Economics

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Treasury Refunding Preview: Taking a Breather

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Summary

- On May 1, the U.S. Treasury will complete its regular quarterly refunding process. The quarterly refunding is the standard process through which Treasury communicates any changes in its debt management policy.
- The torrid pace at which Treasury has been ramping up its debt issuance over the past year looks set for a breather. The federal budget deficit has narrowed in fiscal year (FY) 2024 compared to FY 2023, led by strong revenue growth and roughly flat spending. Furthermore, the Federal Reserve appears poised to slow its pace of balance sheet runoff in the months ahead.
- In our view, current Treasury security coupon auction sizes appear well-suited to meet Treasury's financing need, and as a result we do not expect any changes to auction sizes at Treasury's upcoming refunding announcement. One small exception is in Treasury-Inflation Protected Securities (TIPS), where Treasury likely will continue to initiate small auction size increases in order to keep TIPS' share of the Treasury market unchanged.
- That said, *net* issuance of coupon securities will remain sizable due to past auction size increases. With Treasury notes and bonds doing the heavy lifting for government financing in the quarters ahead, we expect Treasury to lean much less heavily on issuance of Treasury bills. The stock of outstanding T-bills has increased from $4 trillion to $6 trillion over the past year, an enormous 50% increase. We project net T-bill issuance to be -$225 billion (i.e. $225 billion of paydowns) from March 31 through year-end.
- Given our expectations, we would be surprised if the May 1 Treasury refunding announcement created fireworks in financial markets similar to what occurred in the second half of last year. Treasury seems well-positioned to meet its financing need for at least the remainder of the year.
- That said, the 2024 U.S. presidential election is less than seven months away, and with it may come material changes in U.S. fiscal policy. Sooner or later, Treasury likely will need to ramp up its auction sizes once again to meet the deficit needs of the future, and markets may need to adjust. Stay tuned.

Wells Fargo Net Treasury Issuance Forecast
Billions of $

	2023	2024				2023	2024
	Q4	Q1	Q2	Q3	Q4	CY	CY
Privately-held net marketable borrowing	775	748	219	546	588	3,100	2,101
Budget deficit	510	555	99	336	498	1,784	1,488
Δ in cash balance	112	7	-25	0	0	322	-19
SOMA coupon redemptions	149	150	170	109	88	615	518
SOMA T-bill redemptions	22	22	0	0	2	74	24
Other	-17	15	-25	100	0	306	90
Gross coupon auctions	921	975	1,121	1,280	1,103	3,314	4,479
Privately-held maturing coupons	583	636	581	721	626	2,266	2,563
Privately-held net coupon issuance	338	339	540	559	477	1,048	1,916
Privately-held net bill issuance	437	409	-321	-14	111	2,052	185
End of quarter cash balance	769	775	750	750	750	769	750

Forecast as of: April 22, 2024

Source: U.S. Department of the Treasury, Bloomberg Finance L.P. and Wells Fargo Economics

The Past Year's Borrowing Binge Is Set to Slow

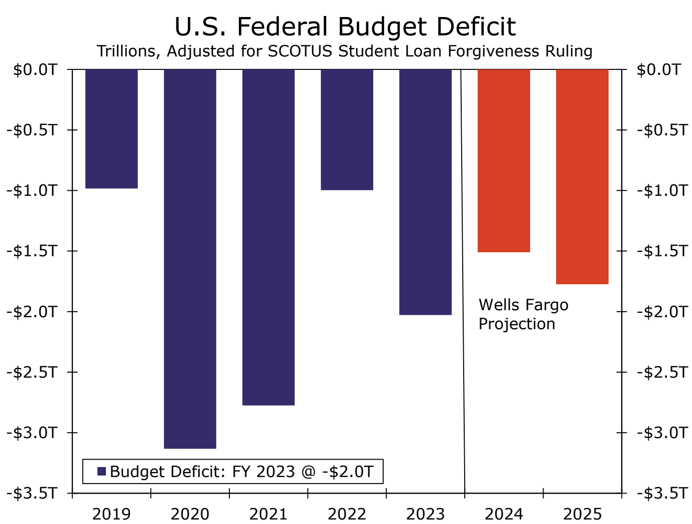
The torrid pace at which the U.S. Treasury has been ramping up its debt issuance over the past year looks set for a breather. The three biggest factors that drive swings in Treasury's borrowing plans are changes in the federal budget deficit, changes in the Federal Reserve's Treasury security holdings and moves in the Treasury's General Account (TGA), i.e. its cash reserve held at the central bank. The federal budget deficit has narrowed in fiscal year (FY) 2024 compared to FY 2023, led by strong revenue growth and roughly flat spending. The Federal Reserve appears poised to slow its pace of balance sheet runoff in the months ahead. Furthermore, last year's debt ceiling showdown created a backlog of Treasury bill issuance that has since been cleared, helping to restore the TGA to its normal level.

