Economics

Special Commentary — October 18, 2024

Treasury Refunding Preview

Economist(s)

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Summary

- We do not anticipate any major policy shifts from the U.S. Treasury at its upcoming quarterly refunding announcement on October 30. We expect coupon auction sizes to remain unchanged for the third consecutive quarter.
- Fiscal year (FY) 2024 concluded on September 30, and the federal government ran a budget deficit of roughly $1.8 trillion for the year. Looking ahead to FY 2025, we project the budget deficit will widen to $1.9 trillion. A new Congress and president could shake up the fiscal outlook, but we suspect any big changes to the federal budget would not be felt until FY 2026.
- The end of the Federal Reserve's quantitative tightening program is slowly coming into view, and this should help keep growth in Treasury's financing need in check over the next year or so.
- The return of the debt ceiling adds another wrinkle to the borrowing outlook. The debt ceiling has been suspended since June 2023, and it will be reinstated on January 2, 2025. It is still a little too early for precise estimates of the "X date," or the date on which the Treasury would be unable to meet all of its obligations. That said, our preliminary read is that the timeline next year would look similar to what occurred in 2023, when the "X date" appeared to be sometime in the first half of June.
- Given these factors, we are skeptical that coupon auction sizes will increase in the first half of next year. We suspect it will be August 2025 at the earliest before coupon auction sizes start to grow again.
- In the near-term, we expect net T-bill supply to be roughly $50 billion in the current quarter. We project approximately $500 billion of net T-bill issuance in Q1-2025 followed by a $330 billion reduction in T-bills outstanding in Q2 for a total projected net increase in the first half of next year of $170 billion. These projections are conditional on the assumption that the debt ceiling is increased or suspended at some point in the next three to four months. If the debt ceiling is a binding constraint into the summer, much of the new bill supply we expect in the first half of next year will be pushed into the second half of the year.

Wells Fargo Net Treasury Issuance Forecast
Billions of $

	2024		2025		2024	2025
	Q3	Q4	Q1	Q2	CY	CY
Privately-held net marketable borrowing	798	527	953	176	2,316	2,148
Budget deficit	577	562	728	201	1,902	1,898
Δ in cash balance	108	-186	100	0	-69	100
SOMA coupon redemptions	91	75	75	0	485	75
SOMA T-bill redemptions	0	0	0	0	22	0
Other	22	75	50	-25	-24	75
Gross coupon auctions	1,280	1,103	1,087	1,106	4,479	4,407
Privately-held maturing coupons	721	626	636	599	2,563	2,544
Privately-held net coupon issuance	559	477	451	507	1,916	1,863
Privately-held net bill issuance	239	50	502	-331	400	285
End of quarter cash balance	886	700	800	800	700	800

Forecast as of: October 21, 2024

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

Waiting for the Election

We expect it to be a relatively quiet Treasury refunding announcement on October 30. In our view, Treasury's current coupon auction schedule is well-suited to meet its financing needs for the next few quarters, and any unexpected swings in the financing need can be met by an expansion or contraction in supply of Treasury bills. The U.S. election could shake up the fiscal outlook, but we suspect Treasury will wait for clarity before adjusting its future borrowing plans.

Budget Deficit Outlook

Fiscal year (FY) 2024 concluded on September 30, and the federal government ran a budget deficit of roughly $1.8 trillion for the year. Looking ahead to FY 2025, we project the budget deficit will widen to $1.9 trillion (Figure 1). There are a few reasons to be optimistic that the federal budget deficit may not grow too much in the year ahead. The FOMC cut the federal funds rate by 50 bps at its September meeting, and we anticipate another 150 bps of rate cuts through the end of FY 2025. Although this may not impact intermediate and longer-term interest rates all that much, it should reduce yields on shorter-dated Treasury securities, most notably yields on the $6 trillion of T-bills outstanding. This in turn should help slow the growth in the federal government's interest outlays, at least in the short-term. Robust asset price returns this year also bode well for tax collections come the filing deadline in April.

