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Economics and Macro Strategy

WELLS FARGO SECURITIES

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Economics and Macro Strategy
Where Will That $2 Trillion Come from Anyway?

- **Net Treasury issuance is set to surge in the coming weeks and months.** At present, we look for the federal budget deficit to be $2.4 trillion in FY 2020 and $1.7 trillion in FY 2021. If realized, the FY 2020 federal budget deficit would be the biggest deficit as a share of the economy since World War II.
- The U.S. Treasury needs to raise **a lot** of money in very short order. **All told, we expect net Treasury issuance excluding Fed purchases to be a stunning $1.4 trillion in Q2.**
- Of course, excluding Fed purchases ignores the elephant in the room. Last week, the Fed purchased roughly $75 billion Treasury securities **per day** as part of its open-ended quantitative easing program.
- We assume that the Fed's pace of purchasing will slow, but when it is all said and done, **we expect the Fed to have absorbed roughly three-quarters of the net increase in total Treasuries outstanding in 2020.**
- More specifically, we look for net T-bill issuance after accounting for Fed purchases to be $942 billion, while net issuance of Treasury notes and bonds will be negative $284 billion after accounting for Fed buying in calendar year 2020.
- The Federal Reserve's robust appetite for Treasury securities should help keep net interest costs down for the federal government. It should also help prevent primary dealer balance sheets from becoming too bloated with Treasuries, stretching their ability to fund other asset classes.
- **We expect Treasury to lean heavily on T-bill issuance to meet the near-term financing need.** Specifically, we look for $1.1 trillion of net T-bill issuance in Q2-2020, with the Fed buying $240 billion of that. New all-time auction highs are likely in every tenor of T-bill over the next month or two.
- **For Treasury securities 2Y and longer, we expect a sizable boost to monthly auctions at the May Refunding, followed by smaller increases in August and November.**
- This should permit the Treasury to follow a similar playbook to the one followed in 2008-09: meet the initial surge in issuance with a dramatic increase in bills, and then over time smaller deficits and higher coupon auctions should keep bill supply in check.
- **The confidence intervals around our forecasts are larger than usual.** As the May 6 refunding announcement nears, some of this uncertainty may dissipate, and we will update our forecasts as necessary.

Treasury Issuance to Surge, but Fed Buying Will Help Soak It Up

Net Treasury issuance is set to surge in the coming weeks and months. Congress has passed three bills that contain numerous measures to deal with the economic and public health repercussions from the COVID-19 outbreak, and these tax and spending changes need to be deficit-financed. In addition, as our economic forecast has continued to deteriorate, federal tax revenues are likely to be much lower than previously anticipated.

At present, we look for the federal budget deficit to be $2.4 trillion in FY 2020 and $1.7 trillion in FY 2021 (Figure 1). Relative to our forecast back in early February, these estimates are up from $1.05 trillion for FY 2020 and $1.1 trillion for FY 2021. This would amount to federal budget deficits as a share of GDP of 11.2% in FY 2020 and 7.9% in FY 2021. **If realized, the FY 2020 federal budget deficit would be the biggest deficit as a share of the economy since World War II, when budget deficits were 25-30% of GDP at their peak (Figure 2).**

Figure 1

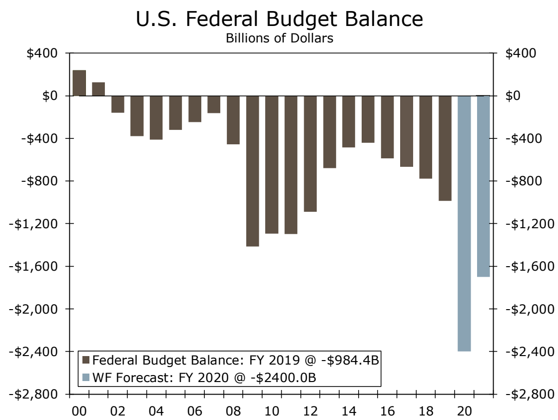
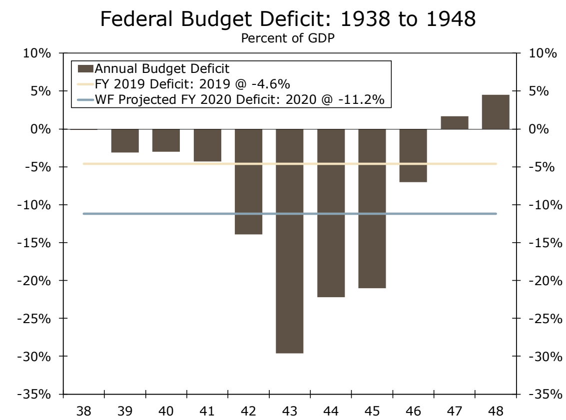


