

July 30, 2020

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Economics and Rate Strategy

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Economics and Rate Strategy *Treasury Refunding Preview: Cash Is King*

- If another sizable fiscal package does not come to fruition, the U.S. Treasury's current financing schedule is not too far off from being well-suited to the financing need.
- But even if a big package is realized, we expect significant auction changes to be deferred until November. The U.S. Treasury's incredibly high cash balance alleviates a good portion of the funding pressure that would normally arise from the passage of a large deficit-financed bill.
- Our baseline expectation for the August refunding next week is for smaller increases to auction sizes for most tenors than occurred in May, though still large increases by historical standards. We look for \$1 billion per month increases to the 2Y, 3Y, 5Y and 7Y, such that the monthly auction for each security is \$3 billion higher in October than it was in July. For the 10Y, 20Y and 30Y, we look for a one-time \$2 billion increase to the August original issue, which would also apply to subsequent re-openings.
- The absence of another major fiscal package would position Treasury to do one more (relatively) small round of increases in November. At that point we think the increases would stop, and elevated coupon-issuance/a shrinking budget deficit would create an environment where total Treasury bills outstanding could decline materially.
- Our baseline borrowing forecast, which has no additional stimulus baked in, implies a nearly \$600 billion decline in T-bills outstanding in the second half of 2020, with a continued contraction into 2021.
- We think the enactment of another sizable fiscal package would have a much more material impact on auction sizes at the November and February 2021 refundings, as well as T-bill supply in the second half of 2020.
- Under this scenario, we think there would be much more aggressive increases in coupon issuance at the November and February 2021 refundings, more along the lines of what was done in May. Net bill issuance in the second half of 2020 might even rise by a few hundred billion, depending on the size and structure of the package.
- We expect TIPS auctions will get a boost in August as Treasury remains committed to keeping the TIPS program an integral part of the regular auction schedule. In our base case, we have an increase of \$3 billion per auction to be announced next week. Nonetheless, we would not be surprised if Treasury waited until the November refunding to make a move along these lines.

Please see page 6 for the rating definitions, important disclosures and required analyst certifications.
All estimates/forecasts are as of 07/30/20 unless otherwise stated.

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Stimulus Discussion Clouds the Treasury’s Borrowing Outlook

The federal government’s financing need in the coming quarters is murky, clouding the path forward for Treasury security issuance. However, we expect significant changes to be deferred until November even if Congress passes another major spending program.

If another sizable fiscal package does not come to fruition, the U.S. Treasury’s current financing schedule is not too far off from being well-suited to the financing need. Federal fiscal year 2020, which ends on September 30, appears likely to see a deficit close to our baseline forecast of \$3.4 trillion, absent another major fiscal stimulus bill. In FY 2021, we expect the deficit to remain elevated relative to the period prior to COVID-19. Even so, the deficit should be at least \$1 trillion smaller next year than in FY 2020 (Figure 1).

Assuming no additional major fiscal package is passed, we think one more decent sized, across-the-board increase in coupon-bearing securities at the August refunding would be the appropriate move. Our baseline expectation is for smaller increases to auction sizes for most tenors than occurred in May, though still large increases by historical standards. We look for \$1 billion per month increases to the 2Y, 3Y, 5Y and 7Y, such that the monthly auction for each security is \$3 billion higher in October than it was in July. For the 10Y, 20Y and 30Y, we look for a one-time \$2 billion increase to the August original issue, which would also apply to subsequent re-openings. This would position the Treasury to do one more (relatively) small round of increases in November. At that point we think the increases would stop, and elevated coupon-issuance/a shrinking budget deficit would create an environment where total Treasury bills outstanding could decline materially.

