Liquid Insight

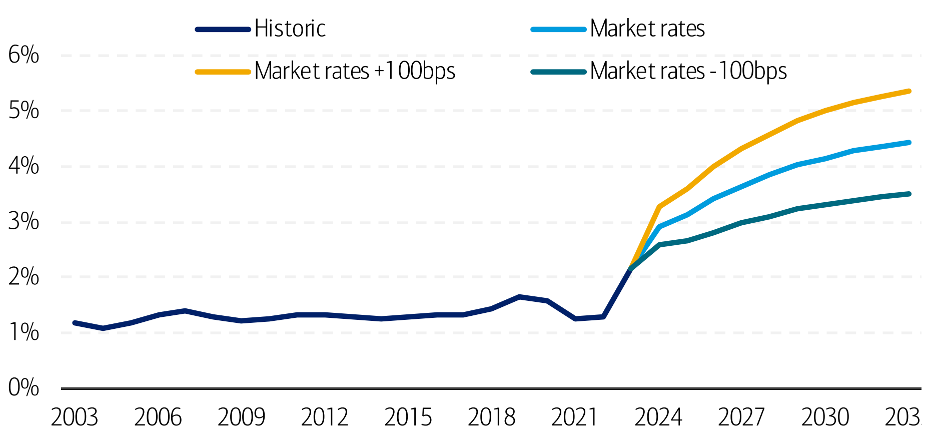
Interest expense boosts deficit & supply forecasts

Key takeaways

- Higher interest rates increase deficit spending and result in larger UST issuance, creating a spiral effect
- Rates will have to realize more than 100bps below forwards for costs to not rise materially as a share of GDP
- This backdrop supports our views for steeper yield curves and narrower swap spreads

By Meghan Swiber and Stephen Juneau

Exhibit 1: Marketable coupon & bill financing cost as a share of GDP
Interest rate costs on marketable debt to increase markedly as a share of GDP even if rates realize 100bps below forwards



Source: BofA Global Research, Haver, Bloomberg, Note: Calculations assume a constant paydown of coupons outstanding using stable WAM assumption and OIS forwards for market rates

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Unsustainable deficit meets its match

The unsustainable fiscal path in the US is nothing new. What is new are higher interest rates that are now priced to stay elevated for a longer period. Interest rate costs have a direct impact on how much the US government needs to spend to finance its debt and contributes to the overall deficit. We revise our deficits higher for the next several fiscal years alongside US Treasury issuance. We now expect US Treasury to deliver more aggressive coupon supply increases next week and anticipate increases to continue through July 24.

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Deficit: 6% is the new 3%

The FY 2023 deficit surprised expectations and finished the year at $1.7tn. After netting out the effects of student loans, the deficit effectively doubled to $2.0tn or 7.5% of GDP. The upside surprise was largely a function of a drop in revenues, primarily from other income tax receipts. Given this upside surprise, we revise up our deficit forecast for the next several fiscal years. We now expect deficits of $1.8tn in FY 2024, $1.9tn in FY 2025 and $2.0tn in FY 2026.

In addition to the higher FY 2023 deficit, a major reason for our upward revisions are higher interest expenses. Assuming that market forwards are realized, gross financing costs from marketable debt will increase materially as a share of GDP in coming years (Exhibit 1). While net interest expenses will get some relief from the resumption in student loan payments, net interest expenses will account for an increasing portion of the overall deficit (Exhibit 2). Indeed, we expect net-interest expenses as a share of GDP to increase from 2.5% in FY 2023 to 3.5% in FY 2026, highest on record.

Meanwhile, we forecast the primary deficit to fall from 5.0% in FY 2023 to 3.3% of GDP in each of the next two fiscal years. Admittedly, there remains considerable uncertainty around our forecasts given the House is still without a speaker and Congress has made little progress on appropriations for FY 2024, which started on October 1. If we do see a primary deficit in line with the caps from the Fiscal Responsibility Act, then we expect a drop in mandatory outlays to and a partial rebound in revenues to drive he primary deficit lower in FY 2024.