These factors have combined to create an outlook where gross auction sizes for Treasury security notes and bonds are likely to remain unchanged for the foreseeable future, although *net* issuance of coupon securities will remain sizable due to past auction size increases. For Treasury bills, the deluge of issuance that has occurred since the debt ceiling was lifted in June 2023 probably has ended for the time being. We project net T-bill issuance to be -$225 billion (i.e. $225 billion of paydowns) from March 31 through year-end.

The Federal Budget Deficit Is Narrowing...For Now

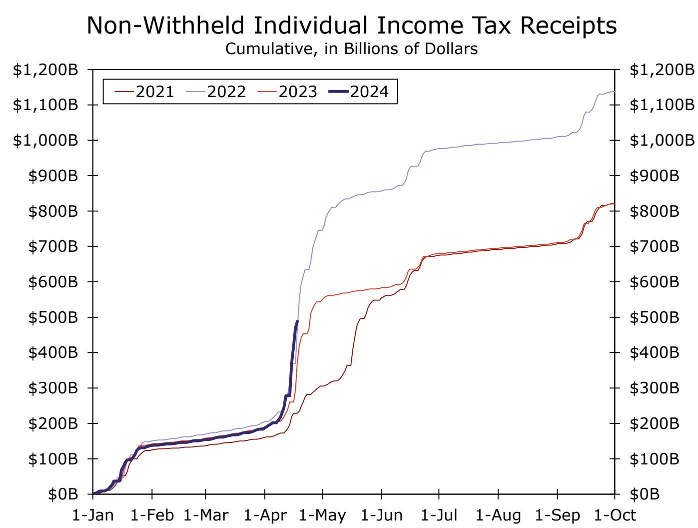
We project the federal government will run a budget deficit of $1.5 trillion in fiscal year 2024, a narrowing from the roughly $2 trillion deficit incurred in FY 2023 (Figure 1).[1] Strong revenue growth has been the primary contributor to a smaller deficit this year. We project that federal revenues will increase 12% this fiscal year to roughly $5 trillion. Robust employment growth has kept taxes withheld from workers' paychecks rising at a solid rate, while non-witheld individual income tax receipts are on pace to best what was collected in 2023. That said, these collections likely will remain below the blockbuster levels seen in 2022 (Figure 2). Solid asset price returns in 2023 and the postponement of certain tax payment deadlines for taxpayers in areas affected by natural disasters last year have provided a lift to revenue growth in FY 2024.

Figure 1



Source: Congressional Budget Office and Wells Fargo Economics

Figure 2



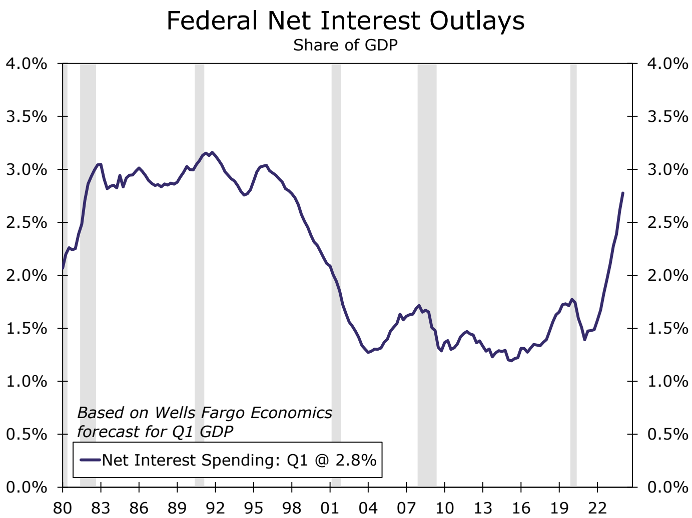
Source: U.S. Department of the Treasury and Wells Fargo Economics

We expect federal spending to be roughly flat this fiscal year at $6.5 trillion. Some segments of the federal budget continue to grow at a robust pace. Interest costs on the national debt were $440 billion through the first half of FY 2024, a 43% increase from the same period one year ago. As a share of GDP, interest spending is approaching the highs seen in the 1980s and early 1990s (Figure 3). Outlays on Social Security and Medicare have grown at a 9% and 10% pace, respectively, in FY 2024. Rapid spending growth by the Department of Defense (+8%) and Department of Veterans Affairs (+13%) has also contributed to upward pressure on federal outlays.