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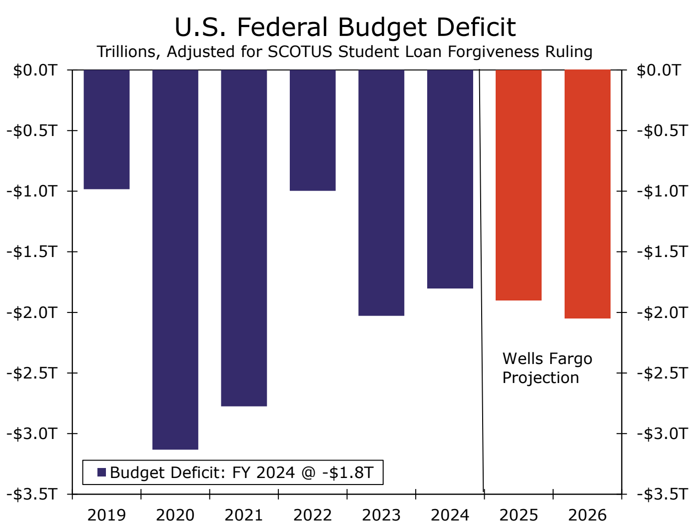
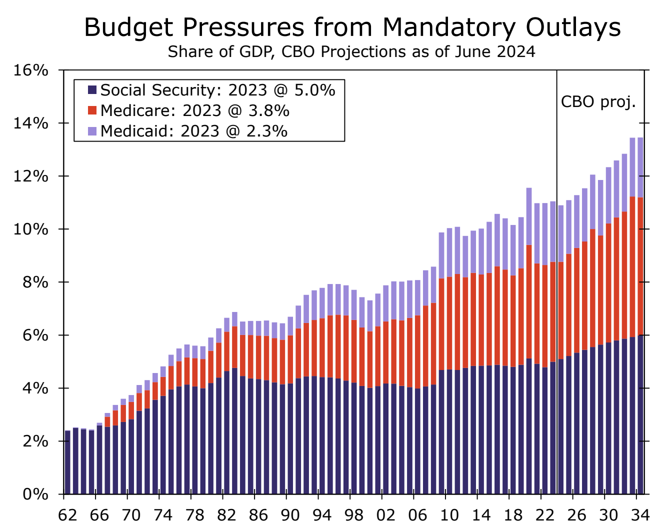
That said, the structural budget pressures emanating from an aging population and rising health care costs likely are not going away anytime soon (Figure 2). A new Congress and president could shake up the fiscal outlook, but we suspect any major change in the federal budget would not be felt until FY 2026. We have written previously that we think the next president and Congress may need most of next year to arrive at a consensus on how to address the year-end 2025 expiration of the 2017 tax cuts. A major change in trade policy also looms as a potential policy shift. A large increase in tariffs on U.S. imports would generate additional tax revenue and help reduce the budget deficit, all else equal, but once again the prospects for such a move are highly uncertain. For now, we are assuming a current policy baseline in our projections: the 2017 tax cuts are extended next year, but no new fiscal expansion or contractions are implemented. We suspect Treasury is making a similar baseline assumption for the time being.

Figure 1



Source: Congressional Budget Office and Wells Fargo Economics

Figure 2



Source: Congressional Budget Office and Wells Fargo Economics

Quantitative Tightening Outlook

The end of the Federal Reserve's quantitative tightening (QT) program is slowly coming into view, and this should help keep growth in Treasury's financing need in check over the next year or so. Starting in June, the Federal Reserve reduced the cap on monthly balance sheet runoff for Treasury securities from $60 billion per month to $25 billion per month. The Federal Reserve reinvests the proceeds of

