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Economics and Rate Strategy

Treasury Refunding Preview: T-Bill Barrage

- **We expect no change to coupon auction sizes at the July 31 refunding announcement**. Net Treasury issuance should remain historically high due to large and rising structural budget deficits, which were only reinforced by the latest budget deal.
- **We look for net Treasury issuance to total $1.1 trillion in calendar year 2019 after accounting for changes in Federal Reserve holdings.** Coupon notes and bonds account for essentially all of the total, while Treasury bills account for just $23 billion.
- This relatively small-looking annual number for net T-bill issuance, however, masks the coming onslaught over the next few quarters. **Treasury will need to spend the next few months rebuilding its cash balance and replenishing its extraordinary measures before having to finance the large seasonal deficits that occur annually in February and March.**
- Since the start of the year, net T-bill issuance has been -$129 billion, but **from August through March 2020 we expect T-bills outstanding to rise by a significant $423 billion.** The Federal Reserve will likely absorb only a very small portion of this supply (~$17 billion or so).
- Repo rates have remained elevated and dealer balance sheets are already stuffed with Treasury securities. Steady growth in supply between now and next spring may only further exacerbate these challenges.
- **Our base case remains for the Fed to stop reducing its Treasury holdings in September**. Beginning in October, the Fed intends to replace up to $20 billion per month in MBS principal pay-downs with Treasury securities.
- Based on updated estimates from our colleagues in RMBS research, Treasury purchases replacing MBS are likely to **reduce Treasury supply available to the public by about $60 billion in Q4-2019 and roughly $233 billion in 2020.** These purchases will take place in the secondary market, not through auction add-ons.

Please see page 4 for the rating definitions, important disclosures and required analyst certifications.
All estimates/forecasts are as of 07/25/19 unless otherwise stated.

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Structural Deficits Keep Treasury Supply Elevated

We expect Treasury will leave nominal coupon auction sizes unchanged at the July 31 refunding announcement. In light of the recent budget deal, we have made no immediate changes to our budget deficit forecasts. Assuming it does indeed become law, we may eventually tweak our deficit forecasts once the Congressional Budget Office (CBO) has weighed in with more information on things like spend-out rates, but this information is more likely to lead to modest tweaks to our forecast than wholesale changes. We call for budget deficits of $950 billion and $1.05 trillion in fiscal 2019 and 2020, respectively. Thus, the issuance need should remain heavy.

Offsetting some of the bite of increasing deficits is the approaching conclusion of the Fed's balance sheet reduction. As announced following the March FOMC meeting, we expect the Fed will stop reducing the size of its balance sheet and resume reinvesting all maturing Treasury securities starting in October. This reduces the amount of financing Treasury needs to raise from the public. Why is that? Recall that when the Fed reinvests maturing Treasury securities into new issues it is done through auction add-ons that are outside the scope of the typical public auction process and thus do not require auction sizes to be raised.

Some market denizens are calling for the Fed to end the balance sheet normalization process at its meeting on July 31, in conjunction with a widely expected 25bps rate cut. While this is not our baseline forecast, a decision by the FOMC to do so would reduce our projected financing needs from the public by $28 billion in Q3-2019.

We expect net Treasury issuance to top $1.0 trillion by a small margin in 2019, down just slightly from our estimates following the May refunding announcement. The 2019 issuance total should be down year over year, largely due to changes in Fed balance sheet policy. The Fed's balance sheet reduction process was in full swing for the entirety of 2018, resulting in an additional $230 billion in issuance needs for the year. More recently, balance sheet reductions have continued, but the pace has been tapered and will likely cease all together in the near future. While the completion of the Fed's portfolio reductions will relieve some issuance pressure, we expect large structural deficits to persist for years. Consequently, Treasury supply should remain much higher than historical norms. For instance, our $916 billion estimate for 2020 is nearly two times the $525 billion average annual pace that prevailed for 2013-17 (Figure 1).

Figure 1

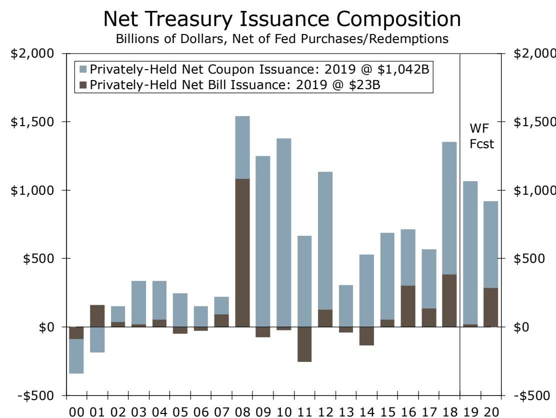
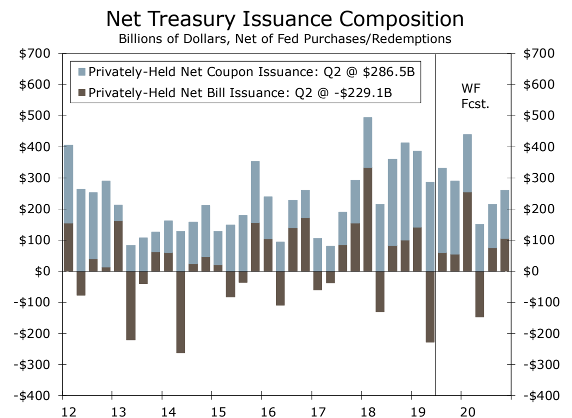


