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Economics and Rate Strategy
Treasury Refunding Preview: What to Watch

- Based on our deficit forecast, the outlook for the Federal Reserve's redemptions of Treasury securities and our cash balance projections, **we believe another across-the-board increase in nominal coupon auction sizes is unlikely at the upcoming quarterly refunding on January 30**, and possibly for the next few refundings.

- Instead of an increase in nominal coupon auctions, we expect the final details of the overhaul to the TIPS program will be announced, resulting in **additional net TIPS issuance of $26 billion in 2019**.

- What could lead to larger auction sizes than we currently expect?
  - Federal Reserve balance sheet reductions lasting longer than we anticipate
  - A deteriorating economic outlook
  - Fiscal policy changes leading to a larger budget deficit

- **We look for net issuance of T-bills in Q1 to be $158 billion**. The debt ceiling reinstatement makes things a bit more interesting than the quarterly total suggests and could lead to a backloaded jump in T-bill supply. **Late February through the end of March is poised to see a surge in net T-bill issuance**, potentially to the tune of about $175 billion over a six-week stretch.

- Complicating matters further, **there is higher-than-usual uncertainty this year when it comes to Q1 cash flow for the government** given that this is the first tax season under the Tax Cuts and Jobs Act and the government remains partially shutdown. Unexpected swings in receipts/outlays would likely have a large impact on T-bill issuance and could disrupt money markets in late Q1/early Q2.

- In sum, we expect money markets to be volatile for the next few months. They should be tamer than a year ago, but still wild enough to cause angst.

Are Even Larger Coupon Auctions in Store in 2019?

2018 was a booming year for Treasury issuance.

2018 was a booming year for Treasury issuance, starting with the surge in T-bill issuance in Q1 and followed by steady increases in nominal coupon auction sizes across the entire curve at all four quarterly refundings. For example, the size of the 2-year note auction has risen from $26 billion at the end of 2017 to $40 billion at present, while the 30-year bond original issue has climbed from $15 billion to $19 billion. Perhaps even more strangely, these sizable increases came in an environment of about 3% real GDP growth, widely viewed as well-above potential.

As the first Quarterly Refunding of 2019 approaches on January 30, do we expect a similar trend to play out this year? Probably not. **In our view, another across-the-board increase in nominal coupon auction sizes is unlikely at the upcoming refunding, and possibly for the next few refundings.** Based on our projections for the federal budget deficit, Federal Reserve redemptions of Treasury securities, the cash balance and other factors, we expect net Treasury issuance of $1.37 trillion in calendar year (CY) 2019 ($1.1 trillion excluding SOMA redemptions), essentially flat from CY 2018.[1] At current nominal coupon auction levels, and if the Treasury increases net TIPS issuance about $20-$30 billion for the year, net T-bill issuance would be about 24% of the total. This is close to the 25-33% guidance Treasury has given previously, which suggests little need to change the funding mix.

What could lead to auction size increases?

We identify three risks that could lead to even larger coupon auctions in the coming quarters.

We identify three risks that could lead to even larger coupon auctions in the coming quarters:

- Federal Reserve balance sheet unwind program lasts longer than we expect (we look for the balance sheet to stop shrinking in late 2019/early 2020)
- Deteriorating economic outlook
- Policy changes in Washington that lead to a larger budget deficit.

All three of these developments are plausible in our view, but they are problems probably best left to future refundings.

Treasury WAM to hold steady

We have expected Treasury to rely a bit more heavily on the long end of the curve for the massive amounts of issuance in 2018 and 2019 in order to maintain or even lengthen the weighted average maturity (WAM) of debt outstanding. So far, Treasury has not shifted materially to the long end. As a result the WAM is set to fall slightly to 68 months in Q1 2019 from 69 months at the end of Q4. We expect the WAM to remain very near 68 months for the remainder of 2019.

