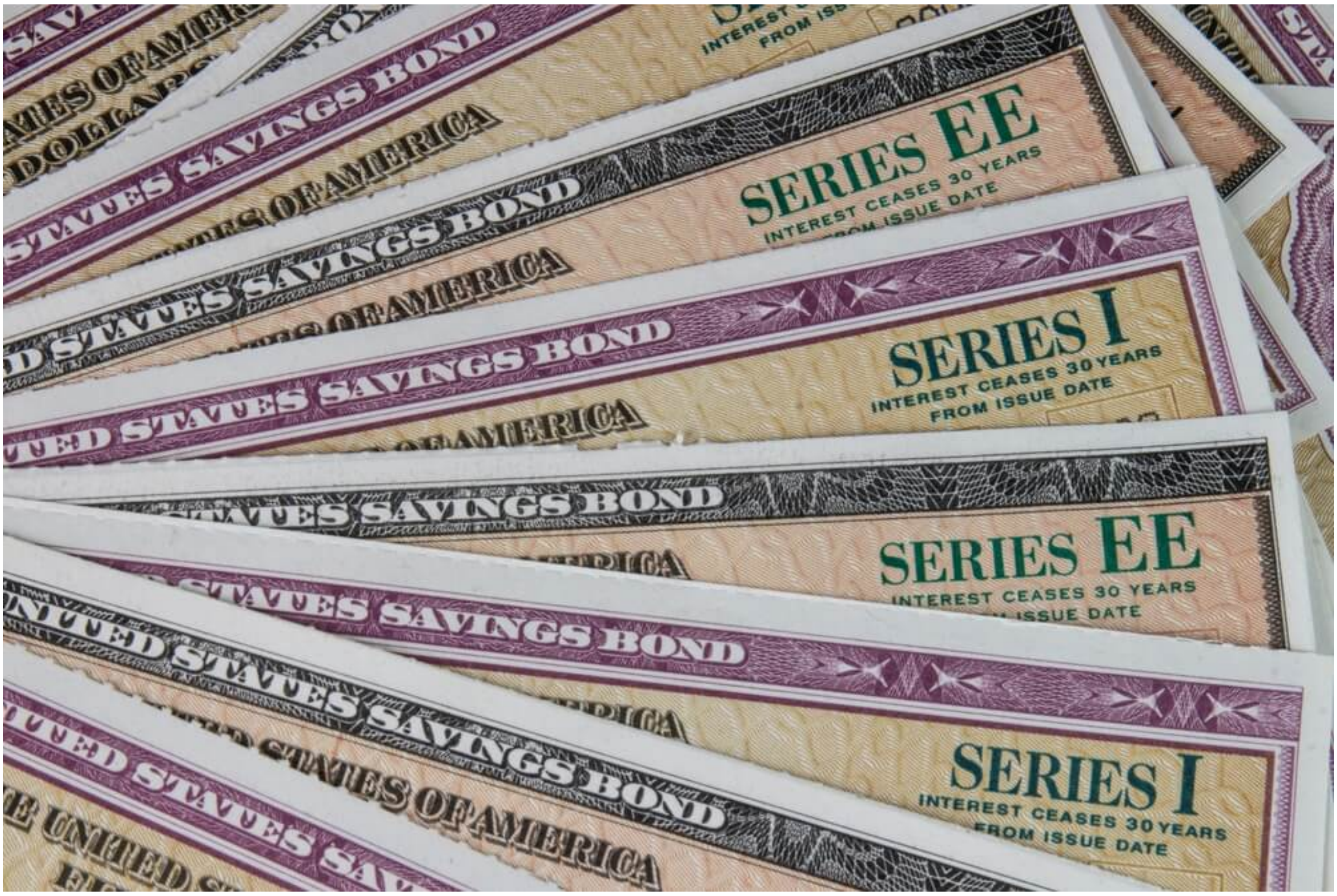
Government bonds are no longer a reserve asset



Developed nations' government debt is gradually losing its place as a reserve asset for global central banks.

This is a monumental change in financial and monetary history, and fiscally irresponsible governments seem to ignore it.

Many governments, particularly in Europe, continue to believe they will be able to issue more bonds forever despite weaker solvency and persistent inflation.

They seem to prefer to erode their currency than to stop the current level of insane spending. The result is likely to be more monetary destruction through currency debasement.

Many citizens do not understand the connection between inflation and government solvency. When a government issues debt, it is printing currency. If the public finances of the nation are weak and global demand for those bonds weakens, the currency they issue loses value and inflation rises.

