US Rates Watch

May refunding: buybacks & higher coupons on the way

Coupon increases coming soon

As we anticipated Treasury held coupon auction sizes stable across the curve at the May refunding. UST communications also reinforced our expectation for buyback rollout & coupon size increases; the timing of both was somewhat earlier than we expected.

- **Buybacks** were announced to start in CY '24; this generally fits with our previously expected timeline but was confirmed earlier than we anticipated.
- **Coupon size increases** were also confirmed & may start a quarter earlier than we had expected; we adjust our coupon supply forecast accordingly.

We anticipate net bill supply to increase by $1.4tn from debt limit resolution through the end of the year.

Should the debt limit be resolved by the August refunding, UST will likely consider increasing coupon auction sizes. An earlier start to coupon adjustments allows UST to manage bills as a share of marketable debt closer to TBAC's suggested range (15-20%) as well as pre-fund buyback operations to start in CY '24.

Exhibit 1 shows the coupon auction sizes we expect in the August and November refudnings. We pencil in gradual increases in auction sizes shown in Exhibit 2: 2y-5y +$9bn, 7y +$6bn, 10y and 30y +$3bn, 20y +$2bn, TIPS starting with the new issue +$1bn, 2y FRN starting with new issue +$3bn. As discussed in the TBAC minutes, we expect UST to increase TIPS auction sizes alongside nominal issuance. However, UST will continue to monitor demand for TIPS to ensure that increases in sizes are met with appropriate demand.

Compared to our expectations discussed in May refunding preview, these coupon adjustments are sooner and larger to account for an earlier potential debt limit resolution and buyback financing. Bills temporarily breach 20% of marketable debt in FY'24 despite these adjustments (Exhibit 3, Exhibit 4). We do not expect UST to increase coupon auction sizes further given: 1) bills will fall back into range in FY '25, 2) higher bill supply vs TBAC's guidance does not pose the same risks to market functioning as lower bill supply. Higher bill supply likely to be met by strong MMF demand via ON RRP.

UST's presentation on buybacks suggest that financing need would increase between $180bn and $240bn to support buybacks for liquidity and cash management purposes. In Exhibit 5, we show bills as a share of marketable debt for end of FY '24 and FY '25 assuming different buyback amounts. Even with buybacks at the upper end of UST's suggested range, bills will still be below 20% by end of FY '25 incorporating our auction size adjustments and assuming QT ends in April '24.

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UST = Treasury

QT= quantitative tightening

TBAC= Treasury Borrowing Advisory Committee

FY= fiscal year

WAM= weighted average maturity

The TBAC minutes reflected a discussion around whether to adjust 2y - 7y auction schedule such that new issues are quarterly followed by 2 reopenings vs monthly new issues. The TBAC presenting member sounded positive on such a change though we think the pros and cons to this approach are mixed (as discussed in February refunding preview). TBAC guidance was that further study was necessary and that the monthly new issue cadence for the 2y was valuable. We do not yet reflect any schedule changes in our auction calendar but, would not be surprised to see Treasury move in this direction given the positive impression from the TBAC presenting member.

Bill supply and debt limit implications

Our bill supply forecasts have shifted as we have pulled forward our expectations for a debt limit resolution and coupon auction size increases. Our base case for the debt limit resolution is now a last-minute agreement ahead of Treasury's X-date of June 1, though the risks are skewed to a later X-date. For the purposes of our bill supply forecast, we assume a June 1 debt limit resolution.

TBAC recommends $479b of bill issuance in Q2, and $555b in Q3, totaling $1,033b. This is $158b above BofA forecasts for bill issuance over the next two quarters (Exhibit 6). The discrepancy is likely driven by different treatment of September month-end coupon settlements; we see this as a is relatively minor technical difference in our estimates.

We continue to believe the most consequential market development is likely to be the UST supply surge *after* debt limit resolution. We currently forecast $1.4tn of bill supply after the debt limit is resolved through the end of the year (Exhibit 9). Bill supply surge will be used to rebuild Treasury cash balance from near zero to $700b by end '23 & fund deficits.