In short, we expect deficits to remain elevated and at levels not typically seen at this stage in the economic cycle.

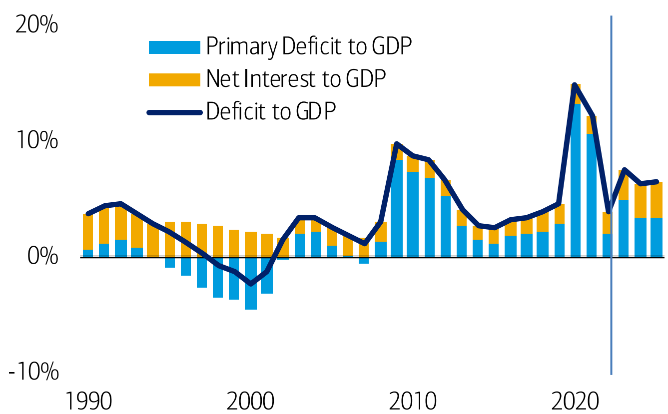
An unsustainable path with no easy fix

Investors have recently turned their attention to the sobering outlook for higher deficits. They often ask what could be done in the near-term to correct the current trajectory. In short, there are few easy options for politicians. The annual appropriations process only controls discretionary spending, which is a shrinking share of total outlays (Exhibit 3). Mandatory outlays, which includes entitlement spending like social security and Medicare, are viewed as untouchable by many politicians. Similarly, tax hikes also aren't palatable, and net interest expense is a function of prior deficits and market rates.

One option Congress will face at the end of FY 2025 is a decision on the Trump tax cuts. If Congress is serious about correcting the increasingly concerning trajectory of debt-to-GDP, it would not extend the Trump tax cuts. While this would not be enough fiscal

Exhibit 2: Deficit-to-GDP (%)

We expect net interest to comprise a larger share of the deficit-to-GDP ratio in coming years



Source: CBO, BofA Global Research

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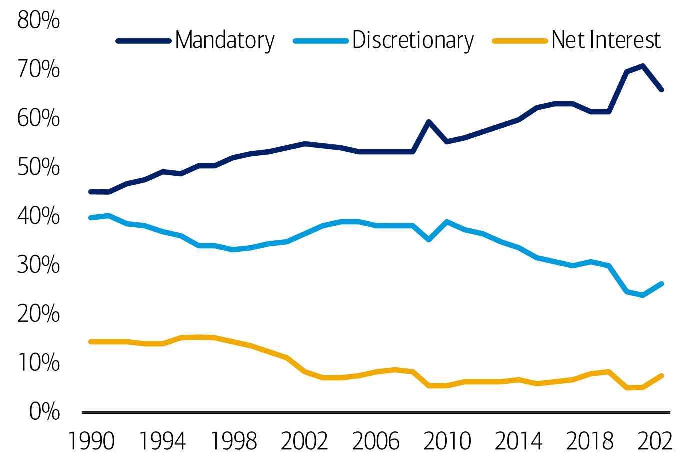
Exhibit 3: Shares of total outlays by major outlay (FY)

Discretionary spending makes up a shrinking share of outlays



Source: CBO

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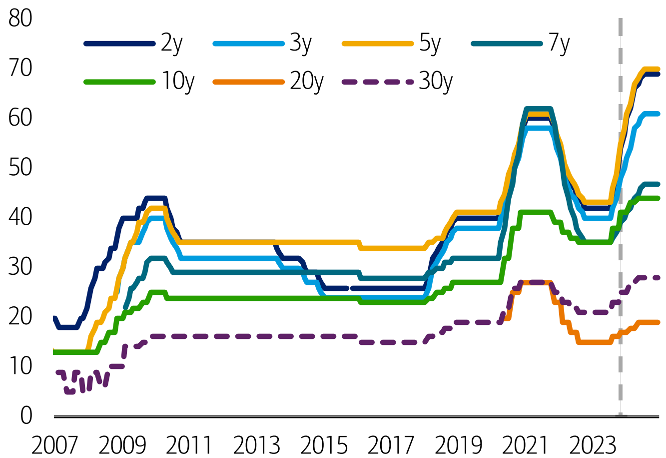
adjustment to correct the current trajectory, it will likely be the first real test of Congress' resolve around the increasingly unsustainable fiscal path.