Figure 2



Source: U.S. Department of the Treasury and Wells Fargo Securities

Another factor that will influence Treasury supply available to the market but not actual public auction sizes is the planned shift in the composition of the Fed's balance sheet. The Fed intends to begin replacing MBS principal pay-downs with Treasury securities up to $20 billion per month beginning in October. Over time, replacing MBS with Treasuries should move the balance sheet towards a composition that is primarily Treasuries, a stated policy goal of the Federal Reserve. These purchases are required to take place in the secondary market, not through auction add-ons. Based on the latest estimates from our colleagues in RMBS research, these purchases should result

in **$60 billion of MBS principal being shifted into Treasury holdings in Q4 with another $233 billion in calendar year 2020.**

Figure 3 shows the New York Fed's guidance as to where along the curve it intends to invest MBS pay-downs. A robust 15% of purchases likely will be allocated to T-bills, a segment of the Treasury market where the Fed currently has no holdings. Another 17% are slated for Treasuries with up to 1.5 years remaining until maturity. This results in nearly one third of these Treasury purchases taking place at the very front end of the curve. **This supports our call for the Treasury curve to steepen over time**.

Figure 3: Fed's intended Treasury purchases by sector and maturity bucket

	Nominal Coupon Securities By Maturity Range (years)*								Bills	TIPS**	FRNS
	0-¾y	¾-1½y	1½-2¼y	2¼-3y	3-4½y	4½-7y	7-20y	20-30y	0-1y	0-30y	0-2y
Sector Weight	8%	9%	8%	8%	11%	13%	7%	11%	15%	8%	2%

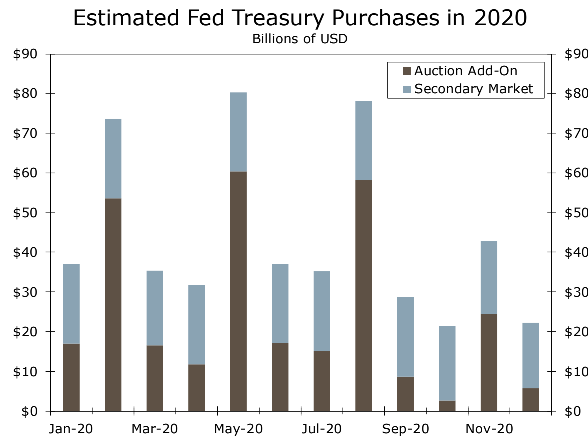
* The on-the-run 3-year note will be considered part of the 2¼ to 3-year sector and the on-the-run 7-year note will be considered part of the 4½ to 7-year sector.

** TIPS weights are based on unadjusted par amounts.

Source: Federal Reserve Bank of New York, Bloomberg LP and Wells Fargo Securities

The Fed is set to be quite active in the Treasury market looking ahead to 2020. Figure 4 highlights estimated Fed purchases through auction add-ons (replacing maturing Treasuries) and in the secondary market (replacing MBS principal) on a monthly basis. We estimate the Fed could take down as much as $80 billion in May 2020. A more typical month should be in the $20-40 billion range. Assuming the Fed stays the course with current plans, this will offset some of Treasury's issuance needs due to higher deficits going forward.

Figure 4



Source: Bloomberg LP and Wells Fargo Securities

Here Come the Bills

The big story we see developing in Treasury supply comes from the T-bill side of the equation. Through the first seven months of the year, the total amount of Treasury bills outstanding has actually fallen by $129 billion, an unusual development given the sizable budget deficits and funding needs of the federal government. These pay-downs have occurred, in part, because of limitations on issuance related to the debt ceiling.

As of this writing, it appears Congress is on the brink of agreeing to a budget deal that would suspend the debt ceiling until July 31, 2021. Assuming this deal becomes law in the near future, the Treasury would be free to once again begin issuing debt as needed. The first order of business will be to replenish the cash balance, which at roughly $200 billion is unusually low at present (in more "normal" times, the cash balance is between $300 and $400 billion). An earlier-than-expected suspension of the debt ceiling would allow Treasury to rebuild the cash balance more gradually and

from a higher base than if the debt ceiling had been lifted closer to the "X date". That said, **the pace at which Treasury decides to ramp up the cash balance to more normal levels is one of, if not the, key question for the near term supply outlook.** Our forecast assumes the cash balance ends Q3-2019 at $300 billion and Q4-2019 at $350 billion. We will receive more guidance from Treasury about this on Monday, two days before the official refunding. As a reminder, higher cash balance assumptions will likely mean more near term T-bill issuance and vice versa. So for example, if the Treasury were to signal that it intends to target a cash balance of $325 billion for Q3-2019, this would imply an extra $25 billion in T-bill issuance in that quarter.