Figure 1

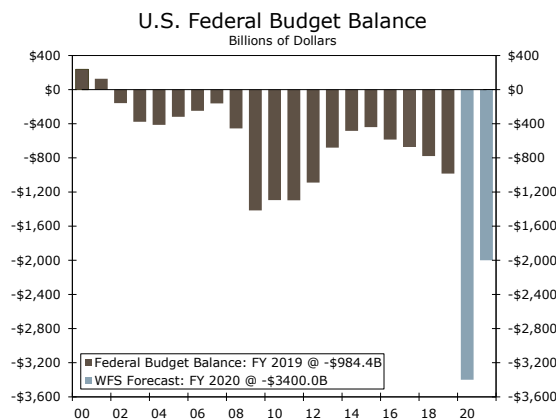
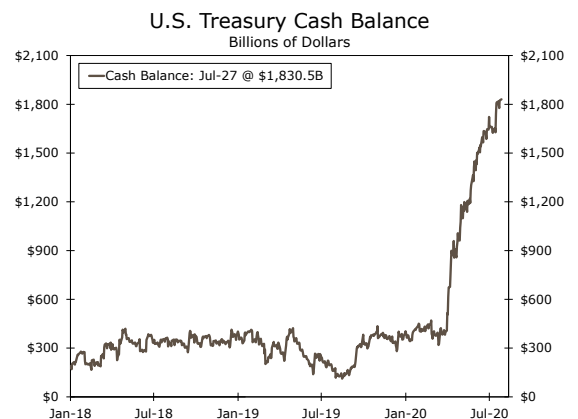


Figure 2



Source: U.S. Department of the Treasury and Wells Fargo Securities

Looming in the background, however, is the potential for another trillion dollar stimulus bill in Congress. But, the timing, size and prospects for such a package remain highly uncertain. How will Treasury handle this?

In our view, even with more stimulus potentially in the offing, we doubt Treasury will do a much bigger increase to auctions in August. The U.S. Treasury’s incredibly high cash balance alleviates a good portion of the funding pressure that would normally arise from the passage of a large deficit-financed bill (Figure 2). With so much cash on hand, the Treasury has plenty of money to quickly get out another round of household economic impact payments, or continue paying expanded unemployment benefits. Additionally, bigger coupon auction increases would only raise a fairly modest amount of money in the near term. If Treasury repeats the auction increases seen in May, the incremental funding would be “only” \$42 billion above what our forecast assumes for August-October. In the context of the numbers being thrown around for the next fiscal package, this is nearly a rounding error.

We think another sizable fiscal package would have a much more material impact on auction sizes at the November and February 2021 refundings, as well as T-bill supply in the second half of 2020. Since early April, Treasury has made cash management bills (CMBs) a staple of the debt issuance toolkit, essentially adding five new tenors of benchmark T-bills (Figure 3). At the peak, the regularly-issued CMBs have added as much as \$200 billion in gross T-bill supply in a single week.¹ Although some of these CMBs have been scaled back over time, they remain a key fixture of Treasury’s debt issuance at present. Anecdotally, the market reception has been very strong and has coincided with a large increase in demand from a variety of different investors, including 2a7 funds, bank portfolios, corporates and municipalities. Demand has waned at least slightly over the past couple of months. ICI data on money market mutual funds show that over the past 10 weeks, government-only funds have experienced \$221 billion in outflows. However, even after recent outflows, net inflows since March remain above \$1 trillion (Figure 4).

Figure 3

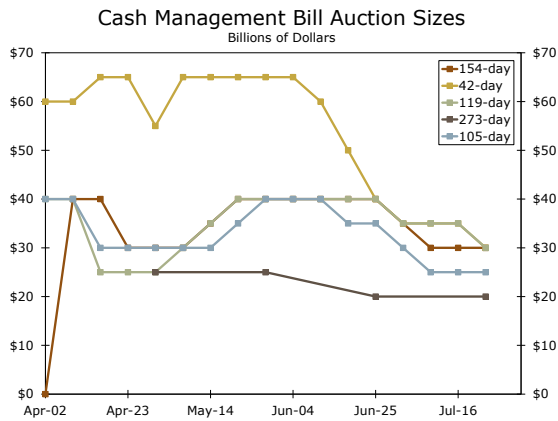
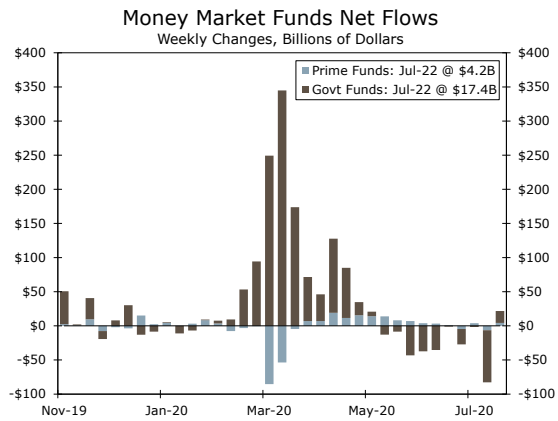


