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Liquid Insight

Debt limit stress is back

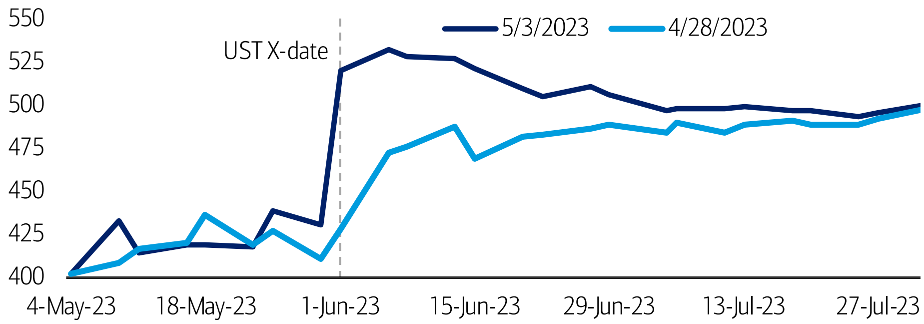
Key takeaways

- Debt limit stress has increased with Yellen's June 1 X-date guidance; we pull forward X-date to match
- Market stress likely to increase, esp in 2H May, via: bill curve hump, cheaper mid Jun UST coupons, potential risk off
- DL resolution likely at last minute; push to Sept 30 possible & worst case can't be ruled out. UST bill supply surge post DL.

By Mark Cabana, Katie Craig, & Ralph Axel

Exhibit 1: Treasury Bill Curve (bp)

Market is reflecting much greater debt limit stress in early June



Source: BofA Global Research, Bloomberg

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Debt limit risks have risen

Debt limit (DL) market stress is back. DL focus increased this week with UST Secretary Yellen guiding market to a June 1 X-date. Updated Treasury financing estimate numbers & extraordinary measure headroom shifts us to match Yellen's June 1 X-date.

The bill market has reacted meaningfully to Yellen's guidance (Exhibit 1). The bill curve now shows a more pronounced "hump" the first week of June. We expect broader market stress around DL to build in coming weeks, likely evident in 2H May.

In this note we discuss our DL outlook & market impact. Bottom line: DL market concern will likely increase in coming weeks & be shown via a more acute hump in the UST bill curve, mid-June UST coupon cheapening, and potential risk off later in May. Resolution likely at last minute; push to Sept 30 possible. Worse case outcomes can't be ruled out.

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CP: Commercial Paper
CD: Certificate of Deposit
MMF: Money Market Fund
OIS: Overnight Index Swap
ON RRP: Overnight Reverse Repo Facility
SOFR: Secured Overnight Financing Rate

Yellen guides to debt limit X-date of June 1

Treasury Secretary Yellen guided the public to a potential June 1 "X-date" (date after which UST may not be able to meet all government obligations). Yellen's guidance was modestly earlier than we projected.

Recall, we have recently been flagging two key dates for Treasury debt limit guidance: (1) full exhaustion of cash & extraordinary measures (EM), and (2) Tsy loss of confidence to meet all outstanding obligations. Importance of date 2 > date 1. We had expected Yellen to guide the market to 1H June, potentially the second week.

Yellen's guidance to June 1 likely reflects of (1) conservative Treasury bias, (2) higher Q2 financing estimates, (3) lower EM. For detail see: Debt limit: Yellen & Q2 financing need.

BofA X-date timing: now early June with EM update

Treasury published their updated financing estimates for 2023 on Monday. The important takeaway for us was the higher-than-expected financing needs in Q2 & Q3 which are important inputs into our X-date forecast. While the Treasury's marketable borrowing and Treasury General Account (TGA) forecasts are worth noting, we focus on their financing needs given they provide the best estimate of quarterly funding need (Exhibit 2).

