US Rates Watch

X-date shift & bill supply update

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X-date shift earlier, Yellen likely to stick with early June

We pull forward our X-date estimate from mid- to early-August due to: (1) April tax receipts, which are on the low end of our expectations, and (2) higher deficit forecast revision from our US economists. Our new X-date is August 1 but could slip to late July (Exhibit 1).

Importantly, we think UST will see their cash balance & extraordinary measure buffer too low for comfort in early June. UST Secretary Yellen will likely hold her guidance for an early June X-date with a very low cash buffer for now.

We expect to hear additional guidance on the X-date from Yellen in the next two weeks. Yellen will likely continue to err on the side of earlier & more conservative X-date estimates to limit the risk of UST technical default. We expect to hear a revised X-date estimate from Yellen no later than early May.

Below we offer thoughts on (1) April tax receipts (2) higher deficit forecast (3) UST implications.

April tax receipts: low end of our expectations

The April tax data thus far has come in on the lower end of our expectations. However, we reserve full tax date judgement until IRS check processing slows to a trickle. The TGA has also been increasing slower than expected not only due to taxes but also because of an unexpected Government Account Series transaction that drew on TGA cash.

Tax data has lagged last year but has been much stronger vs the average of pre-COVID years (Exhibit 2). 2023 tax receipts are likely lower in part due to a 7% increase in inflation indexed tax brackets, which all else equal has led to less income tax revenue.

TGA & GAS dynamics: positive net issuance in the Government Account Series (GAS) is a net draw on the TGA. The unexpectedly high issuance on April 17th led to a smaller increase in the TGA from tax receipts than we had previously expected. A lower cash balance will leave the Treasury with less cash on hand and risks an earlier X-date.

Bottom line from tax receipts: tax inflows have been on the lower side of our estimates. The soft tax receipts & lower TGA due to GAS issuance causes us to pull forward our X-date from mid- to early-August. The X-date could slip to late July. We flagged the risk of an earlier X-date in April tax season & debt limit X-date.

... see following pages for more detail on deficit forecasts & UST implications...

UST: US Treasury

DL: debt limit

GAS: Government Account Series

TGA: Treasury General Account

CY: Calendar Year

FY: Fiscal Year

OIS: Overnight indexed Swap

IRS: Internal Revenue Service

Larger deficit also factors into earlier X-date

Our US economists also revised to a larger deficit in FY '23 this week. They now expect the FY 2023 deficit to be $1350bn. The larger deficit forecast revision was largely a mark-to-market as the deficit has already eclipsed $1tn halfway through the fiscal year. Moreover, the data suggest personal income tax collections are unlikely to surprise to the upside this April owing in part to lower capital gains taxes. We will not have the full picture on tax season until early May, but initial data suggest income tax collections are unlikely to surprise to the upside.

Bottom line from deficit revision: An upward revision to the deficit outlook adds to the risk for an earlier X-date.

Yellen X-date guidance: err on conservative side

The soft April tax receipts & large deficit will likely encourage Yellen to stick to her original early June X-date guidance, in our view. Indeed, a $100b miss in TGA forecast could see the UST default in early June (Exhibit 1). For reference, the 1 standard deviation in TGA daily changes since '21 has been $75b, which leaves UST with a tight margin for error.

UST Secretaries must be conservative in providing early X-date estimates to avoid threat of unexpected UST default. We expect to receive updated guidance from Yellen by the first week of May. If Yellen sticks with an early June X-date estimate, we expect to see a more acute cheapening of bills around these dates.

Debt limit concern is driving bill curve dislocation

Debt limit concerns have resulted in a palpable dislocation in the UST bill curve. The bill curve now prices a notable "hump" around the X-date potential range from early June to August (Exhibit 3). Investor desire to concentrate investments before this potential X-date range has also contributed to a historically steep 1m-3m bill curve (Exhibit 4).

We continue to expect the debt limit will be resolved at the last minute, just prior to delayed UST payments or a technical UST default. However, we acknowledge the risks are elevated for the UST to potentially cross the X-date for the first time in history. The bill curve hump & recent widening of US CDS reflect similar concerns.

We continue to expect a large bill supply surge after the debt limit is resolved. The deficit revision from our US economists now implies total bill supply in FY '23 of $800+bn. However, the total amount of bill supply in FY '23 vs FY '24 will very much depend on the timing a debt limit resolution & TGA rebuild process. Between FY '23 & FY '24, we expect $2tn+ of bill supply. Bill supply will surge post debt limit.