The large wave of bill supply will result in: (1) material bill vs OIS cheapening (2) higher dealer UST holdings => upward pressure on bi-lateral repo (3) cheapening of money market rates, including CP / CD (4) sharp drop in ON RRP use. We also expect increased USD funding pressure in XCCY basis due to higher CP / CD rates.

Short-term debt limit resolution: Recent headlines emphasize the risk of a short-term resolution that pushes the debt limit to Sept 30. To forecast bill supply based on this risk scenario, we assume a June 1 short-term resolution, TGA quickly ramping up to $500b over the summer, before falling back to ~$150b by Sept month-end to align with the assumed TGA level when the resolution was passed. Based on this forecast, we see the X-date pushing back to Feb '24.

This temporary resolution would result in $50b more bill supply over Q2, but $450b lower than our base case over FY'23 (Exhibit 10, Exhibit 11). The lower relative bill supply forecast from Sept '23 – Feb '24 will likely result in less cheapening in bills vs OIS, a weaker drop in ON RRP, and less cheapening in broader money market rates.

Buybacks confirmed: music to our ears

The May refunding included confirmation Treasury would implement a more consistent buyback program. The refunding announcement stated: "Treasury expects to begin a regular buyback program in calendar year 2024." This is music to our ears. We have long advocated for a Treasury buyback program to support market liquidity (see Buybacks as UST liquidity tool and UST buyback FAQs: Momentum building) We are very encouraged that it is now confirmed.

We were pleasantly surprised by the timing of this announcement. We did not expect the Treasury to confirm buyback rollout until after the debt limit, assuming debt managers would want to stay "under the radar" until resolution. Regardless of buyback confirmation timing, the implementation timeline is generally consistent with our prior expectations. We previously thought buybacks would be implemented 6-12m after debt limit resolution & UST's 2024 guidance today lines up with our expectation. We are not sure why Treasury decided to confirm UST buyback operations today but we suspect it may be due to potential future turnover with Treasury leadership; it is not uncommon for senior Treasury leaders to depart in years 2-4 of any administration & debt managers may have wanted to confirm the future buyback program while existing UST leadership is in place.

Buyback implementation will serve to support market functioning by (1) cutting tails on how cheap certain USTs trade (2) providing confidence to the market of last resort buyer. Buybacks will be most effective at reducing dislocations & tightening spreads between off-the-run & on-the-run USTs. Buybacks will also provide more confidence to market makers in the UST market; dealers will know they can move Treasuries in inventory off their balance sheet to the US Treasury at a price.

The rates market viewed the buyback announcement positively with SOFR swap spreads widening from 3 to 30Y tenors (2Y spreads likely tightened with TBAC confirmation of very elevated bill supply after debt limit resolution). We are surprised by extent of the SOFR spread widening. This spread widening is likely reflective of buybacks cutting the tails on how cheap certain USTs can trade, though we think the biggest impact will be in off-the-run UST richening to on-the-run USTs.

Going forward, buyback focus will now shift to implementation details. Treasury should ensure buybacks operate as a tool that is small enough to allow for orderly market functioning but large enough that it can prevent material UST dislocations. We think $5-10b per month in both the 0-1Y & 1Y+ tenors is a good place to start. Treasury should retain flexibility to increase or decrease buyback sizes based on market conditions.

We expect Treasury to err on the side of more maturity buckets & smaller sizes per maturity bucket (vs fewer maturity buckets & larger sizes per maturity bucket). The logic of more maturity buckets is that it provides dealers greater assurance there will be a price by which a security can be moved within a bucket (vs a larger maturity bucket that many identify one part of a maturity bucket as cheap & limit the ability of dealers to reduce holdings in another part of that maturity bucket). Buyback maturity composition will likely be the most important detail of implementation