Figure 4



Source: U.S. Department of the Treasury, Bloomberg LP and Wells Fargo Securities

If no additional fiscal package materializes, Treasury can begin phasing out these regularly issued CMBs. Our baseline borrowing forecast implies a nearly \$600 billion decline in T-bills outstanding in the second half of 2020, with a continued contraction into 2021. But, if a deficit-financed fiscal package of \$1 trillion or so comes to fruition, Treasury can maintain or expand these CMBs such that T-bill issuance is at least flat for the remainder of this year. Bill issuance might even rise by a few hundred billion, depending on the size and structure of the package. We doubt another fiscal package would be solely funded by Treasury bills, particularly over the medium-term, as T-bills outstanding have already more than doubled from December 2019 levels (Figure 5).

Thus, the enactment of another large fiscal package would likely see much more aggressive increases in coupon issuance at the November and February 2021 refundings. One option available to Treasury at that time would be to repeat the sizable increases seen in May 2020. It appears though that Treasury is at least exploring other avenues. In the most recent primary dealer refunding survey, Treasury solicited opinions for new ideas in light of recent increases in the financing need. Perhaps the most intriguing option Treasury tossed out was for a reduction in individual auction sizes but an increase in auction frequency, such as going from one auction per month for nominal coupon securities to multiple auctions per month. Treasury also suggested monthly new issues of longer-dated securities (10Y, 20Y and 30Y), replacing the current new issue/two smaller re-openings that occur every three months.

Our sense is that such a dramatic shift in the auction calendar is unlikely to be beneficial and does not seem necessary right now. Record auction sizes have gone over without a hitch in essentially every tenor since the May refunding announcement. This past week, Treasury auctioned \$48 billion, \$49 billion and \$44 billion in 2Y, 5Y and 7Y notes, respectively, each coming at record

¹ This figure includes issuance of a 273-day (39-week) bill, which occurs once a month.

low yields. Bid-to-cover ratios also remain at healthy levels, signaling plenty of demand for Treasury securities at auction. Adopting a twice-a-month auction schedule could have an adverse impact on liquidity with more new issues in the market but at smaller sizes. Perhaps if the next fiscal package is much bigger than expected, Treasury will have no choice but to make such a dramatic shift in the financing schedule, but for now we think the auction schedule can largely remain as is.

Figure 5

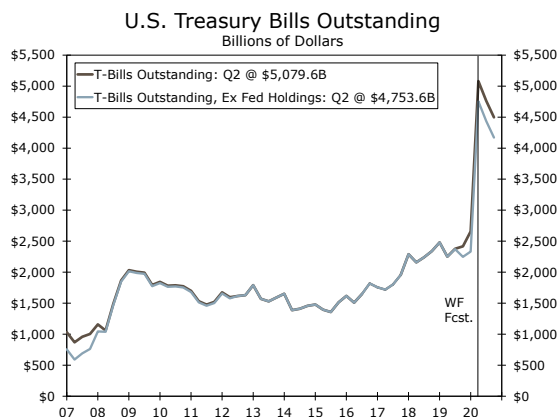
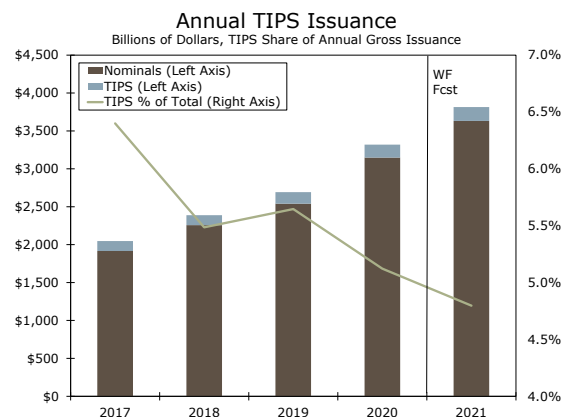


Figure 6



Source: U.S. Department of the Treasury and Wells Fargo Securities

What about TIPS?