Figure 2



Source: U.S. Dept. of the Treasury, Office of the Management and Budget and Wells Fargo Securities

In the immediate term, the U.S. Treasury needs to raise **a lot** of money. Some stimulus measures, like greater infrastructure spending or a payroll tax cut, lead to higher outlays/lower revenues that are spread out over many months, or even years. Mailing checks to households will require raising money immediately, as will financing expanded unemployment benefits during a period of record initial jobless claims. Pushing back the tax filing deadline from April 15 to July 15 will delay the usual inflow of tax receipts seen in April, and sizable amounts of money will need to be raised to finance lending to businesses. **All told, we expect net Treasury issuance excluding Fed purchases to be a stunning $1.4 trillion in Q2.**

While net issuance should slow in subsequent quarters, it will likely remain quite heavy. For calendar year 2020, we look for net Treasury issuance excluding Fed purchases to be $2.8 trillion, split nearly evenly between bills and notes and bonds (Figure 3). To put these numbers into context, we expected a total of just $1.1 trillion in our February 5 forecast update.

Of course, excluding Fed purchases ignores the elephant in the room[1]. Last week, the Fed purchased roughly $75 billion Treasury securities **per day** as part of its open-ended quantitative easing program. Total Fed purchases of Treasury securities in March were more than $800 billion. Prior to that, the largest monthly increase in the Fed's Treasury holdings on record was $120 billion in March 2011.We assume that the Fed's pace of purchasing will slow. Indeed, the Fed has announced that it will reduce its purchases to $60 billion per day starting on April 1. We expect the Fed to purchase $800 billion of Treasury securities in Q2, $300 billion in Q3 and $100 billion in Q4.

When it is all said and done, we expect the Fed to have absorbed roughly three-quarters of the net increase in total Treasuries outstanding in 2020. More

[1] On March 23, the Federal Reserve announced it will purchase Treasury securities and agency mortgage-backed securities "in the amounts needed" to support market functioning and the economy.

specifically, we look for net T-bill issuance including Fed purchases to be $942 billion, while net issuance of Treasury notes and bonds is negative $284 billion after accounting for Fed buying (Figure 4). The Federal Reserve's robust appetite for Treasury securities should help keep net interest costs down for the federal government. It should also help prevent primary dealer balance sheets from becoming too bloated with Treasuries, stretching their ability to fund other asset classes. Were this to occur, it could put additional pressure on the financial system during a time of extreme duress.

Figure 3 (excluding Federal Reserve)

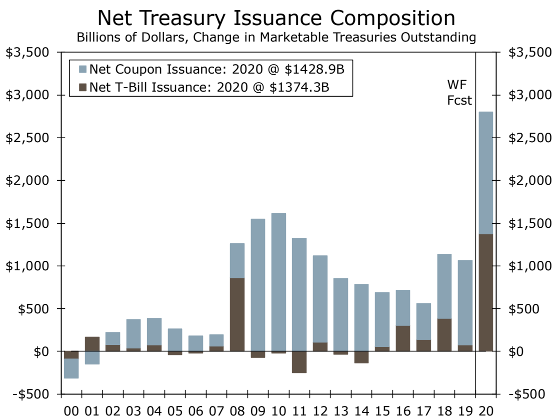
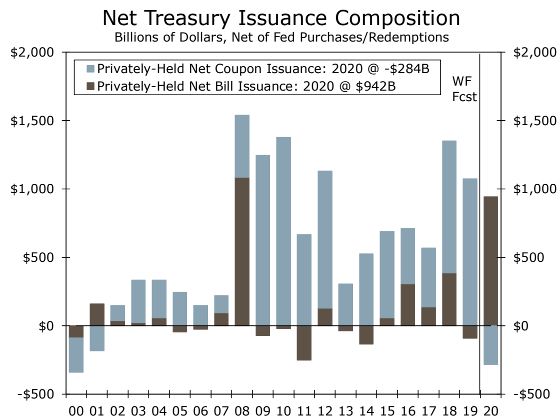


Figure 4 (with Federal Reserve)



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

What Will This Mean for Auction Sizes?