Exhibit 1: Expected auction calendar through November '23 refunding

Expect auction size increases across the curve through January '24

	2y	3y	5y	7y	10y	20y	30y	5y II	10y II	30y II	2y FRN
5/31/2023	42	40	43	35	35	15	21		15		22
6/30/2023	42	40	43	35	32	12	18	19			22
7/31/2023	42	40	43	35	32	12	18		17		24
8/31/2023	44	42	45	36	37	16	23			8	22
9/29/2023	46	44	47	37	34	13	20		15		22
10/31/2023	48	46	49	38	34	13	20	22			26
11/30/2023	49	47	50	39	38	17	24		15		24
12/29/2023	50	48	51	40	35	14	21	20			24
1/31/2024	51	49	52	41	35	14	21		18		27

Source: BofA Global Research, US Treasury

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Exhibit 2: Expected auction size changes from May refunding

Expect auction size increases across the curve through January '24

	2y	3y	5y	7y	10y	20y	30y	5y II	10y II	30y II	2y FRN
8/31/2023	2	2	2	1	2	1	2			-	-
9/29/2023	4	4	4	2	2	1	2		-		-
10/31/2023	6	6	6	3	2	1	2	1			2
11/30/2023	7	7	7	4	3	2	3		-		2
12/29/2023	8	8	8	5	3	2	3	1			2
1/31/2024	9	9	9	6	3	2	3		1		3

Source: BofA Global Research

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Exhibit 3: Financing estimates by fiscal year

Expect bills as a share of marketable debt to grow through FY '24 and then moderate, assuming QT ends in April '24

	2023	2024		2025	
		QT ends in May '25	QT ends Apr '24	QT ends in May '25	QT ends Apr '24
1 Baseline deficit	1,350	1,450	1,450	1,600	1,600
2 Other adjustment	326	-		-	-
3 Financing need (1 + 2)	1,676	1,450	1,450	1,600	1,600
4 Change in cash balance	(36)	100	100	-	-
5 Note: cash balance end period assumption	600	700	700	700	700
6 Marketable borrowing need (3 +4)	1,640	1,550	1,550	1,600	1,600
7 Gross coupon auctioned	3,194	3,672	3,672	3,703	3,703
8 Total coupon maturing	3,057	3,081	3,081	2,254	2,254
9 Fed coupon rollover	249	45	329	139	464
10 Public coupon maturing (8 - 9)	2,809	3,036	2,752	2,115	1,790
11 Net coupon supply (7 - 10)	385	636	920	1,588	1,913
12 Coupon runoff from Fed bal sheet	*649*	*600*	*316*	*325*	-
13 *Net coupon supply to public (11 + 12)*	*1,034*	*1,236*	*1,236*	*1,913*	*1,913*
14 Net bill supply (6 - 11)	1,255	914	630	12	(313)
15 Bill runoff from Fed bal sheet	71	120	44	32	-
16 *Net bill supply to public (14 +15)*	*1,326*	*1,034*	*674*	*44*	*(313)*
17 Net supply issued (11 + 14)	1,640	1,550	1,550	1,600	1,600
18 *Net supply to public (13 + 16)*	*2,360*	*2,270*	*1,910*	*1,957*	*1,600*
19 Starting assumed coupons	20,050	20,435	20,435	21,071	21,355
20 Starting assumed bills	3,645	4,900	4,900	5,814	5,530
21 End assumed coupons (11 + 19)	20,435	21,071	21,355	22,659	23,268
22 End assumed bills (14 + 20)	4,900	5,814	5,530	5,826	5,217
23 Bills as % of coupons + bills (22 / (22 + 21))	19.3%	21.6%	20.6%	20.5%	18.3%