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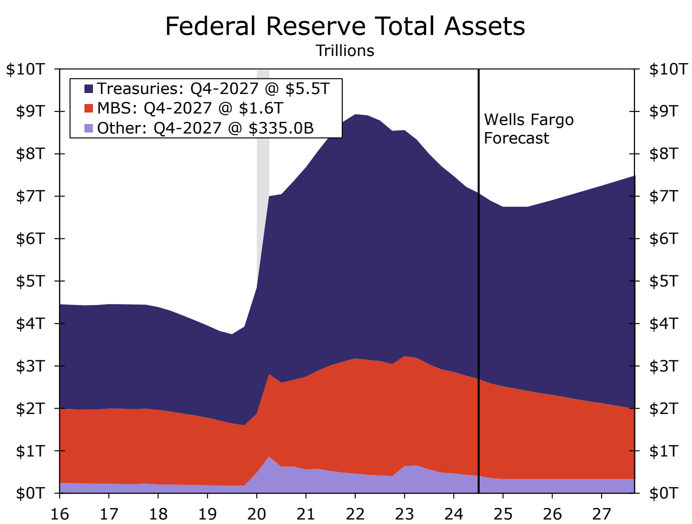
maturities in excess of $25 billion, eliminating the need for Treasury to raise that money from private investors.

Our base case forecast assumes that QT will run at its current pace through Q1-2025. Starting in Q2-2025, we look for the Federal Reserve to hold the overall size of its balance sheet unchanged for a couple of quarters while letting MBS runoff continue, with MBS proceeds reinvested into Treasury securities (Figure 3). The cessation of Treasury security runoff and eventual return to Treasury security purchases in 2025 should help keep Treasury's financing need relatively flat over the next year despite continued growth in the federal budget deficit.

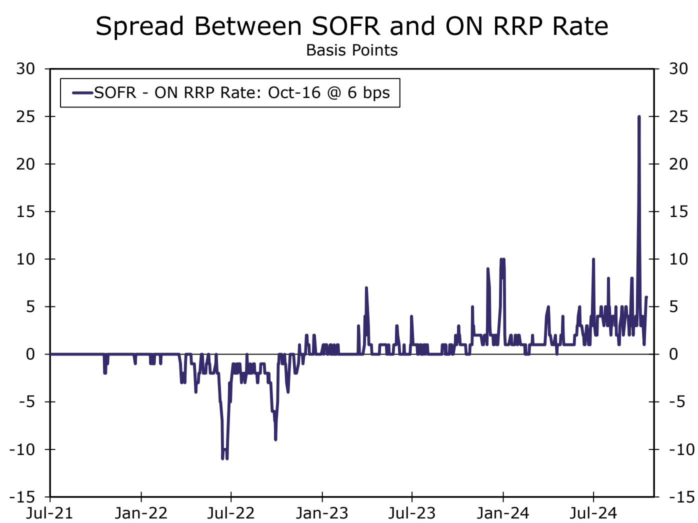
It is possible that QT could run a bit longer than we currently project, but we are starting to see signs that the liquidity draining effects of QT are being felt. The Secured Overnight Financing Rate (SOFR) increased by roughly 20 bps around this previous quarter-end amid some funding market pressures. This rather large increase was part of a broader trend of repo rates steadily climbing relative to the rates offered for parking money at the Federal Reserve, such as the overnight reverse repurchase facility (Figure 4). Recent comments from key Federal Reserve officials suggest that they are not yet quite convinced that bank reserves are scarce enough to warrant the end of balance sheet runoff. On October 10, Federal Reserve Bank of New York President John Williams stated that he believes the level of bank reserves is still "way above" the "ample" level of reserves the Federal Reserve is targeting. That said, the persistent drift higher in repo rates and recent spike around quarter-end leads us to believe QT will end sooner rather than later.