That said, lower spending in a variety of other areas is helping to keep total federal outlays from rising much. The end of some COVID-era policies have reduced spending on Medicaid and the Supplemental Nutritional Assistance Program (SNAP) by 2% and 24%, respectively, fiscal year-to-date. We expect outlays of the Federal Deposit Insurance Corporation (FDIC) to fall this fiscal year relative to last year given the spending that was needed to resolve the regional bank failures that occurred in the spring of 2023. A moratorium on processing claims for the Employee Retention Tax Credit has also helped offset spending pressures emanating from elsewhere in the budget.

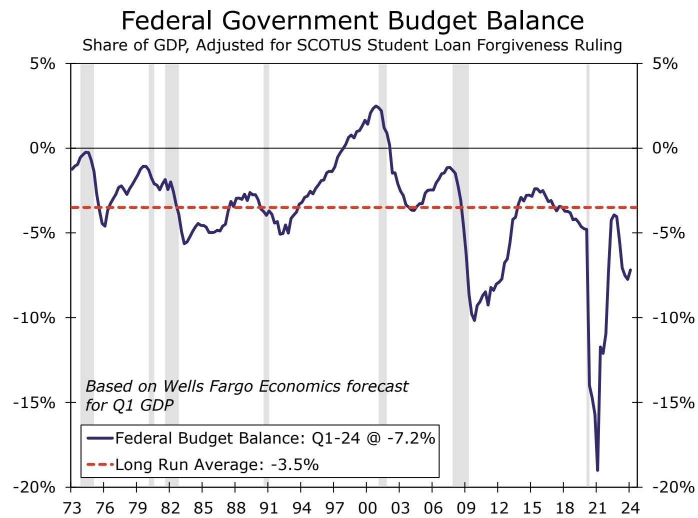
Looking ahead to FY 2025, which begins on October 1, we project a federal budget deficit of $1.8 trillion. We expect revenue growth to moderate as the one-off factors boosting receipts this year fade, while outlays should accelerate as various one-off distortions fade out. If realized, a $1.8 trillion deficit in FY 2025 would be materially wider than the budget deficit we anticipate in FY 2024, but it would still be below the $2.0 trillion of red ink incurred in FY 2023. That said, a deficit of $1.8 trillion would be roughly 6% of U.S. GDP, about 1.5 percentage points bigger than the deficit that prevailed in FY 2019 and 2.5 percentage points larger than the average deficit over the past 50 years (Figure 4).

Figure 3



Source: U.S Department of Treasury, U.S Department of Commerce and Wells Fargo Economics

Figure 4



Source: U.S. Department of the Treasury, U.S. Department of Commerce and Wells Fargo Economics

Quantitative Tightening: Shifting from a Headwind to a Tailwind

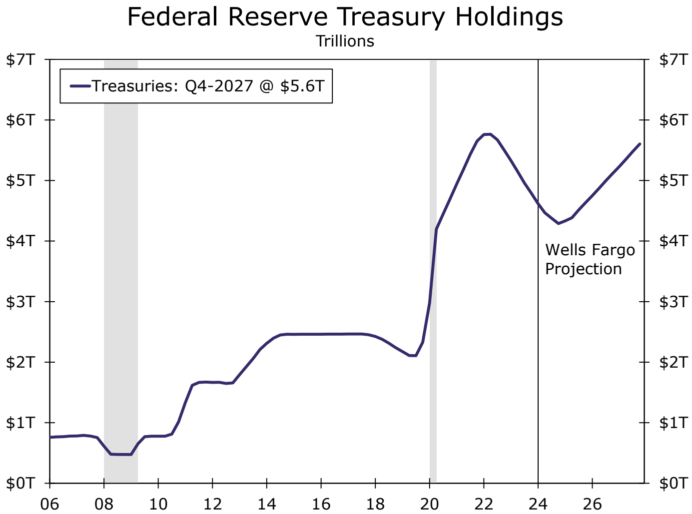
The pending slowdown in the Federal Reserve's balance sheet runoff program also eases the financing burden on the U.S. Treasury. As we have written in our most recent Fed Flashlight report, we expect the FOMC to announce at its May 1 meeting that the Committee is reducing the monthly caps on Treasury security runoff from $60 billion to $30 billion, with Treasury runoff halted entirely by the start of 2025. As a reminder, balance sheet runoff does not impact the total amount of federal debt outstanding, but it does increase the amount of debt that must be absorbed by private investors. The $60 billion per month of Treasury security runoff that has been ongoing since September 2022 has added $720 billion to the annual total that Treasury needs to raise from investors at auction (Figure 5). A slowdown to $30 billion per month and eventual cessation of runoff mitigates the need for Treasury to increase the size of its auctions for notes and bonds anytime soon.