Source: BofA Global research, US Treasury, NY Fed

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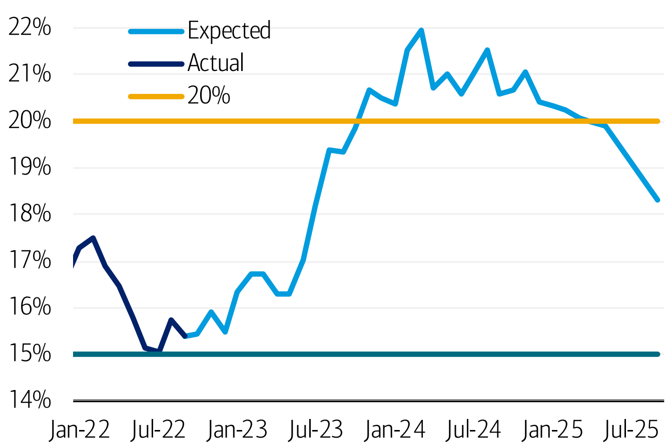
Exhibit 4: Projected bill supply as % of marketable debt (%)

Bills will rise above 20% of marketable debt in FY'24 before declining in '25



Source: BofA Global research, US Treasury

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Exhibit 5: Bills as a share of marketable debt assuming BofA auction size increases through January '24 and QT ends in April '24

Even with buybacks at the upper end of UST range, bills still would end FY '25 below 20%

Buybacks per FY ($bn)	FY '24 End	FY '25 End
120	20.90%	19.00%
180	21.10%	19.33%
240	21.27%	19.67%

Source: BofA Global Research

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Exhibit 6: BofA bill forecast vs TBAC recommended ($bn)

Our T-bill forecast is below TBAC recommended net bill issuance over the next 2 quarters

	Q2'23	Q3'23	Total
BofA Bill forecast	117	758	875
TBAC recommended bill issuance	479	555	1033
Difference	-362	204	-158

Exhibit 6: BofA bill forecast vs TBAC recommended ($bn)

Our T-bill forecast is below TBAC recommended net bill issuance over the next 2 quarters

Q2'23	Q3'23	Total

Source: BofA Global Research, US Treasury

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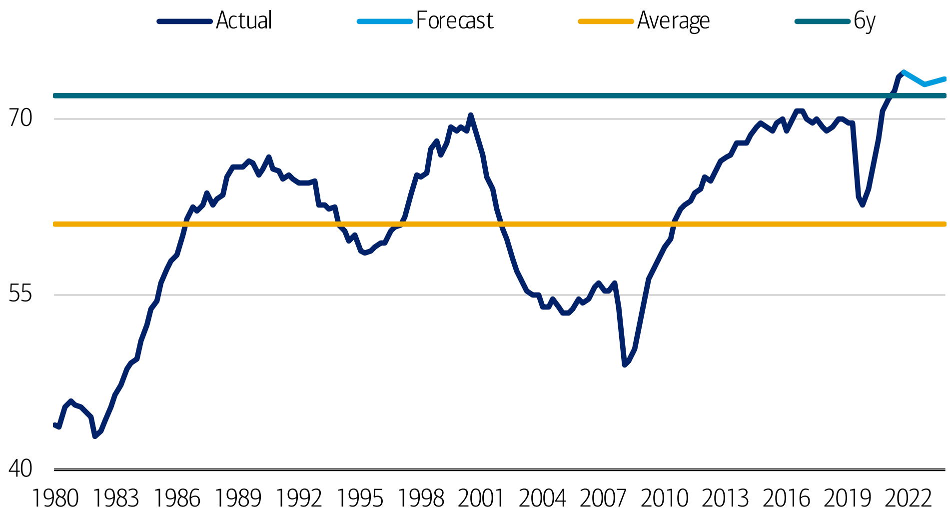
Exhibit 7: Actual and expected weighted average maturity (WAM) through FY '24 (months)

WAM expected to stay elevated



Source: BofA Global Research, US Treasury

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Exhibit 8: Projected monthly Treasury bill and coupon issuance ($bn)

