Welcome to the Roaring 20s

Implications of Treasury's 20-year bond announcement

Fixed Income Strategy

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- Treasury shocked market participants on Thursday night in resurrecting the 20-year bond following a 35-year hiatus, with plans to start auctioning this security in 1H20. The timing of this announcement is unusual, as Treasury is adequately financed for the balance of 2020 and traditionally reserves significant changes to its financing schedule for quarterly refunding announcements, the next of which falls on February 5

- We project Treasury will first auction the 20-year bond in May. We think 20-year issuance should mature on the 15th of the month, with maturities in February, May, August, and November to align with existing STRIPS market maturities. Given TBAC recommendations, auctions are likely to occur in the third week of the month, alongside the monthly TIPS auction

- TBAC had recommended initially sizes of $13bn for new issues and $11bn for reopenings, but we think sizes are likely to be smaller at onset. We project $11bn new-issue auctions and $9bn reopenings for an initial outstanding of $29bn per CUSIP. These sizes should grow in 2021

- Adding the 20-year requires Treasury make cuts to other securities until the financing gap opens in 2021. We project Treasury will cut monthly 10- and 30-year auction sizes by $3bn, as well as $1bn cuts to FRNs, 2-, 3-, 5-, and 7-year notes to accommodate the introduction of the 20-year in May. Focusing the cuts at the long end is in line with TBAC's recommendation, and has the additional feature of keeping the WAM of Treasury's debt stable around current levels

- The 20-year sector has cheapened in recent month and is pricing some discount for expected 20-year issuance. Given current levels, we expect the 20-year to price in the context of OIS+45bp, or currently approximately 32bp over the current 10-year note.

See page 5 for analyst certification and important disclosures.

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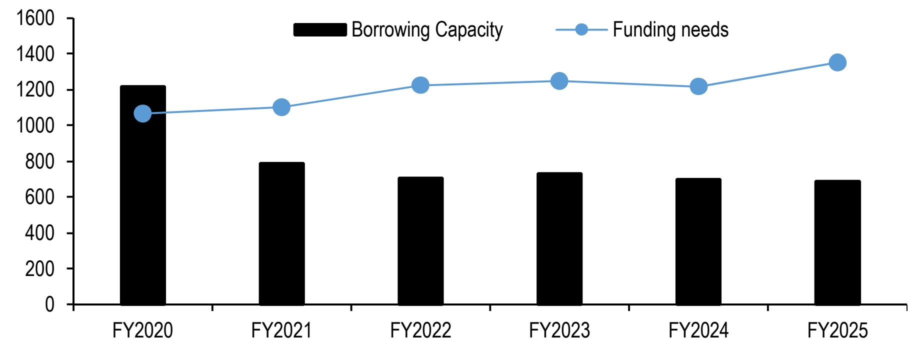
Treasury shocked market participants on Thursday night in resurrecting the 20-year bond following a 35-year hiatus, with plans to start auctioning this security in 1H20.[1] While we have long thought that adding a 20-year maturity made sense in the context of Treasury's sizeable financing needs over the coming decade and its approach to debt management (for more details see *To a trillion and beyond: The outlook for Treasury supply in 2020*, 11/12/19), two things are surprising about this announcement. **First**, as we wrote in our 2020 supply outlook, Treasury is likely over-financed for 2020, and we did not expect the 20-year to be auctioned until late 2020 or early 2021 (**Exhibit 1**). This aligns with Treasury's own work, which indicates the current auction calendar is sufficient to meet Treasury's borrowing needs for the remainder of this year. **Second**, the timing of the announcement is highly unusual; Treasury traditionally reserves significant financing announcements for its mid-quarter refundings, and the next refunding announcement is less than three weeks away on February 5. Moreover, poring through 20 years of historical data, we cannot find another instance in which Treasury announced a change to its debt management strategy outside of a refunding announcement, and this off-cycle statement runs against the grain of being "regular and predictable."

Exhibit 1: Treasury's borrowing capacity declines sharply in FY21 and beyond, as maturities pick up as a result of the large increases made to monthly 2- and 3-year auction sizes in 2018
Projected net coupon borrowing capacity* versus total funding needs**; $bn



* Assumes JPM gross issuance forecast is realized and incorporates borrowing capacity created by SOMA
** Expected change in public debt, based on CBO's budget projections and off-balance sheet funding needs
Source: J.P. Morgan, US Treasury, Congressional Budget Office

However, we can discern some of Treasury's motivation in the timing of this announcement. Twice, in last night's statement, Treasury referenced the goal of expanding its borrowing capacity over time. Thus, is appears Treasury is motivated to create additional borrowing capacity now, rather than waiting until FY21. Thus, Treasury has a runway to ramp up auction sizes into next year, when financing needs far outstrip its borrowing capacity.