Figure 3



Source: Federal Reserve System and Wells Fargo Economics

Figure 4



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

Treasury General Account and Debt Ceiling Outlook

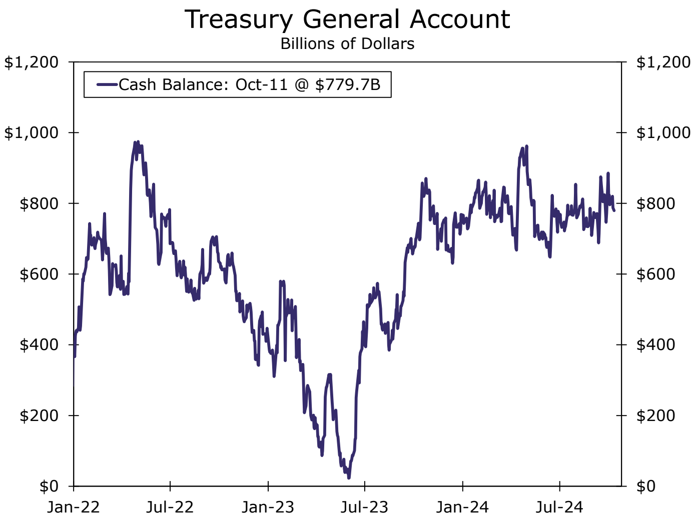
The return of the debt ceiling adds another wrinkle to the borrowing outlook.

The return of the debt ceiling adds another wrinkle to the borrowing outlook. The debt ceiling has been suspended since June 2023, and it will be reinstated on January 2, 2025. There is a chance that the lame duck session of Congress could deal with the debt ceiling when it also must grapple with the looming expiration of government funding on December 20, but absent Congressional action, the debt ceiling will once again become a binding constraint on Treasury's operations starting next year.

At the previous refunding, Treasury made clear that it intended to maintain a cash balance of roughly $700 billion going into year-end. Treasury also will have access to its usual toolkit of extraordinary measures that can free up an additional few hundred billion dollars of borrowing capacity under the debt limit.[1] It is still a little too early for precise estimates of the "X date," or the date on which the Treasury would be unable to meet all of its obligations. That said, our preliminary read is that the timeline next year would look similar to what occurred in 2023, when the "X date" appeared to be sometime in the first half of June.

For now, our baseline borrowing forecasts assume a timely debt ceiling resolution in the coming months, but Congress may wait until the last minute to address the debt limit. In 2023, the net new supply of Treasury securities was relatively subdued in the first half of the year due in part to the debt ceiling constraint. But once that constraint was lifted in June, a flood of T-bill supply came to the market as Treasury rebuilt its cash balance (Figure 5) and resumed normal operations. Coupon auction increases began in August of that year and continued through early 2024. If the debt ceiling debate takes up much of the first half of next year, then we could be in for a similar pattern of issuance in 2025.

Figure 5



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

Coupon Supply Outlook

On balance, existing gross coupon auction sizes are raising enough money on a net basis that changes are unlikely to be announced at the October 30 refunding (Figure 6). One very small exception is the auction for the 10-year Treasury Inflation-Protected Security (TIPS), which we expect to rise by $1 billion as Treasury seeks to keep TIPS stable as a share of the overall Treasury market. If current auction sizes are left unchanged through year-end, we project privately-held net coupon issuance will total $1.9 trillion in calendar year 2024, accounting for 83% of the net marketable borrowing for the year. The remaining 17% ($380 billion or so) will have come from net issuance of Treasury bills.

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Figure 6

Wells Fargo Gross Coupon Issuance Forecast
Billions of $

	2024						2025					
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
2y	69	69	69	69	69	69	69	69	69	69	69	69
3y	58	58	58	58	58	58	58	58	58	58	58	58
5y	70	70	70	70	70	70	70	70	70	70	70	70
7y	44	44	44	44	44	44	44	44	44	44	44	44
10y	39	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	22	25	22	22	25	22	22	25	22	22	25	22
2y FRN	30	28	28	30	28	28	30	28	28	30	28	28
5y TIPS	0	0	0	24	0	22	0	0	0	25	0	23
10y TIPS	19	0	17	0	17	0	20	0	18	0	18	0
30y TIPS	0	8	0	0	0	0	0	9	0	0	0	0
Gross Issuance	364	360	360	369	369	365	365	361	361	370	370	366