Figure 1

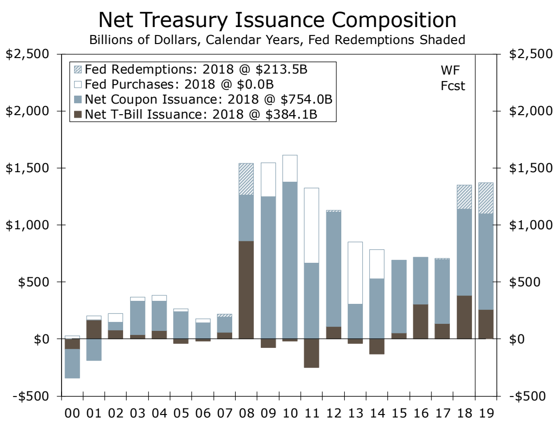
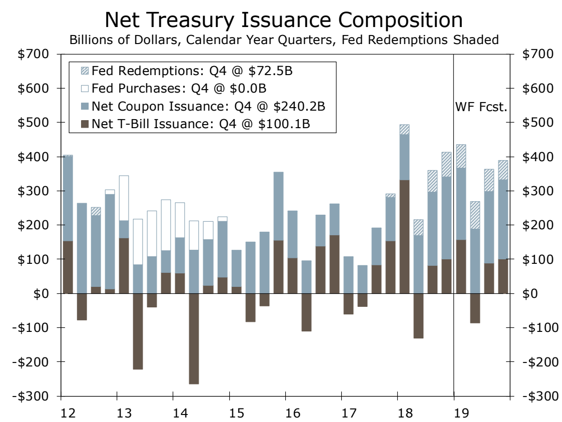


Figure 2



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

[1] As a reminder, the Federal Reserve's Treasury security redemptions do not increase the total debt outstanding, but they do impact the amount that must be auctioned to and absorbed by the public. We look for $270 billion in Treasury security redemptions from the SOMA in CY 2019.

Changes to the Treasury Inflation-Protected Securities Program

Treasury has already revealed a modification to the TIPS auction schedule that will now feature two 5y original issues (and still two reopenings) and just one 30y reopening (from two previously). In addition, Treasury has indicated it intends to increase TIPS issuance by $20-30 billion in 2019, relative to the $131 billion issued in 2018. **We expect Treasury to announce a $1 billion increase to the 5y and 10y auction sizes and a $3 billion increase in the 30y auction sizes**. These increases would apply to original issues and subsequent reopenings and result in a $26 billion increase in issuance this year (Figure 3). The TIPS increase allows the Treasury to take its foot off the pedal when it comes to nominal auction increases, and helps TIPS stay near 9% of the overall Treasury market.

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Figure 3. 2018 TIPS auction calendar and sizes, 2019 estimates

	2018		2019E	
Month	Tenor	Size	Tenor	Size
January	10-Yr OI	13	10-Yr OI	13
February	30-Yr OI	7	30-Yr OI	10
March	10-Yr Reopen	11	10-Yr Reopen	12
April	5-Yr OI	16	5-Yr OI	17
May	10-Yr Reopen	11	10-Yr Reopen	12
June	30-Yr Reopen	5	5-Yr Reopen	15
July	10-Yr OI	13	10-Yr OI	14
August	5-Yr Reopen	14	30-Yr Reopen	8
September	10-Yr Reopen	11	10-Yr Reopen	12
October	30-Yr Reopen	5	5-Yr OI	17
November	10-Yr Reopen	11	10-Yr Reopen	12
December	5-Yr Reopen	14	5-Yr Reopen	15
Total		**131**		**157**

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

T-Bill Outlook: Is a Repeat of Q1-2018 Looming?

The near-term outlook for T-bill supply is particularly interesting. We project net T-bill issuance of $158 billion in Q1-2019. As illustrated in Figure 4, this would be the second highest Q1 for net T-bill issuance since 2013, but it would still be about half the Q1-2018 level that sent shockwaves through money markets. **Nonetheless, in our view the quarterly numbers understate the potential for robust T-bill supply to cause market volatility.**

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Why should bill issuance lead to volatility?

First, we expect supply this quarter to be backloaded. We expect total bill supply to fall by about $33 billion in January 2019, making it +$191 billion in February and March. Last year, net issuance was +$10 billion in January, then +$323 billion in February/March.