Higher deficits, higher supply

Our US Econonics team's revised forecasts for a higher deficit prompts us to revise our estimates for US Treasury supply higher. We now expect a repeat of the increase in auction sizes observed at the August refunding next week, followed by moderating increases at the February and May refundings (see: November Refunding preview). Per our forecasts, this results in auction sizes rising to historic highs across all tenors besides the 7y and 20y (Exhibit 4).

Exhibit 4: Treasury auction sizes by tenor with projections through YE '24 ($bn)

We forecast that Treasury note and bond auction sizes will grow through July 24



Source: BofA Global Research, US Treasury

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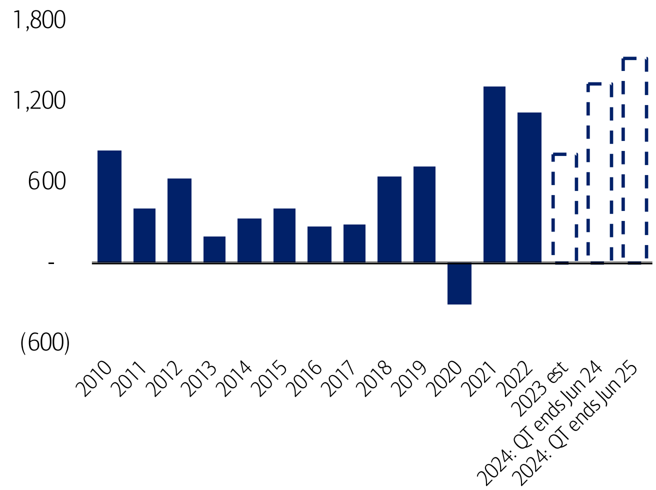
Exhibit 5: Net coupon supply ex Fed purchases and including Fed QT impact by FY ($bn, 10y equivalent)

Our forecasts suggest historically elevated supply in 2024



Source: BofA Global Research, US Treasury, Federal Reserve

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In Global Rates Viewpoint, we discussed the significant duration supply adjustment starting in Q4 for the US. Our new forecasts reflect upward revisions to these numbers. Assuming QT ends in June 2024, we anticipate that supply over calendar year 2024 will be around $1.34tn in 10y equivalents around $90bn higher than previously forecasted. This would see marketable debt ex-Fed at the highest levels observed historically, even beyond 2021, when there was larger structural demand from investors like banks (Exhibit 5). Should QT extend through mid-2025 (likely more consistent with Fed projections) marketable debt ex-Fed in 2024 would total $1.53tn.

All of the duration supply means continued upward pressure at the back end of the rates curve, cheaper longer-dated USTs vs OIS, & steeper UST curves. Higher duration supply should mean structurally steeper UST curves. The supply backdrop support our cheaper intermediate to longer-dated SOFR spread & 5s30s nominal curve steepening views.

Regular and predictable > opportunistic

An important assumption in our forecasts is that UST does not alter its overall issuance strategy based on shape of the yield curve and/or interest rate levels. If UST believes interest rates will move lower, an opportunistic approach might suggest reducing WAM and issuing more in bills & shorter-dated coupons. We think that this is unlikely.

As shown in Exhibit 6, our supply assumptions already reflect bills as a share of marketable debt remaining elevated through FY 26. This is consistent with comments from Assistant Secretary Frost in late September that bill supply can remain elevated before normalizing towards the 15-20% level recommended by TBAC. We do not expect Treasury to use bills >20% to meaningfully lower UST WAM; rather bills >20% will be tolerated to smooth the path towards higher net cash raise via coupons.