Exhibit 2: Treasury financing need table as of May 1 ($bn)
Treasury revised their Apr-Jun financing need higher by $117bn

	Financing Need	Marketable Borrowing	All Other Sources	Total	Change in Cash Balance	End of Quarter Cash Balance	SOMA Redemptions
	1	2	3	4 = 2 + 3	5 = 4 - 1	6	7
Apr - Jun '23	112	726	-242	484	372	550	-180
Jul - Sep '23	438	733	-244	488	50	600	-158

Source: US Treasury

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Earlier this week we pulled forward our X-date projection due to Treasury's higher than expected financing needs. Treasury then subsequently updated their remaining extraordinary measures (EM) (Exhibit 3), which were much lower than we expected for April month-end. This significantly reduces our estimate for remaining headroom in May and pulls forward our expected X-date now to June 1, consistent with Yellen's guidance (Exhibit 4). We will continue updating our X-date projection with incoming information.

Exhibit 3: Treasury Extraordinary Measures ($bn)
As of April 28, excludes the $8.3bn increase expected on May 1 & June 1 and the $145bm increase on June 30

Impacted Funds	Measures Authorized	Measures Used	Measures Remaining
CSRDF/PSRHBF	29	(29)	-
G Fund	294	(270)	24
ESF	17	-	17
Totals	340	(299)	41

Source: US Treasury

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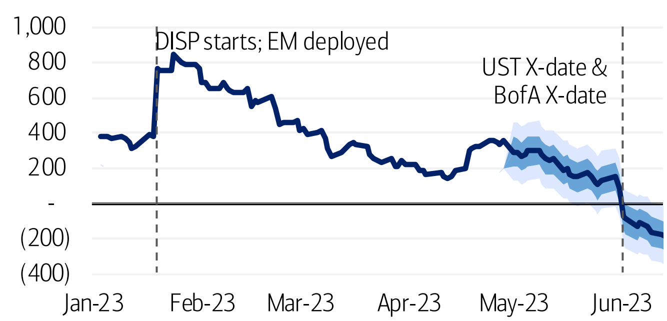
Exhibit 4: Projected EM and TGA remaining
We pull forward our X date to June 1, consistent with US Treasury



Source: BofA Global Research, US Treasury

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Yellen guidance: impact on political & market timeline

Yellen's guidance pulls forward the political & market stress timeline. Updated thoughts:

Political timeline: time is of the essence since there is now <1m to reach resolution. We expect deliberation to accelerate in coming weeks. The longer it takes to achieve a deal, the greater the possibility of a short-term DL extension. Our base case has always been a DL resolution just prior to the X-date which would be in late May. The next most likely option is a short-term DL extension potentially to Sept 30. Lower probability & worse case outcomes can't be ruled out, in our view.

Logic for Sept 30 extension: if government cannot agree on a debt limit resolution prior to the X-date, a smaller "can kick" solution is possible. An extension to Sept 30 would align government spending & DL timing. Republicans would likely be willing to tie directly spending bill & debt limit; Democrats may be reluctant but might not have other option.

A Sept 30 "can kick" would likely see near-term bill supply increase, a higher Treasury cash balance, and temporary reserve drain. We assume TGA would probably be temporarily rebuilt to $400-500b and see a similar build in bill supply. TGA rebuild & higher bills would likely see an associated liquidity drain from ON RRP or reserves (ON RRP drop likely because bill supply driven). For more detail on bill supply, see [May refunding recap].

We assume a DL "suspension" till Sept 30 means UST extraordinary measures are refreshed. This would push out the timing of a technical default to Feb '24.

Lower probability outcomes: a variety of other outcomes are possible but lower odds, in our view. We focus on two: (1) discharge petition, and (2) X-date breach.

- Discharge petition: this is a method of introducing a bill for a vote on the House floor. The normal route is for the House Rules Committee to introduce. A discharge petition requires a majority of signatures (218 today) to move a vote forward. Democrats started the discharge petition process in January, and there is a chance that it becomes an avenue for a solution to a DL increase this summer.
- X-date breach: it is possible a resolution won't be reached by the X-date which means delayed payments, debt prioritization, or legal challenges all become possible. These are low probability outcomes, but can't be ruled out.