The timing of bill supply will also be a function of debt limit resolution timing. In our base case late July / early Aug debt limit resolution we continue to believe we could see $1.1tn of bill supply by end CY '23. This assumes a TGA balance at year-end of $700b. Risks are to a slower pace of bill issuance & smaller TGA at year end.

We assume an earlier debt limit resolution in June would still result in heavy bill supply but more supply would come over the summer than we currently forecast (Exhibit 5). Conversely, a temporary debt limit resolution that kicked the X-date to Sept 30 would likely result in a small bill wave between June and Sept, but a much slower increase in the TGA heading into year-end. Ultimately, we project this would result in $400b less bill supply in CY'23 (Exhibit 5).

Debt limit impact on USTs out the curve

Clients have increasingly inquired about the market impact from a technical UST default. We encourage clients to focus on: (1) US OIS curve, and (2) UST-OIS spread. On net, we expect that most UST yields will decline & curve bull steepen in a technical UST default.

US OIS curve: any technical UST default will 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.

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 still use non-delayed payment USTs as flight to quality instruments.

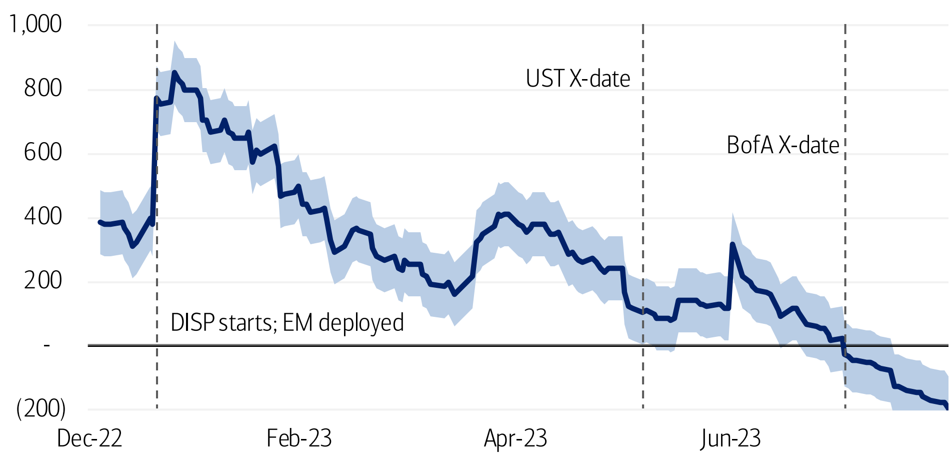
We think a technical UST default is quite unlikely. Prior communications from the Fed have suggested that it is possible to prioritize UST payments, thought this has never been done in practice. We also think President Biden would authorize UST debt prioritization above other government obligations. We think the Fed will also likely use open market operations to remove any delayed payment security from the market (including large scale repo operations, outright purchases, & discount window changes).

Bottom line: April tax receipts have been on the low side of our expectations and the deficit is tracking higher. This causes us to pull forward our X-date estimate from mid- to early-August but believe it could easily slip to late July. Yellen will likely hold her guidance for an X-date in early June, which could see a more meaningful cheapening of bills around the start of June.

We continue to expect a large bill supply surge after the debt limit. The timing & magnitude of the bill supply will be a function of debt limit resolution. Our base case is for $1.1tn of bill supply after a late July / early Aug resolution including end CY '23 TGA balance of $700b. Risks are to a slower pace of bill issuance & smaller TGA at year end.

Exhibit 1: UST TGA and extraordinary measures projections ($bn)

UST X-date: June 5; BofA X-date: Aug 1



Source: BofA Global Research, US Treasury, Bloomberg. Note: error band = +/- $100b

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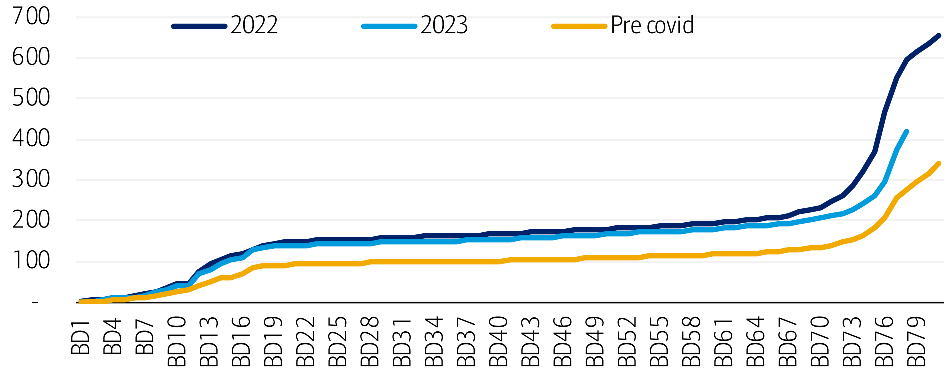
Exhibit 2: Cumulative individual tax receipts in '22, '23 & avg of pre-COVID years ($bn)

