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Muni Finance and the Federal Fiscal Food Fight.

With federal deficits soaring, bond issuers may face higher financing costs. State and local cash managers shine for now, but all eyes will be on the coming congressional budget battle.

Deficit financing has caught up with Uncle Sam, as federal outlays for interest payments have surged to record levels and the nation's annual budget deficit is on track to double in this fiscal year. That's just for starters: To dampen inflation, the Federal Reserve has hiked short-term interest rates and keeps jettisoning U.S. bonds, not buying them as it had been. Meanwhile, key foreign buyers including China have recently exited the Treasury market, also driving yields a bit higher.

Those federal interest expenses appear doomed to escalate yet higher in the next year or two as older, cheaper debt rolls off the books while forthcoming budgets remain locked in deficits and ambitious prior infrastructure appropriations are spent. Beyond that, compound interest will be America's gnarlier enemy unless budget discipline is re-established on Capitol Hill. The Fitch rating service has downgraded Treasury debt, citing the partisan congressional dysfunctionality fueling this fiscal food fight.

So far, the indirect impact on the municipal bond market of these tectonic macro shifts is measured in fractions of a percentage point, so it's hardly the end of the world. In California earthquake-speak, it's a tremor, not a Big One. Meanwhile, the impact on state and local operating budgets today is arguably net-positive for most. But fiscal hawks and critics of Modern Monetary Theory are crowing that a dreary hangover of elevated and more costly interest rates seems to be here to stay — at least until the next recession, when the central bank presumably will have no choice but to once again cut rates and investors flee stocks to pile into the safety of government bonds. Bond market math is indeed a dismal science.

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by Girard Miller

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