Market stress: Yellen's updated guidance has pulled forward market DL concern. The bill market clearly reflects this with a concentration of concerns in the first week of June. In coming weeks, we expect to see Treasury coupon securities with a coupon payment after the X-date start to cheapen vs securities with a May coupon date.

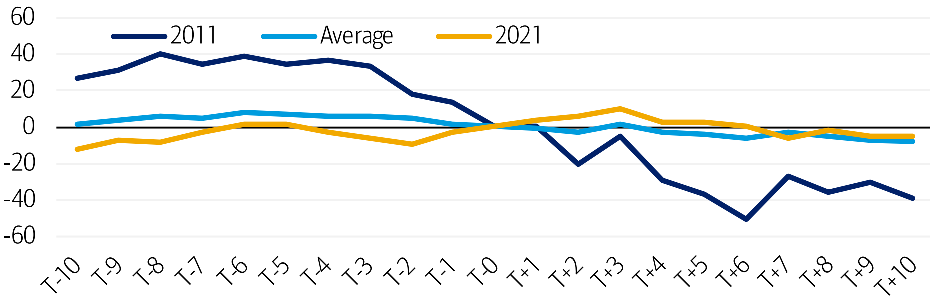
Broader rates: We think of broader rate impact as: (1) US OIS curve (2) UST-OIS spread. We expect that most UST yields will decline & curve bull steepen with DL stress.

US OIS curve: any technical UST default will likely see the US OIS curve bull steepen. The US OIS curve bull steepening will be driven by financial stress & increased recession risk with sharp fiscal tightening (e.g. delayed social security payments). The market will likely price increased probability of Fed rate cuts or intermeeting cuts in this scenario. Historically, rates have declined around debt limit standoffs (Exhibit 5).

UST-OIS spread: we expect material dislocations on the UST curve with any technical UST default. Delayed payment UST securities are likely to cheapen materially vs OIS, including short-dated bills & coupons with impacted payments. However, USTs that have recently received coupon payments should rally (lower yield) in any scenario. We believe investors will likely still use non-delayed payment USTs as flight to quality instruments.

Delayed payment UST securities will also likely be more difficult to fund in repo & may end up trading as their own cheaper segment of the UST repo market. In the event of technical UST default, we expect the Fed to use all available tools to fund these dislocated securities (via repo, securities lending, lower discount window, outrights).

Exhibit 5: US 10yr yield around prior X-dates (bp chg)
Rates have generally declined around debt limit standoffs



Source: BofA Global Research, Bloomberg

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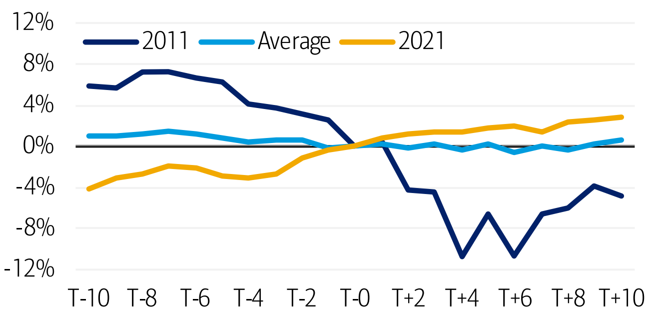
Broader markets: prior debt limit episodes imply that broader markets don't seem to price in debt limit scenarios until two weeks before the projected X date. In 2011, the debt limit was not resolved until the projected X-date, which weighed heavily on investor sentiment, leading to lower equity prices and higher volatility (Exhibit 6, Exhibit 7). In later debt limit scenarios, especially those in which the debt limit was resolved several days or weeks before the projected X-date, the impact on risk assets was less severe.