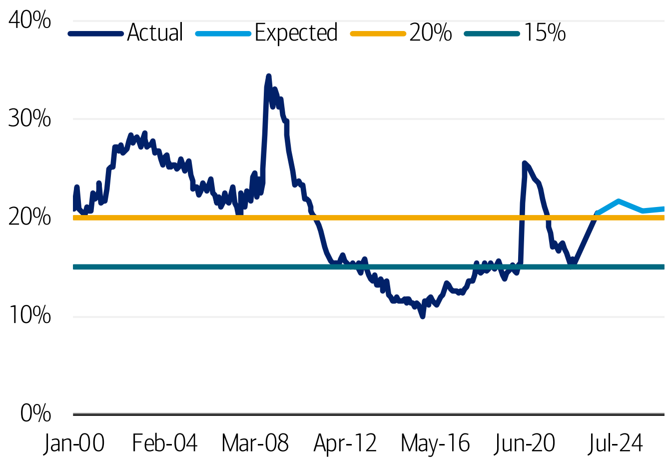
UST WAM typically extends when the yield curve is flat/ inverted and contracts when the curve is steeper (Exhibit 7). While this is not a hard and fast rule—the fact that some parts of the UST curve are still inverted or historically flat would suggest that UST instead continue to extend WAM.

If UST were to take a more formal view on the direction of rates and implement a strategy that is opportunistic vs regular and predictable—this would create more uncertainty around issuance patterns. UST believes that regular and predictable issuance is the way to issue at lowest cost to taxpayer. Additionally, Treasury solicits feedback from TBAC and dealers before making major financing changes. A quick and unexpected change in UST issuance strategy would violate its current framework.

Treasury's issuance approach has long sought to lower costs to the taxpayer through 2 key tenants: (1) lowest interest cost over time (2) lowest interest cost variability. Lowest interest cost has typically meant issuing short, while lowest interest cost variability has typically meant issuing long. Treasury has sought to optimize the two and is unlikely to quickly change strategy. Treasury views their debt management approach like steering a tanker: they need to move slowly and carefully because they issue so much debt.

Exhibit 6: Bills as a % of marketable debt

Given our expectations for deficit and QT ending in June '24, bills as a share of marketable debt should remain elevated through FY 26



Source: BofA Global Research, US Treasury

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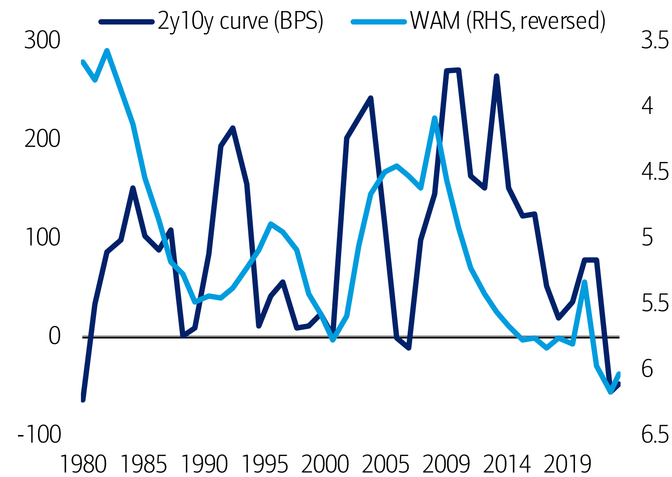
Exhibit 7: Yield curve and UST WAM

WAM typically higher when curve is flatter



Source: BofA Global Research, Bloomberg

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Bottom line: Higher interest rates will likely have a meaningful impact on deficit spending and result in larger UST issuance, creating a spiral effect. Rates will have to materialize more than 100bps below forwards for costs to not rise materially as a share of GDP. A daunting supply picture becomes even more challenging given the backdrop of higher financing costs. This supports our views for steeper yield curves and narrower swap spreads.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Positioning matters until it doesn't**, Global FX Weekly**, 20 Oct 2023
- Hi 5s 20**, Global Rates Weekly**, 20 Oct 2023
- Waiting for the next catalyst, **Liquid Cross Border Flows**, 16 Oct 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: Positioning matters until it doesn't 20 October 2023

Global Rates Weekly: Hi 5s 20 October 2023

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