Inflation is the erosion of the purchasing power of the currency, and this happens when confidence in the issuer evaporates, as investors and domestic citizens see that the nation's public finances are worsening in an alarming way.

Central banks understand this. Sovereign bonds are currency, and they can only become a reserve asset if the value stands over time.

Japan is abandoning bonds as a reserve

The trend of Japanese and global central banks buying fewer foreign sovereign bonds should be a top headline in all financial media. Global central banks and investors fear, correctly, that developed nations' public finances have become unsustainable and that the bonds they issue will lose value over time as persistent inflation continues.

Japan, traditionally one of the largest holders of foreign sovereign debt, is gradually abandoning bonds as a reserve. In 2022, Japanese investors began reducing their holdings of foreign bonds due to increasing hedging costs and the risk of persistent inflation.

This partial repatriation of Japanese capital raised concerns about the potential impacts on foreign yields because many European governments and the US Treasury usually count on strong Japanese demand to cover their debt issuances.

> The outlook for Japanese foreign bond investments will be dictated by the concerns about deficit spending and inflation expectations

Looking ahead to 2025, the outlook for Japanese foreign bond investments remains uncertain and will be dictated by the concerns about deficit spending and inflation expectations.

The Bank of Japan (BOJ) is expected to continue its gradual hiking cycle, which, combined with a potential Fed cutting cycle, could result in lower USD/JPY hedging costs. However, as inflation in the US rises, the Fed may not cut rates as fast as some desire.

If hedging costs decline, it could make foreign bonds more attractive to Japanese investors unwilling to take the full risk of weaker solvency ratios and persistent inflation. The yield provided by sovereign bonds does not offset the risk of price depreciation of the bonds and rising inflation.

Competition for investor demand will increase

This trend is not limited to Japan. Many global central banks have been engaging in quantitative tightening (QT), reducing their balance sheets by letting bonds mature or actively selling them.

This, added to those central banks that have decided to switch from government bonds to gold to strengthen their balance sheets, may be a significant blow to the expectations of European and US Treasuries of ample demand for their large issuances ahead.

This means competition for investor demand will increase. Between 2024 and 2026, over USD 4.5 trillion in bond debt from Emerging Market and Developing Economies (EMDEs) will mature. Developed nations will likely absorb as much fixed income demand as possible, given the relatively lower risk of their issuances.

The shift away from foreign bond purchases can impact currencies severely

However, diminishing investor demand in a world of persistent inflation means issuers will have to accept higher yields and short-term duration, which contribute to a weaker currency.

Reduced demand for foreign bonds from central banks can lead to significant market volatility, especially when governments are unwilling to reduce spending and deficits. Major buyers exit the market, there could be upward pressure on bond yields, and interest expense costs will likely rise in government budgets.

Even if domestic central banks try to mitigate the risks with quantitative easing, persistent inflation limits the scope of monetary policy decisions. The shift away from foreign bond purchases can impact currencies severely.

As central banks lose confidence in government debt and switch to gold, many investors will have to follow the same example and abandon bonds.

Protect yourself

Since 2022, sovereign bonds have failed to protect investors from market volatility. Instead of being a safe and valuable asset, they have created large latent losses in pension funds and also in central banks' asset bases.

In the past, this risk was disguised with quantitative easing. The Federal Reserve, the ECB, the Bank of England, and the Bank of Japan would engage in large asset purchases that would increase money supply and provide liquidity to the bond market in periods of uncertainty. However, inflation was not a persistent problem then.

Governments could stop spending in an unsustainable way and increasing their debt. However, it seems no one wants to do that - Daniel Lacalle

Governments have put central banks in an impossible situation. They need to choose between monetary easing, which may hurt the economy with higher inflation, or maintaining rates and liquidity stable, which will create market volatility.

Of course, there is an easier solution: Governments could stop spending in an unsustainable way and increasing their debt. However, it seems no one wants to do that.

They prefer to destroy the currency and perpetuate inflation, and global central banks know it. That is why demand for sovereign bonds is likely to slump in the next months.

This trend has not led to a dramatic market impact so far. However, there is one certain outcome: currency purchasing power demolition. Thus, investors need to reduce exposure to sovereign bonds and look for alternatives like gold.

Fiscally irresponsible governments prefer to erode the purchasing power of their currency than to reduce their spending imbalances. Protect yourself.