A new battle for cash has begun – and it could sink stocks

ROGER MONTGOMERY

For much of the past decade, investors became accustomed to abundant cheap capital.

As rates surged in 2022, that world began contracting, and another wave is now under way.

The United States is entering an unfamiliar period. Two of the largest borrowers in modern financial history are demanding enormous quantities of money. One is the US government. The other is the artificial intelligence revolution. Increasingly, they're competing for the same capital.

Starting with Washington, the Congressional Budget Office expects the US federal deficit to reach $US1.9 trillion ($2.64 trillion) in 2026, equivalent to 5.8 per cent of GDP.

Debt held by the public already stands at about 101 per cent of GDP, and the CBO expects it will reach 120 per cent by 2036.

Perhaps more importantly, net interest costs are projected to rise from 3.3 per cent of GDP this year to 4.6 per cent by 2036.

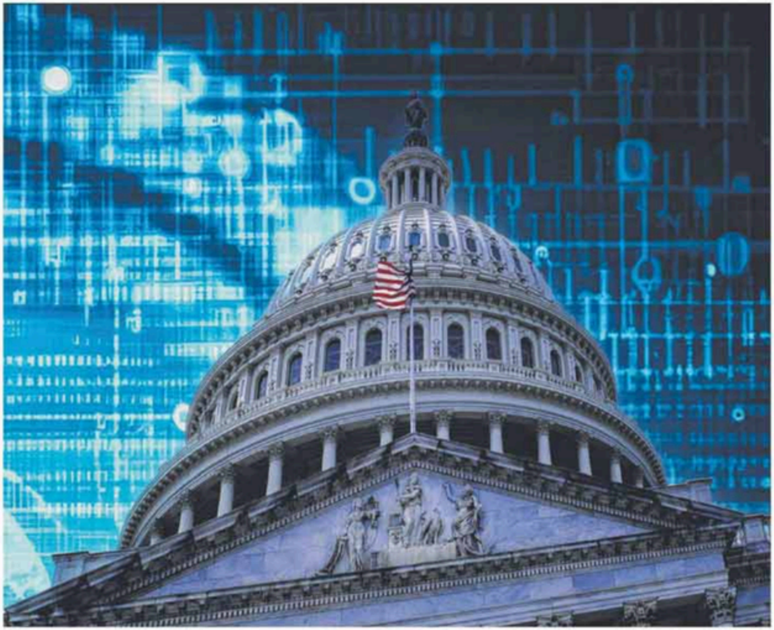
In other words, America isn't merely refinancing an enormous stock of existing debt. It's adding enormous amounts annually.

Then add artificial intelligence.

Describing AI infrastructure financing as one of the defining capital deployment themes of the present era, JP Morgan estimates capital expenditure by the five largest US hyperscalers will reach $US697bn in 2026, up $US173bn from its forecast at the beginning of the year.

Initially, much of the spending was financed through the impressive free cashflows generated by companies such as Microsoft, Alphabet, Amazon and Meta. But the scale of planned data centres, semiconductor purchases, power generation and transmission infrastructure is becoming so enormous that internal cash can't fund each entrant's race.

Consequently, the AI build-out is reaching into the wallets of corporate bond markets, project finance, bank lending and structured debt, simultaneously creating an extraordinary contest for capital.



The demand for capital is putting pressure on America's economy

In the red corner is the world's largest sovereign borrower, and in the blue corner is the largest private sector infrastructure boom in history. For now, neither borrower is particularly price-sensitive. Washington has to fund its deficits and tech companies believe they'll become irrelevant if they don't win the AI race – ignoring the fact we'll all seemingly do just fine without the most expensive frontier models.

But the price could change because capital is not unlimited.

Supply and demand find their equilibrium through price, and for the bond market the price is the yield. If investors are asked to buy enormous quantities of Treasury securities while simultaneously being offered attractively priced AI corporate and infrastructure debt, US government bonds will need to offer higher yields to keep attracting marginal buyers.

And that costs the government a lot of money.

It helps explain the Treasury's recent actions and why that deserves attention.

The US Treasury announced in August it would at least double the maximum size of buybacks involving longer-dated nominal securities, from $US2bn to at least $US4bn per operation. Treasury explicitly said the purpose was to provide greater liquidity support in the 10-30-year portions of the market. In other words, it was providing demand to ease the pressure on rising bond market rates.

The amounts themselves are a drop in the ocean that is the $US1.9 trillion deficit, but the signal matters. You see, you have to remember Treasury is sensitive to liquidity conditions at the long end of the bond market. Rising long-term yields are transmitted rapidly into corporate borrowing costs, mortgage rates and the valuation of long-duration assets such as technology companies.

Recession on the way?

If long-bond rates rise persistently, they could trigger a recession and stockmarket calamity.

But there's a limit to what financial engineering can achieve. And it's financial engineering the US Treasury is playing with.

As bond rates rise, bond prices fall. And because rates have risen since the bonds were issued at 1 per cent rates during the pandemic, Treasury is buying the bonds back at a big discount. But Treasury needs cash to buy those bonds, and to raise it, it is issuing short-term Treasury securities at close to 4 per cent.

So, Treasury can alter the maturity composition. It can conduct buybacks. It can attempt to improve market liquidity. And the Federal Reserve can influence financial conditions. But none of these measures eliminates the underlying requirement that someone must ultimately finance America's ballooning deficits.

If markets ever conclude policymakers have effectively drawn a line in the sand – say, that a particular long-term yield will not be tolerated, and let's call that 5 per cent, traders may test that resolve just as they did the British pound back in 1992, forcing it to exit the European Exchange Rate Mechanism.

Ironically, the trader who tested the Bank of England for George Soros in 1992 was none other than Scott Bessent, now the US Treasury Secretary.

What it means

For the stockmarket, the dangers are real and present.

The higher the risk-free return available from government bonds, the greater the return investors should demand from everything else. Mathematically, that means lower valuations.

And it's particularly important for long-duration growth companies, whose valuations depend heavily on profits not expected for many years into the future. Higher discount rates make those future earnings worth less today.

The more money AI infrastructure consumes, the greater the potential competition with government borrowing. The greater that competition, the greater the upward pressure on yields. And the higher yields rise, the more demanding the valuation arithmetic becomes for AI stocks themselves.

None of this means equities crash. It does, however, suggest the investment environment, and therefore the return outlook, is changing. I'd argue that aggregate market returns will become more subdued while the dispersion of returns between individual companies increases.

In that environment, owning the index may be less rewarding. The better opportunities are with businesses whose investment cases don't depend principally on ever-lower discount rates or ever-higher valuation multiples. The best opportunities will be in companies capable of improving earnings, margins and returns on capital through genuine structural change.

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