'23 is tracking 23% below where we were this time last year but well above the pre-COVID average



Source: BofA Global Research, US Treasury, Bloomberg

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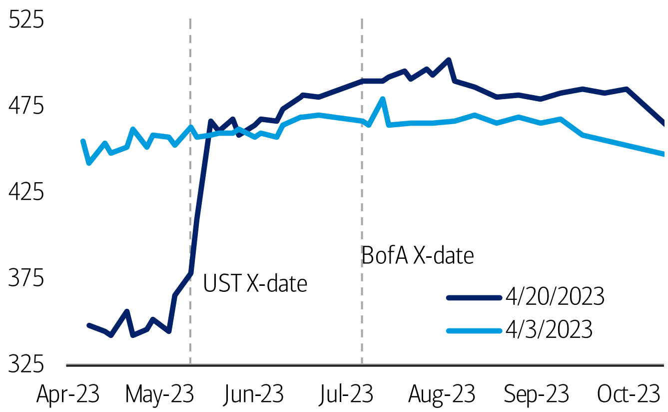
Exhibit 3: Treasury Bill Curve (bps)

Front-end bills have richened while bills maturing close to projected X-date have cheapened



Source: BofA Global Research, Bloomberg

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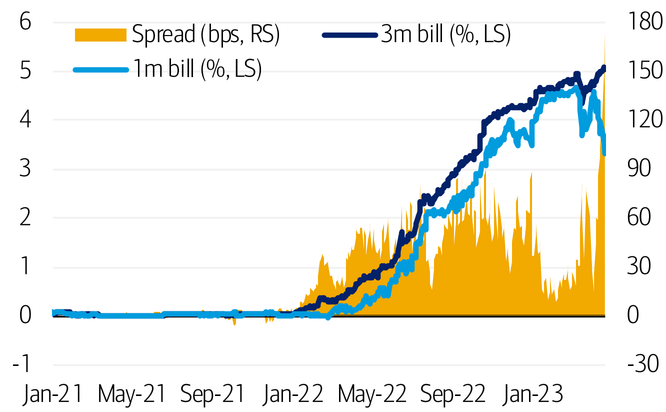
Exhibit 4: 1m and 3m bill rates and spread

1m-3m bill curve spread has widened significantly



Source: BofA Global Research, Bloomberg

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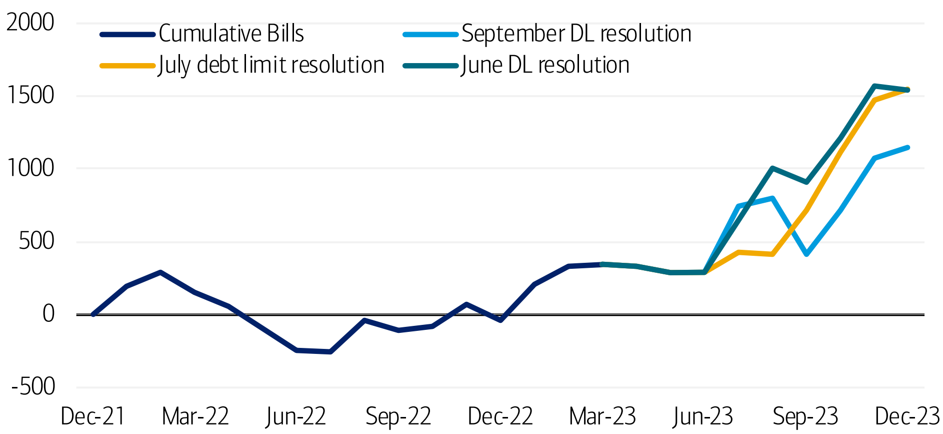
Exhibit 5: Cumulative bill supply projections: June vs July vs August resolution dates (bps)

A June or July resolution results in the same amount of bill issuance but more occurring over the summer with a June resolution. Sept DL resolution assumes a slower TGA increase at year-end



Source: BofA Global Research, Bloomberg

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