Forecast as of: October 21, 2024

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

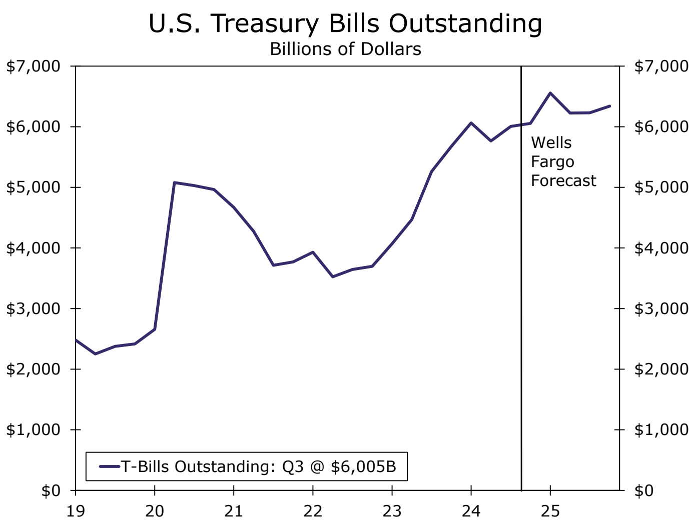
Turning to next year, we are skeptical that coupon auction sizes will increase in the first half of the year. We suspect it will be August 2025 at the earliest before coupon auction sizes start to rise again. There are a few reasons we believe this. First, a wider federal budget deficit will add to Treasury's financing need, but the end of QT will help serve as an offset. Second, if the debt ceiling is not resolved until the spring/summer, Treasury may be reluctant to start an auction cycle increase in the midst of a debt ceiling showdown. Third, we suspect that 2025 will involve a lengthy debate over how to handle the expiring provisions of the 2017 Tax Cuts and Jobs Act.[2] As discussed earlier, those tax cuts are slated to expire at year-end 2025, so fiscal policy uncertainty may remain elevated until late next year.

Bill Supply Outlook

We project T-bills as a share of the total Treasury market to remain roughly stable around 21%-22% over the next year.

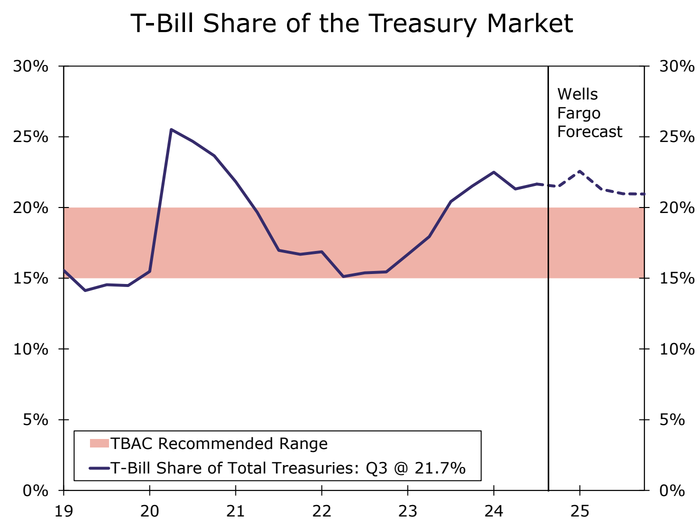
Where does this leave the outlook for T-bill supply? In the near-term, we expect net T-bill supply to climb by another $200 billion or so, followed by some paydowns in December such that total T-bills outstanding increases by approximately $50 billion in the current quarter. We expect $500 billion of net T-bill issuance in Q1-2025 as Treasury raises money to finance the seasonally large budget deficits that occur every February and March. The seasonal influx of tax revenues come April should help drive a $330 billion reduction in T-bills outstanding in Q2 for a total projected net increase in the first half of next year of $170 billion (Figure 7). To reiterate, these projections are conditional on the assumption that the debt ceiling is increased or suspended at some point in the next three to four months. If the debt ceiling is a binding constraint into the summer, the Treasury's cash balance will be much lower than is the case in our forecast, and much of the new bill supply we expect in the first half of next year will be pushed into the second half of the year. In either scenario, we project T-bills as a share of the total Treasury market to remain roughly stable around 21%-22% over the next year (Figure 8).

Figure 7



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

Figure 8



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

Endnotes

1 – U.S. Department of the Treasury. Description of Extraordinary Measures. January 19, 2023. (Return)

2 – See Talking Taxes: What Will Happen to the Tax Cuts and Jobs Act? September 19, 2024. (Return)

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