BofA Global Research Podcasts

Treasury supply expected to surge while rates to fall by year end

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Rates Strategy
United States

Key takeaways

- BofA Global Research Podcasts are an ongoing series of discussions covering growth industries and topical market themes.
- The debt limit crisis was averted but the combination of deficits and the need to replenish Treasury cash means . . .
- Treasury Bill issuance over the next few months will be unusually large. But at the long end, we still expect rates to fall.

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Treasury supply to hit $1 trillion over the coming months

The debt ceiling drama has finally come to a close as Washington signed legislation to raise the debt ceiling and avert default. But the next chapter abruptly follows and involves $1T of Treasury Bill issuance over the next 3 months, 5x the average *annual* supply. Mark Cabana discusses the impact that may have on shorter term Treasuries, the outlook for long dated bonds and whether the agreed upon spending caps will dissuade any of the Treasury bears.

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Full Podcast Transcript

T.J. Thornton, Head of Product Marketing and Predictive Analytics: Hello and welcome to BofA Global Research Podcast, where we discuss what's rising from growth industries to rising risks and opportunities in global markets. I'm T.J. Thornton, Head of Product Marketing at BofA Global Research and we're recording this episode on Friday, May 26, 2023. There's been plenty of focus on the debt ceiling and what the negotiated deal might look like, but there's another issue to contend with, namely $1 trillion of Treasury bill supply. Today we have Head of US Rates Strategy Mark Cabana to discuss what that supply means and also whether compromise and spending caps may have medium or longer term implications for bonds and rates going forward. Thanks Mark for joining.

Mark Cabana, Head of US Rates Strategy: Thanks T.J. for having me.

T.J. Thornton: As mentioned, you expect a big increase in Treasury bill supply once the debt limit deal is resolved. You've addressed this in a few of your recent notes. Why such a big increase in supply and is the Treasury market prepared for this? Also, do you think that the higher short term rates we've seen over the last few weeks have actually been in anticipation of some of the supply?

Mark Cabana: You're right T.J., the market attention will very quickly turn to the large onset of bill supply that we are likely to see. As you noted earlier, we're forecasting over $1 trillion of bill supply in the months of June, July and August collectively. And for just some historical context, in the five years that preceded COVID, the average annual increase in bill supply was $200 billion, so quite literally we're expecting five times the supply in three months. Now why so much? There's really two reasons for that. Number one, the US Treasury needs to rebuild its cash balance, and number two; the deficits are still quite large. Let me explain both in a little bit more detail. On the cash balance, the US Treasury has stated that it would like to have, in its coffers, an amount on any given day that's equivalent to five days' worth of expected outflows. That translates, according to our numbers, to at least $500 billion. Now throughout the debt limit process, we have seen that the cash balance of the Treasury has been reduced, and it was most recently under $50 billion, almost drained the barrel dry, and they will want to replenish that as quickly as they can because they're liquidity manager, they've got a bunch of incoming and outgoing payments on any given day and they want to have a good liquidity buffer. A very real part of the Treasury supply onslaught that we expect is due to the Treasury rebuilding their cash balance. The Treasury has told us that by the end of June, they would like the cash balance to be $550 billion, by the end of September they'd like it to be $600 billion, and so a very large component of the increase in bill supply will be done to replenish that cash balance. For what it's worth, we expect the Treasury will add a little bit of a buffer onto their desired cash balance by the end of the year, and we have that in our forecasts at $700 billion. Roughly half of the initial supply surge is going to come to refill Treasury's liquidity buffer. The other reason for all of the supplies, because the deficit is still very big and the schedule of US Treasury's coupon issuance just doesn't generate all that much net new cash for them on any given month nowadays, and so we expect that there will need to be incremental bill supply in order to account for the deficit spending and the laws that Congress has already passed on, how that spending will be allocated. In addition to the increase in the Treasury cash balance, there's also ongoing deficit financing needs that suggest once we run our numbers that there will need to be about $1 trillion or over $1 trillion of Treasury bill supply in the summer months, in order to both refill that liquidity buffer and to fund the deficit.

T.J. Thornton: As you point out the surge won't last forever, part of this is rebuilding cash balance and once it's rebuilt you won't need to issue as much. Do you think that rates move up initially and then just fall back down, as the market anticipates that the supply will eventually ebb in a few months?

Mark Cabana: The way we've been thinking about this is that there is a level shift in the amount of Treasury supply and that level shift will not necessarily be withdrawn after the initial surge. The speed is quite rapid, but the overall amount of debt outstanding that won't fall back down. That's going to remain quite elevated. The cheapening that we expect to see in front end rates, we think will likely persist, likely indefinitely, as a result of this very strong surge in supply.

T.J. Thornton: And when you say cheapening Mark, are you talking about the front end versus the back end?