Second, the debt ceiling will be reinstated on March 2. By that time, the cash balance must be drawn down to the level at which it stood when the debt ceiling was suspended, which in this case was about $200 billion. At present, the cash balance is nearly $400 billion (Figure 5), meaning Treasury will be much more reliant on cash on hand to meet the financing need over the course of February. Per Treasury's guidance from the last refunding, we assume an end-of-Q1 cash balance of $320 billion. Treasury publishes financing estimates two days before the refunding. **Projected bill supply could change notably if the estimated end-of-quarter cash balance differs significantly from $320 billion.** A larger projected cash balance equates to more bill issuance and vice versa.

Figure 4

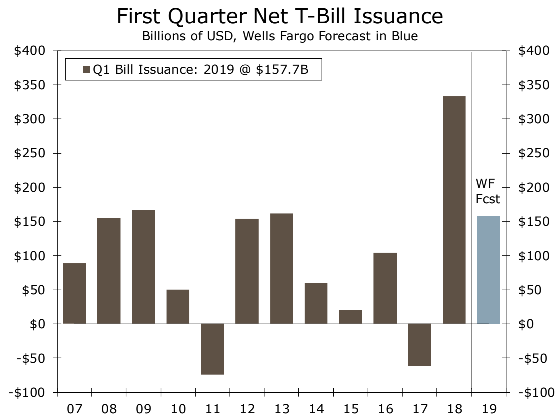
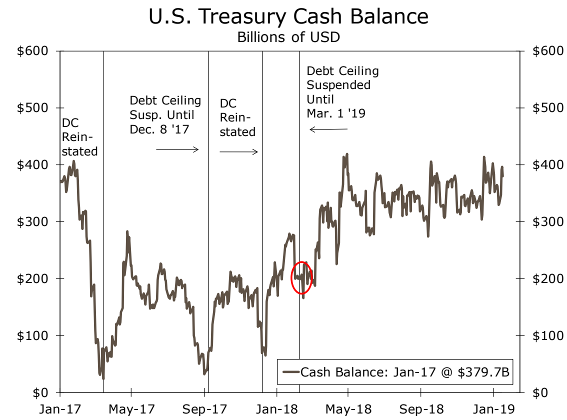


Figure 5



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

Late February through the end of March is poised to see a surge in net T-bill issuance.

Pulling all this together, late February through the end of March is poised to see a surge in net T-bill issuance, potentially to the tune of about $175 billion over a six week stretch. Treasury probably will use cash management bills (CMBs), making the exact timing and pattern of issuance somewhat murky. Even so, the combination of a large seasonal deficit and an anticipated large cash balance build in March could lead to market strains.

Complicating matters further, **the cash flow outlook for the next few months is highly uncertain.** Tax refunds/payments are a big driver of the seasonal deficit in February/March and the large surplus in April. This will be the first filing season under the Tax Cuts and Jobs Act, making projections somewhat more uncertain than usual. The government shutdown has added yet another element of variability into the outlook for tax season. In the last primary dealer survey, our forecast for the FY 2019 budget deficit (-$1,050 billion) was modestly above the median projection (-$1,000 billion). Accordingly, our deficit estimate for Q1-2019 is probably a bit above the consensus, and, as a result, our bill supply number for the quarter also probably accounts for a bit of upside risk relative to the consensus.

In sum, we expect money markets to be volatile for the next few months. They should be tamer than a year ago, but still wild enough to cause angst.

Figure 6. Gross quarterly coupon auction sizes plus gross and net totals, $ billions, 2019

Security	Projected Q1 2019	Projected Q2 2019	Projected Q3 2019	Projected Q4 2019
Notes & Bonds				
2y	120	120	120	120
3y	114	114	114	114
5y	123	123	123	123
7y	96	96	96	96
10y	75	75	75	75
30y	51	51	51	51
2y FRN	56	56	56	56
TIPS				
5y TIPS	0	32	0	32
10y TIPS	25	12	26	12
30y TIPS	10	0	8	0
Total				
Coupons	670	679	669	679
Note/Bond **Net**	209	188	210	232
SOMA redemptions	68	81	64	56
Adj. Note/Bond **Net**	278	269	274	288
Bills **Net**	158	-86	89	101
WAM	68	68	68	68

Source: Wells Fargo Securities

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