Timing and sizing of the 20-year bond

In last night's announcement, Treasury relayed it would give additional information at the next quarterly refunding announcement on February 5, and we expect to learn more about the timing, sizing and structure of this issue at this announcement.

[1] https://home.treasury.gov/news/press-releases/sm878

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However, the TBAC charge question on this topic from the November 2019 refunding offers a number of recommendations. The presenting member recommended 20-year issuance should mature on the 15th of the month, with maturities in February, May, August, and November to align with existing STRIPS market maturities. It also recommended auctions occur in the third week of the month, alongside the monthly TIPS auction. It also proposed initial auction sizes of $13bn new issues and $11bn reopenings. Indeed, in the primary dealer questionnaire released today, Treasury asked dealers about this structure as well as preferred auction sizes for the upcoming 20-year bond. Given these recommendations, we think Treasury will likely schedule its first auction in May, but given that the auction calendar is adequate to meet *current* financing needs, we think initial auction sizes could be smaller, perhaps $11bn new-issue auction sizes with two subsequent $9bn reopenings, for an initial size of $29bn outstanding per CUSIP.

Exhibit 2: We project Treasury will cut auctions sizes across the curve to accommodate the return of the 20-year, with 10s and 30s seeing the most significant cuts…

Projected gross issuance sizes for coupon Treasuries in 2020 assuming the 20-year bond is introduced in May 2020; reopenings shaded in grey; $bn

	2s	3s	5s	7s	10s	20s	30s	5y TIPS	10y TIPS	30y TIPS	2y FRN	Total
Jan 20	40	38	41	32	24	0	16	0	14	0	20	225
Feb 20	40	38	41	32	27	0	19	0	0	8	18	223
Mar 20	40	38	41	32	24	0	16	0	12	0	18	221
Apr 20	40	38	41	32	24	0	16	17	0	0	20	228
May 20	39	37	40	31	24	11	16	0	12	0	18	228
Jun 20	39	37	40	31	21	9	13	15	0	0	18	223
Jul 20	39	37	40	31	21	9	13	0	14	0	19	223
Aug 20	39	37	40	31	24	11	16	0	0	7	17	222
Sep 20	39	37	40	31	21	9	13	0	12	0	17	219
Oct 20	39	37	40	31	21	9	13	17	0	0	19	226
Nov 20	39	37	40	31	24	11	16	0	12	0	17	227
Dec 20	39	37	40	31	21	9	13	15	0	0	17	222
Total	472	448	484	376	276	78	180	64	76	15	218	2687
2019	480	456	492	384	300	0	204	64	73	15	224	2692
Diff.	-8	-8	-8	-8	-24	78	-24	0	3	0	-6	-5

Source: J.P. Morgan

Adding the 20-year requires cuts to other Treasury securities until the financing gap opens in FY21. T-bills have been the shock absorber to any change in Treasury's financing calendar, and this would further dampen the level of outstanding T-bills. However, we are already projecting net bill issuance to run significantly below the recommended 25-30% share of total net issuance in 2020 and with the Fed purchasing bills for reserve management purposes, further reduction in auction sizes could cause excessive dislocations in this sector of the Treasury market. Thus, we think cuts are likely to come in FRNs, notes and bonds. TBAC's work on optimizing the maturity of Treasury's debt argued that further WAM extension from current levels would raise funding costs without a meaningful reduction in risk, and thus Treasury has kept its WAM stable since 2017. In the charge question on 20-year debt, TBAC argued "while issuance of a 20-year bond will clearly cannibalize demand for 10s & 30s, it would also absorb supply from 10 and 30 year auctions." **We therefore project Treasury will cut monthly 10- and 30-year auction sizes by $3bn, as well as $1bn cuts to FRNs, 2-, 3-, 5-, and 7-year notes to accommodate**