Treasury General Account: All Fueled Up

The U.S. Treasury's General Account, which is very roughly the government's version of a household checking account for managing daily inflows and outflows, got to unusually low levels right before the debt ceiling was resolved in June 2023 (Figure 6). Shortly thereafter, Treasury began ramping up its bill issuance to restore its cash balance to more typical levels. Over the past several months, the TGA has been near Treasury's stated target of $750 billion. Over the past week, the surge in tax receipts driven by the April 15 filing deadline have pushed the TGA above Treasury's target.

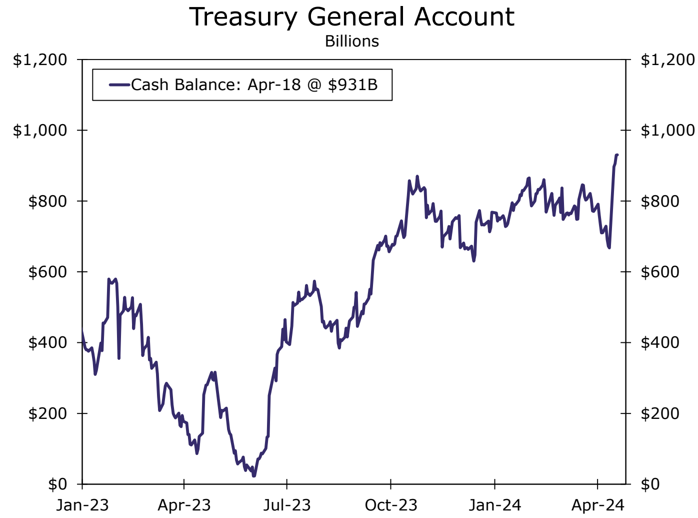
Our expectation is that the TGA will continue to ebb and flow around $750 billion for the foreseeable future. The debt ceiling will be reinstated on January 2, 2025, and we wrote in a report back in February that there was a chance Treasury would be required by law to reduce the TGA down to very low levels by the debt ceiling reinstatement date. A recent memo from the Department of Justice leads us to believe that this will not be necessary, and as a result our issuance forecasts assume a normal $750 billion TGA balance at year-end 2024.