We expect TIPS auctions will get a boost in August as Treasury remains committed to keeping the TIPS program an integral part of the regular auction schedule. In our base case, we have an increase of \$3 billion per auction to be announced next week. We would not be surprised if Treasury waited until the November refunding to make a move along these lines. Regardless, in order for TIPS to maintain its share of annual gross issuance, the increase will need to happen sooner rather than later.

A \$3 billion one-time increase across the board would bring the October 5Y TIPS original issue to \$20 billion, the September 10Y TIPS to \$15 billion and the August 30Y TIPS re-opening to \$10 billion. Treasury recently finished a round of increases to the TIPS program that brought the annual pace of issuance to \$152 billion as it sought to maintain TIPS' share of total issuance. Our expected increases at the August refunding would put 2020 TIPS issuance at \$170 billion. Once fully-phased in for a full year, the TIPS program would reach \$183 billion by 2021. If we assume no further increases to nominal coupon auctions in 2021 beyond what we have penciled in for the remainder of 2020 (which is far from a safe assumption), TIPS share of gross nominal issuance would rise to just under 5%. This would be down from 6.4% in 2017 and the 5.5-5.6% experienced in 2018 and 2019 (Figure 6).

How Much Will the Fed Absorb?

We expect the Fed will maintain its \$80 billion per month pace of Treasury purchases for the remainder of the year. Chairman Powell affirmed that plan at yesterday's FOMC meeting, as the Fed did not make any notable changes to its policy. We no longer have Fed T-bill purchases penciled in as part of the mix. If anything, it seems more likely the Fed could eventually shift purchases further out the curve, as it did during its rounds of quantitative easing following the financial crisis. The downshift in Fed's purchases in the second half of the year, coupled with a major shift to longer-dated coupon issuance, is a key crux for our call for the yield curve to steepen in the second half of the year (Figure 7).

Figure 7. Gross Coupon Auction Schedule, 2020 Historical + WFS Forecast

	Historical							WFS Estimates					Max Size
	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	2008-09
2y	40	40	40	42	44	46	48	49	50	51	52	53	44
3y	38	38	38	40	42	44	46	47	48	49	50	51	40
5y	41	41	41	43	45	47	49	50	51	52	53	54	42
7y	32	32	32	35	38	41	44	45	46	47	48	48	32
10y	24	27	24	25	32	29	29	34	31	31	35	32	25
20y	0	0	0	0	20	17	17	22	19	19	23	20	0
30y	16	19	16	17	22	19	19	24	21	21	25	22	16
2y FRN	20	18	18	22	20	20	24	22	22	25	23	23	0
5y TIPS	0	0	0	17	0	15	0	0	0	20	0	18	8
10y TIPS	14	0	12	0	12	0	14	0	15	0	15	0	8
30y TIPS	0	8	0	0	0	0	0	10	0	0	0	0	0
Coups	225	223	221	241	275	278	290	303	303	315	324	321	215

Source: U.S. Treasury, Bloomberg LP and Wells Fargo Securities

Figure 8. Gross and Net Treasury Issuance+ WFS Forecast

	Historical Q1 2020	Historical Q2 2020	Projected Q3 2020	Projected Q4 2020	Projected 2020
2y	120	132	147	156	555
3y	114	126	141	150	531
5y	123	135	150	159	567
7y	96	114	135	143	488
10y	75	86	94	98	353
20y	0	37	58	62	157
30y	51	58	64	68	241
2y FRN	56	62	68	71	257
5y TIPS	0	32	0	38	70
10y TIPS	26	12	29	15	82
30y TIPS	8	0	10	0	18
Issuance					
Net Coupons	240	348	500	582	1,670
Net Bills	241	2,395	-317	-266	2,054
SOMA Purchases					
Coupons	635	1,070	240	240	2,185
Bills	157	0	0	0	157
Net Coupons to the Public	-399	-722	260	342	-519
Net Bills to the Public	88	2,395	-317	-266	1,901
Cash Balance (quarter-end)	515	800	1,200	1,000	1,000
WAM	69.2	63.9	65.4	66.6	66.6

Source: U.S. Treasury, Bloomberg LP and Wells Fargo Securities

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