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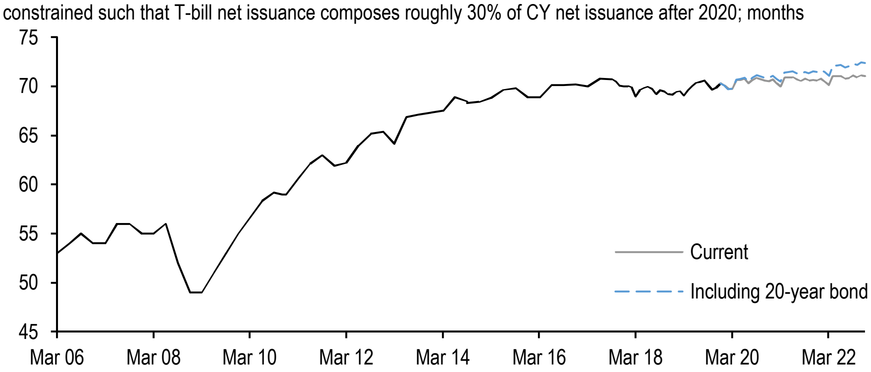
the introduction of the 20-year in May (Exhibit 2). Focusing the cuts at the long end is in line with TBAC's recommendation, and has the additional feature of keeping the WAM of Treasury's debt stable around current levels (Exhibit 3).

Exhibit 3: …and this should have a negligible impact on the WAM of Treasury's debt
Historical WAM and forward projection assuming Treasury begins auctioning 20-year Treasuries in May 2020*, constrained such that T-bill net issuance composes roughly 30% of CY net issuance after 2020; months

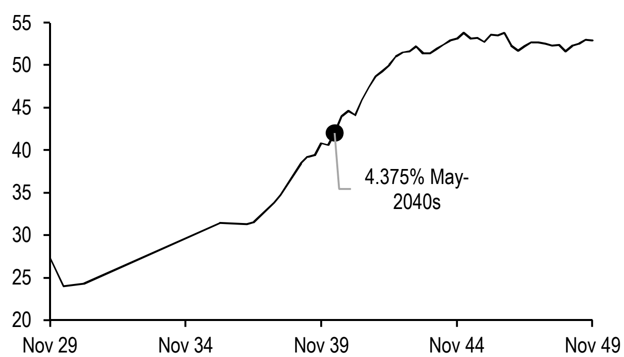


* Assumes changes made to auction calendar presented in Exhibit 2
Source: J.P. Morgan, US Treasury, Congressional Budget Office

Potential pricing and impact on Treasury curve

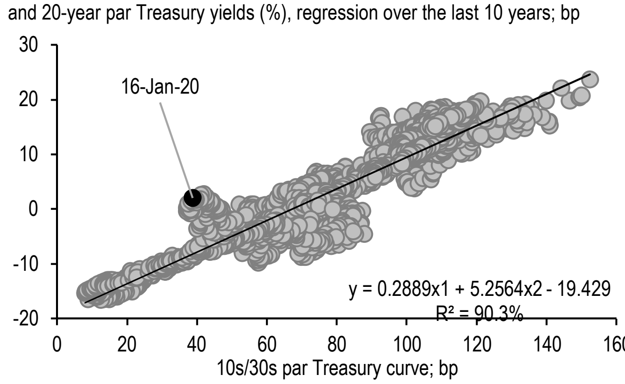
Given this backdrop, where should a prospective 20-year trade? **Exhibit 4** shows the matched-maturity Treasury/OIS curve: the curve between 10- and 30-years is approximately 25bp steep. **At close last night, the 4.375% May 2040 traded OIS+42bp, and gives us some insight into where the new 20-year bond should trade**. We are fully aware issues in the 20-year sector are deeply off-the-run, heavily owned by the SOMA portfolio from the QE era and might not be representative of how a new-issue 20-year may trade, indicating some discount along the curve could be necessary. However, **Exhibit 5** shows that the 20-year has cheapened along the curve in recent months and now appears almost 10bp cheap to the wings after adjusting for the slope of the curve and the level of yields. **Thus, it appears that the 20-year sector is already pricing some discount for expected 20-year issuance, and given current levels, we expect the 20-year to price in the context of OIS+45bp, or currently approximately 32bp over the current 10-year note.**

Exhibit 4: Valuations indicate a 20-year should trade around OIS+40-45bp, though the risk is the new issue trades cheaper than original issue 30-year bonds which have rolled down the curve…
Matched-maturity Treasury/OIS curve; bp



Source: J.P. Morgan

Exhibit 5: …but the 20-year has underperformed, and appears cheap to the wings, even after adjusting for curve slope and rate levels
10s/20s/30s par Treasury butterfly regressed on 10s/30s par Treasury curve (bp) and 20-year par Treasury yields (%), regression over the last 10 years; bp



Source: J.P. Morgan

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