Figure 5



Source: Federal Reserve Bank of New York and Wells Fargo Economics

Figure 6

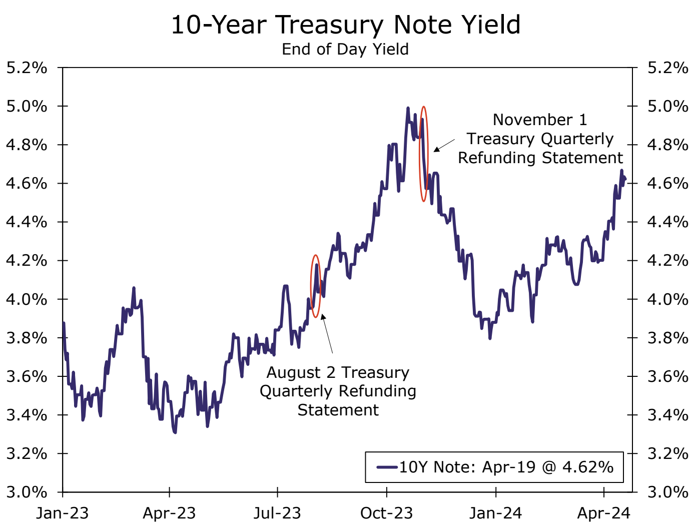


Source: U.S. Department of the Treasury and Wells Fargo Economics

Coupon Auction Sizes To Be Unchanged from May-July

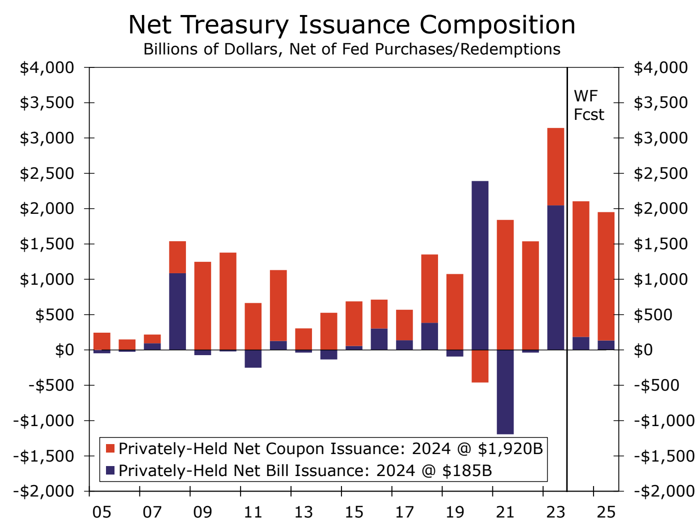
Against this backdrop, we do not expect the U.S. Treasury to increase coupon auction sizes at the upcoming Treasury refunding on May 1.[2] In August 2023 in the face of a growing financing need, Treasury began increasing monthly auction sizes for its coupon-bearing securities. The increases were considerable and played a role in the selloff in longer-term Treasury securities that occurred last year (Figure 7). A more moderate round of increases at the November refunding coincided with the peak in longer-term yields, and Treasury repeated this round of increases at the January refunding. The steady drumbeat higher in auction sizes for Treasury securities has led to monthly issuance that has risen considerably over the past year. For example, the Treasury will auction $69 billion of two-year notes on April 23, a material increase from the $42 billion of two-year notes auctioned in April 2023.

Figure 7



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 8



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

In our view, current coupon auction sizes appear well-suited to meet Treasury's financing need, and as a result we do not expect any changes to auction sizes at Treasury's upcoming refunding announcement on May 1 (Figure 9). Treasury stated in January that it "does not anticipate needing to make any further increases in nominal coupon or FRN auction sizes, beyond those being announced today, for at least the next several quarters." We concur with this view as can be seen in the table below. The $1.9 trillion in net new money raised by coupon issuance this year should be enough to cover the budget deficit and Federal Reserve redemptions of Treasury securities (Figure 8). One small exception is in Treasury Inflation-Protected Securities (TIPS). Treasury has been increasing the size of TIPS auctions in recent months, and in January Treasury stated that it "would be prudent to continue with incremental increases to TIPS auction sizes in order to maintain a stable share of TIPS as a percentage of total marketable debt outstanding."

Figure 9

Wells Fargo Gross Coupon Issuance Forecast
Billions of $

	2024											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2y	60	63	66	69	69	69	69	69	69	69	69	69
3y	52	54	56	58	58	58	58	58	58	58	58	58
5y	61	64	67	70	70	70	70	70	70	70	70	70
7y	41	42	43	44	44	44	44	44	44	44	44	44
10y	37	42	39	39	42	39	39	42	39	39	42	39
20y	13	16	13	13	16	13	13	16	13	13	16	13
30y	21	25	22	22	25	22	22	25	22	22	25	22
2y FRN	28	28	28	30	28	28	30	28	28	30	28	28
5y TIPS	0	0	0	23	0	21	0	0	0	24	0	22
10y TIPS	18	0	16	0	16	0	19	0	17	0	17	0
30y TIPS	0	9	0	0	0	0	0	8	0	0	0	0
Gross Issuance	331	343	350	368	368	364	364	360	360	369	369	365

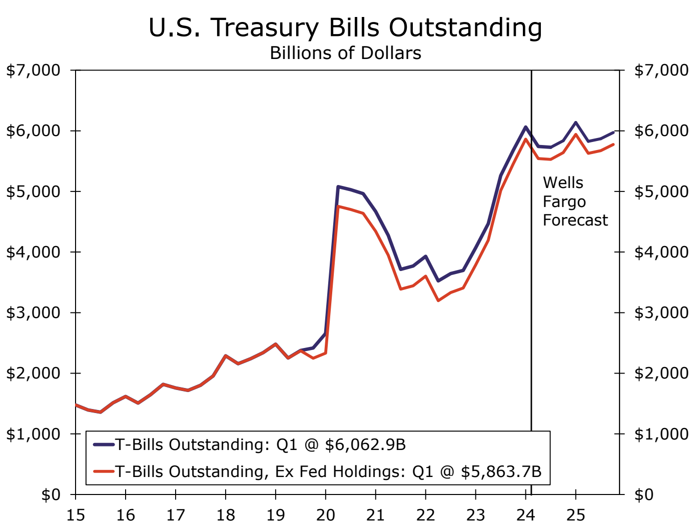
Forecast as of: April 22, 2024

Source: U.S. Department of the Treasury, Bloomberg Finance L.P. and Wells Fargo Economics

