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Treasury Issuance, Duration Demand, and the Shape of the Yield Curve

Why the Composition of Treasury Borrowing May Matter as Much as the Size

Much of the discussion surrounding federal deficits has focused on the size of Treasury borrowing. Equally important, however, may be the composition of that borrowing.

Recent research from Apollo Chief Economist Torsten Slok highlights that Treasury bills have accounted for approximately 85% of gross Treasury issuance over the past year. While this strategy provides funding flexibility and may reduce borrowing costs in the short run, it raises an important question: Is the supply of long-duration, high-quality assets growing quickly enough to meet the needs of investors seeking duration?

To understand why this matters, it is important to recognize that not all Treasury securities serve the same purpose.

Treasury bills are cash-like instruments with maturities of less than one year. They are widely used by money market funds, corporations, and investors seeking liquidity and capital preservation. Treasury notes and bonds, often referred to as coupon securities, provide something very different: duration.

Duration is a critical asset for institutions with long-term liabilities. Pension funds, life insurance companies, retirement income programs, banks, sovereign wealth funds, and other institutional investors often rely on longer-dated Treasury securities to help match future obligations that may extend decades into the future. A three-month Treasury bill cannot effectively hedge a twenty-year pension liability, regardless of how many times it is rolled over.

This distinction is particularly important because the global pool of duration-sensitive liabilities continues to grow.

Demographic trends across much of the developed world are increasing retirement obligations, pension payouts, and insurance liabilities. Defined contribution retirement plans are increasingly offering retirement income solutions that require long-term assets. Insurance companies continue to accumulate liabilities that stretch decades into the future. Pension systems, both public and private, must manage obligations whose value is highly sensitive to long-term interest rates.

As a result, demand for long-duration, high-quality assets may be increasing even as Treasury issuance becomes increasingly concentrated in short-term bills.

This dynamic raises an interesting question for fixed income investors. While market commentary frequently focuses on rising deficits, expanding Treasury debt, and fiscal sustainability concerns, comparatively less attention is paid to the growing demand for duration from institutions whose liabilities require it.

The answer may help explain one of the more puzzling features of today's bond market. Despite record federal deficits, expanding Treasury debt, and persistent concerns about government borrowing, long-term Treasury yields have generally remained lower than many investors expected.

One possible explanation is that the supply of long-duration Treasury securities has not expanded as quickly as the liabilities many institutions seek to hedge. If so, investors may place a greater value on duration than headline debt statistics alone would suggest. In other words, the market's focus on total Treasury debt may overlook the importance of the maturity profile of that debt.

The Federal Reserve's balance sheet policy may also contribute to this discussion. Through quantitative tightening (QT), the Fed continues to reduce its holdings of Treasury securities by allowing bonds to mature without reinvestment. While QT increases the amount of Treasury debt that must ultimately be absorbed by private investors, Treasury's reliance on bill issuance means much of the new supply is concentrated at the short end of the curve rather than in the maturities most sought after by pensions, insurers, and other liability-driven investors.

The result is a market characterized by abundant short-term instruments but potentially more limited growth in long-duration collateral.

This distinction matters because Treasury coupon securities play a central role throughout the financial system. Beyond serving as investments, they function as high-quality liquid assets for banks, collateral within repo and funding markets, benchmarks for pricing corporate and municipal bonds, and hedging instruments across global fixed income markets. Their value extends beyond the income they generate; they are foundational assets supporting the broader financial system.

Ironically, Treasury's increased reliance on bill issuance may have implications for the shape of the yield curve. The government is effectively shortening the maturity profile of its debt at a time when many institutional investors continue to seek longer-duration assets. This mismatch between supply and demand may be one factor helping to anchor longer-term yields despite elevated deficits and substantial borrowing needs.

Whether liability-driven demand ultimately exceeds the available supply of long-duration assets remains an open question. The answer is likely influenced by many factors, including issuance patterns, economic growth, inflation expectations, regulatory requirements, and global capital flows.

Nevertheless, the comparison itself deserves greater attention. Treasury supply is visible and easily measured. Duration demand is less obvious but may be equally important. As pension obligations, insurance liabilities, retirement assets, and other long-term commitments continue to grow, understanding the balance between duration demand and duration supply may become increasingly important in evaluating long-term interest rates.

For investors, the key takeaway is straightforward. The shape of the yield curve may be reflecting more than economic growth expectations, inflation forecasts, or Federal Reserve policy alone. Structural demand for duration from pensions, insurers, retirement systems, banks, and global institutions may also be exerting an important influence on long-term interest rates.

While headlines focus on the growing supply of Treasury debt, investors may benefit from asking a different question: Is enough long-duration Treasury debt being created to satisfy the growing need for duration throughout the global financial system?

The answer may prove increasingly important in understanding the behavior of interest rates, the evolution of the yield curve, and the long-term outlook for fixed income markets.

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