Mark Cabana: Yeah, we think that the most direct impact to the Treasury market will be at the front end. And when we say cheapening, the way that we think about this is really around what is the level of Treasury rate that is expected to prevail in relation to the expected Fed Funds OIS (Overnight Index Swap) path or the path of the Federal Fund's Target Rate. The expected Fed path will move with incoming economic data and guidance from Fed officials, but the surge in Treasury supply will cause rates to move higher around that expected Fed path.

T.J. Thornton: Mark, one of the risks of a failure to resolve the ceiling, even though nobody expected that failure to last very long, was that you would see a big cut to spending and almost certain recession. With resolution, especially thinking about the backend or long rates, the 10-year, do you think rates rise or again, have markets pretty much anticipated this?

Mark Cabana: There is probably some downside risk that has been associated with the debt limit standoff and the possibility of a delayed payment or technical Treasury default. At the front end that'll be a bit more subject to this very strong supply surge. And also, if you're adding more Treasury supply and you're seeing front end Treasury yields increase, then you would think that maybe some investors who've been extending out the curve will be a little bit more incentivized to come in on the curve and that in turn can allow backend rates to rise somewhat in sympathy with front end rates. But we do think that the impact will be most concentrated at the very front end of the curve.

T.J. Thornton: Mark with Republicans managing to use the negotiations to force some spending discipline, does one of the bear cases for Treasuries, which is essentially unchecked spending, go away and does that mean anything for rates?

Mark Cabana: Certainly if there were significant spending reductions or it could also be tax increases. Really, if there was an improvement in the fiscal backdrop of the US that would certainly help argue against one of the bear cases for Treasuries, which is that there's just going to be almost an unchecked increase in supply and the market's demand for that supply is not infinite, and if there were to be any type of lower spending or higher taxes, that would certainly help better balance the deficit. That would mean less Treasury supply and on net that would reduce the bear case arguing against Treasuries.

T.J. Thornton: There's a lot of controversy around the market pricing rate cuts in the second half. Our economists don't expect it, indeed across the street, very few economists do. Most people think that inflation will remain sticky; the Fed won't be able to cut. Why is it then that the market is convinced you will see these cuts? And what is the market view? Why is there this anticipation for cuts?

Mark Cabana: We think that the market has been expecting inflation would moderate faster. Certainly you see this, if you look at inflation swaps, one year forward inflation really does anticipate that the Fed will see a meaningful drop in inflation over the next 12 months. And it seems like the market has been expecting that with lower inflation, the Fed will not need to keep policy as restrictive. There was also an expectation that maybe some of the stress that was evidenced in the banking system could broaden and that would in turn tighten lending standards, tighten the economy and cause the Fed to be able to cut rates later in the year. The incoming information that we have seen is that inflation is not falling as fast, consumer has been remarkably resilient. The overall magnitude of lending has not dropped as significant as some may have feared, that has really caused the market to price out a great deal of the rate cuts that were expected in the second half of the year. And as we speak, the market is pricing in another full rate hike from the Fed by the July meeting. The market is certainly adapting to this, and as we get incoming information that suggests a strong economy and high inflation, so to have those rate cuts faded.

T.J. Thornton: And Mark, last question. If our economists are right and we enter a mild recession in the third quarter this year, how do you think the 10-year will react then and over the next couple quarters?

Mark Cabana: Our forecasts do imply that rates will be falling by the end of the year and that has been expected with a moderation in the US economy. Certainly our economists have been calling for a recession in the second half of the year for quite some time. And if the economy does indeed moderate, then we think that our rate forecasts seem quite sensible. However, if we see an economy that continues to show signs of resilience, inflation that remains sticky high and frustratingly elevated, then those rate declines and curve steepening that we have in our forecasts will be challenged. But for right now, we're still sticking with the moderation in growth and inflation view that still leads us to believe that rates will be lower. It still allows us to say in good faith that we think that clients should be adding to duration around these levels. We've been suggesting that clients trade rates tactically with a long bias, using the 10-year as a proxy. We do think that our guidance though does suggest that investors should be adding to their duration positions in anticipation that the economy will moderate at some point and that rates will also be moving lower.

T.J. Thornton: Mark, thanks very much for joining us today.

Mark Cabana: Thanks for having me.

T.J. Thornton: Though this surge in Treasury bill supply won't last forever, since half is intended to replenish cash, deficits do remain high and Mark looks at this change as a level shift in the supply outlook. It's not all temporary either, and it should keep short end rates high relative to what you'd expect based on where Fed funds are. As for the 10-year Treasury, Mark does think that rates are toward the high end of the range, and he does expect ten year rates to fall by year end, provided we see signs that the economy is moderating and that inflation does the same. Thanks for joining.

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