We have revised higher our Q2 and Q3 financing needs

	Financing Need	TGA EOP	TGA Change	Marketable Borrowing	Net Coupon	Net Bills	Fed Coupon maturities	Fed Bill maturities	Net Coupons to the Public	Net Bills to the Public
	1		2	3 = 1 +2	4	5	6	7	4+6	5+7
Oct-22	90	596	-40	50	28	22	46	14	74	36
Nov-22	269	533	-63	206	60	146	60	0	120	146
Dec-22	62	447	-86	-24	91	-115	53	7	144	-108
Jan-23	71	568	121	192	-49	241	55	5	6	246
Feb-23	313	415	-153	160	41	119	60	0	101	119
Mar-23	322	178	-237	85	74	11	56	4	130	15
Apr-23	-305	316	138	-167	-41	-126	60	0	19	-126
May-23	299	70	-246	53	43	10	60	0	103	10
Jun-23	118	250	180	298	77	221	48	12	125	233
Jul-23	230	300	50	280	-56	335	50	10	-6	346
Aug-23	305	400	100	405	25	380	60	0	85	380
Sep-23	-96	600	200	104	91	13	39	21	130	33
Oct-23	196	600	0	196	26	170	52	8	78	178
Nov-23	252	650	50	302	35	267	60	0	95	267
Dec-23	32	700	50	82	108	-26	46	14	154	-12

Source: BofA Global Research

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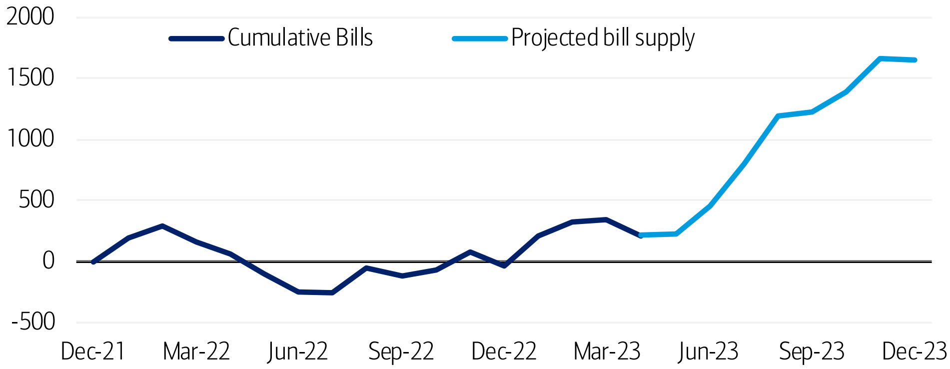
Exhibit 9: Projected cumulative bill supply ($b)

We forecast bills will increase $1.6tn over CY'23



Source: BofA Global Research, Treasury

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Exhibit 10: Scenario analysis base case vs short-term resolution ($b)

A short-term resolution would result in $450b less bill supply in FY'23

	June resolution		Short term resolution to Sept		Difference	
	Change in TGA	Change in bill supply	Change in TGA	Change in bill supply	Change in TGA	Change in bill supply
FY '23	(36)	1,258	(486)	808	450	450
FY '24	100	630	550	1,080	(450)	(450)

Source: BofA Global Research, Treasury

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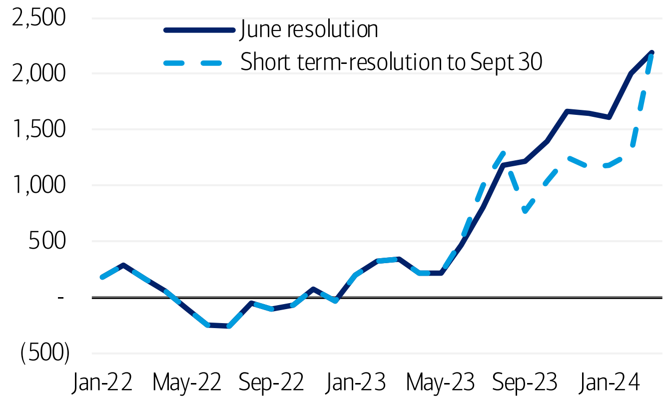
Exhibit 11: Projected bill supply base case vs short-term resolution ($b)

A short-term resolution would result in $450b less bill supply in FY'23



Source: BofA Global Research, Treasury

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