Bill Supply Deluge Has Ended

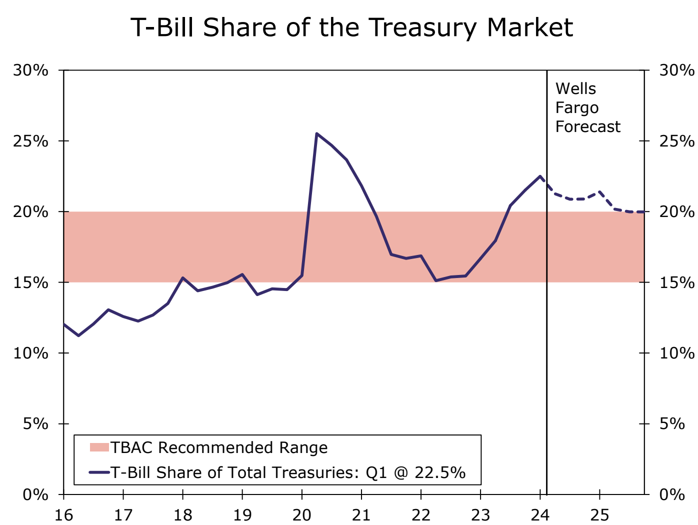
With Treasury notes and bonds doing the heavy lifting for government financing in the quarters ahead, we expect the U.S. Treasury to lean much less heavily on issuance of Treasury bills. The stock of outstanding Treasury bills has increased from $4 trillion to $6 trillion over the past year, an enormous 50% increase (Figure 10). This surge in T-bill issuance played a major role in reducing balances at the Federal Reserve's Overnight Reverse Repo Facility (ON RRP) as money market funds substituted away from RRP balances and into Treasury bills.

Figure 10



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

Figure 11



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

This explosion of short-term debt issuance pushed T-bills as a share of the overall Treasury market from 15.4% at the end of 2022 to 22.5% at the end of Q1-2024. The Treasury Borrowing Advisory Committee (TBAC), an advisory committee comprised of senior representatives from a variety of financial institutions, recommends that bills comprise 15%-20% of the Treasury market (Figure 11).

That said, TBAC has been supportive of recent deviations with the aim of returning to the historical recommendation over time.[3] Under our baseline forecast, T-bills outstanding wax and wane from month to month to help meet typical fluctuations in Treasury's financing needs, but on trend we expect the stock of T-bills to be roughly flat through 2025.

Conclusion: Probably No Major Market Moves from the May 1 Refunding

Given our expectations, we would be surprised if the May 1 refunding announcement created fireworks in financial markets similar to what occurred in the second half of last year. Treasury seems well-positioned to meet its financing need for at least the remainder of the year. That said, the 2024 U.S. presidential election is less than seven months away, and with it may come material changes in U.S. fiscal policy. Sooner or later, Treasury likely will need to ramp up its auction sizes once again to meet the deficit needs of the future, and markets may need to adjust. Stay tuned.

Endnotes

1 – In September 2022, the Biden administration recorded an increase in outlays of $379 billion to reflect its estimate of the long-term costs of the proposed student loan debt cancellation plan. These higher outlays increased the FY 2022 budget deficit by a commensurate amount. However, this student loan forgiveness plan was struck down by the Supreme Court last summer. In August 2023, the administration recorded a $333 billion reduction in outlays for the student loan program to reflect the Supreme Court's decision. That action reduced the deficit for the 2023 fiscal year. The numbers quoted in this report are adjusted to account for these offsetting swings in order to provide a more clear read into the current fiscal trends in the United States. For further reading on this topic, please see the Congressional Budget Office's Monthly Budget Review: Summary for Fiscal Year 2023 published November 2023. (Return)

2 – For more background on the Treasury Quarterly Refunding Process and debt management at the Treasury, please see the following informational webpages provided by the U.S. Department of the Treasury: Treasury Quarterly Refunding Process and Overview of Treasury's Office of Debt Management. (Return)

3 – Treasury Borrowing Advisory Committee. Report to the Secretary of the Treasury from the Treasury Borrowing Advisory Committee. October 31, 2023. (Return)

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