Exhibit 6: S&P 500 around previous X-dates (% change)
S&P performance around x-dates is mixed



Source: BofA Global Research, Bloomberg

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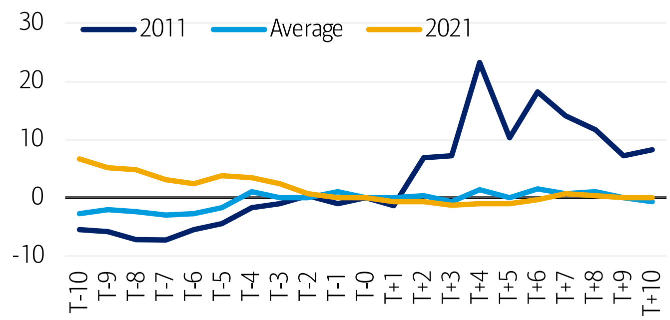
Exhibit 7: VIX around previous X-dates (ppt chg)
Debt limit impact on vol limited outside of 2011



Source: BofA Global Research, Bloomberg

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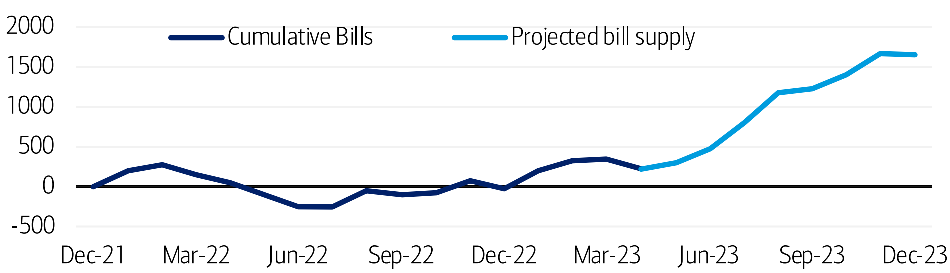
We expect this DL resolution will likely go down the wire which means risk of higher rate & broad market volatility in late May or early June. For more detail see: Debt limit FAQ.

After the debt limit: large UST supply shock

We continue to believe the most consequential rate market development will be the UST supply surge *after* debt limit resolution. We currently expect $1.4tn of bill supply through the end of the year after the debt limit is resolved (Exhibit 8). Bill supply surge will be used to rebuild Tsy cash balance from near zero to $700b by end '23 & fund deficits.

Exhibit 8: Projected cumulative bill supply ($bn)
We forecast bills to increase $1.6tn over CY'23



Source: BofA Global Research, Treasury

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Bill surge will be seminal UST funding event in 2H '23. It will see: (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.

A similar bill supply surge was seen after the debt limit resolution in late '17 & early '18. During this period, bill supply increased $500b, 3m bills cheapened vs OIS by 20bps, SOFR + fed funds shifted higher in the Fed's target range, & ON RRP use fell to near zero. The late '17 & early '18 period is a playbook for the large shift a debt limit supply surge can have on funding markets.

The large surge in bill supply may feel like an extra 25bp money market rate hike. For most of ’22, 3m bills-OIS was 20bps rich. Post DL bill supply, we expect 3m bills-OIS to trade 5-10bps cheap (this is the level required to encourage MMF investors to extend out of ON RRP; inverted OIS curve means bills may need to cheapen even further to pull MMF out of ON RRP). On net, bills will have to cheapen to incentivize buyers. Cheaper bill rates mean banks & other funders will have to pay up to retain funds.

Bottom line: DL market concern will likely increase in coming weeks and be shown via a more acute hump in the UST bill curve, mid-June UST coupon cheapening, and potential risk off later in May. Resolution likely at last minute; push to Sept 30 possible. Worse case outcomes can’t be ruled out, in our view.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- A year of many narratives, **Global FX Weekly**, 28 Apr 2023
- Are we there yet**, Global Rates Weekly**, 28 Apr 2023
- EURUSD & NZD selling, mixed JPY & NOK, **Liquid Cross Border Flows**, 24 Apr 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: A year of many narratives 28 April 2023

Global Rates Weekly: Are we there yet? 28 April 2023

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