By the end of the year, the Treasury's cash balance should have mostly normalized, but there will then be another driver of robust T-bill issuance on the horizon: large Q1 seasonal deficits. The federal government typically runs very large budget deficits from late January through mid-April as a result of tax refunds being issued. Our forecast for the Q1-2020 budget deficit is a whopping $447 billion, $262 billion of which we expect to be financed by net issuance of T-bills. The Fed re-entering the T-bill market later this year should help at the margin, but its projected purchases of $2-3 billion a month is just a small fraction of future supply.

Pulling it altogether, we expect net T-bill issuance to be $406 billion from August-2019 through March 2020, after accounting for anticipated Fed purchases. Excluding Federal Reserve purchases, the total would be $423 billion. If this forecast proves correct, it would push total Treasury bills outstanding up 19% from current levels over just an eight month period. This surge in supply at the front end could put additional pressure on funding markets. Primary dealer holdings of short-dated Treasuries remain high, and general collateral (GC) repo rates have remained historically elevated despite the negative T-bill supply seen so far this year. At present, the effective fed funds rate is a full 5bps above IOER, and the Fed will be watching closely for signs that a surge in T-bill supply is wrecking further havoc on money market rates.

Final Tweaks to TIPS Program

We expect Treasury will complete its changes to the TIPS program at the upcoming refunding. The final changes will include a $2 billion increase to the August 30y TIPS reopening and a $1 billion increase to the September 10y TIPS reopening. This will bring the 2019 annual increase in the TIPS program to $21 billion. With these changes fully phased in, annual TIPS issuance should rise by $24 billion, squarely in the middle of the $22-$27 billion range targeted by Treasury back in January.

Pulling It All Together, What Does This Mean for Financial Markets?

- **The Treasury curve should steepen as purchases replacing MBS very likely will be concentrated at the front end of the curve**. At the same time we expect the Fed to cut rates next week and one more time in the fourth quarter, further propelling the curve steeper.
- **Elevated supply should put structural upward pressure on rates, all else equal.** We call for the yield on the 10y Treasury note to rise to 2.30% by year end.
- **Roughly $406 billion in net T-bill supply over the next eight months could put further pressure on funding markets.** Excluding the typical spike on quarter-end dates, GC repo increased roughly 40bps in Q1-2018 when Treasury issued $333 billion in T-bills. Repo rates already are quite elevated, but still could undergo a hefty increase in the fourth quarter of this year as balance sheet capacity gets especially tight.

Figure 5: Gross and Net Treasury Issuance, 2019-2020

Security	Historical Q1 2019	Historical Q2 2019	Projected Q3 2019	Projected Q4 2019	Projected Q1 2020
Notes & Bonds					
2y	120	120	120	120	120
3y	114	114	114	114	114
5y	123	123	123	123	123
7y	96	96	96	96	96
10y	75	75	75	75	75
30y	51	51	51	51	51
2y FRN	56	56	56	56	56
TIPS					
5y TIPS	0	32	0	32	0
10y TIPS	24	11	26	12	26
30y TIPS	8	0	7	0	8
Total					
Net Coupons	180	209	230	288	235
Net Bills	140	-229	59	62	264
SOMA Redemptions	65	65	43	0	0
SOMA Purchases (-)	0	0	0	60	59
Coupons	0	0	0	51	50
Bills	0	0	0	9	9
Net Coupons to the Public	245	274	273	237	185
Net Bills to the Public	140	-229	59	53	255
WAM	69	70	70	70	71

*removes reinvestments of SOMA maturities through auction add-ons

Source: Bloomberg LP and Wells Fargo Securities

Figure 6: Gross bill auctions by tenor and net weekly supply, Q3 2019

week of	4-week	8-week	13-week	26-week	52-week	net supply
7/1/2019	40	35	36	36	0	-9
7/8/2019	40	35	36	36	0	-6
7/15/2019	35	35	36	36	26	-11
7/22/2019	35	35	36	36	0	-14
7/29/2019	40	35	39	39	0	0
8/5/2019	50	35	39	39	0	10
8/12/2019	50	35	39	39	26	15
8/19/2019	50	35	39	39	0	18
8/26/2019	50	35	39	39	0	13
9/2/2019	55	35	39	39	0	8
9/9/2019	55	35	39	39	26	8
9/16/2019	55	35	42	39	0	11
9/23/2019	60	35	42	39	0	16
Prior Quarter CMB						-
Current Quarter CMB (issued and mature in Q3)						50
Q3 total						59

Source: Bloomberg LP and Wells Fargo Securities

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