We expect Treasury to lean heavily on T-bill issuance to meet the near-term financing need. Insatiable demand for ultra-safe, short-dated assets has pushed T-bill yields towards zero and in some cases negative. The bid-to-cover ratio, a measure of demand for Treasury auctions, skyrocketed for the four-week T-bill at last week's auction (Figure 5). ICI data for the week ended 3/25 show government only money market funds saw record inflows of a whopping $345 billion.

Treasury can help meet this demand with a surge of supply, all while financing this infusion of debt at rates of more or less zero. Can the market handle this much T-bill supply? There is some historical precedence for funding a skyrocketing deficit in this way. During the throes of the Great Recession from Q2-2008 through Q1-2009, total T-bills outstanding roughly doubled, going from $1 trillion to $2 trillion in just three quarters (Figure 6). Over the next several years, Treasury gradually termed out its debt through increased coupon issuance and retiring T-bills. Total T-bills outstanding dipped below $2 trillion in Q3-2009 and did not top that level again until Q1-2018.

Figure 5

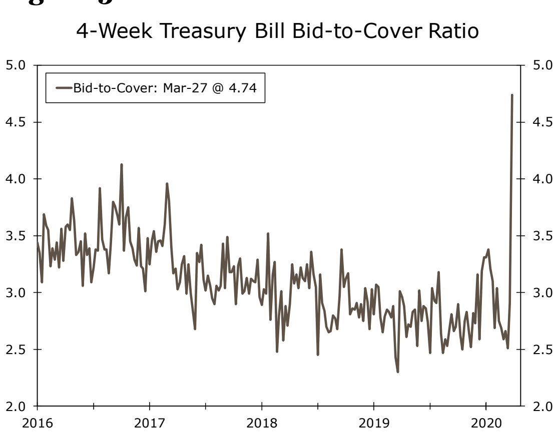
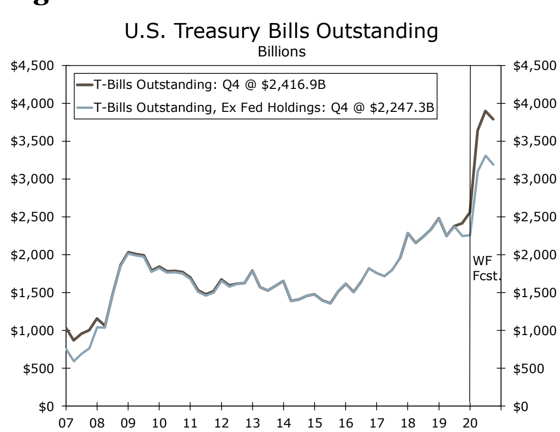


Figure 6



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

Specifically, we look for $1.1 trillion of net T-bill issuance in Q2-2020, with the Fed buying $240 billion of that. New all-time auction highs are likely in every tenor of T-bills over the next month or two. Gross issuance on a weekly basis could easily hit the $250 billion mark, and this will be in addition to what will likely be a massive slug of issuance in Cash Management Bills (CMBs). Treasury relied heavily on CMBs in late 2008 following the passage of TARP. It issued $320 billion net ($515 billion gross) in October 2008 alone. For additional context, in Q4-2008 T-bills made up nearly 75% of total issuance on a net basis. We have roughly the same profile for Q2-2020, with T-bills accounting for a little over three-quarters of net issuance (prior to Fed purchases).

For Treasury securities 2Y and longer, we expect a sizable boost to monthly auctions at the May Refunding, followed by smaller increases in August and November (Figure 7). This should permit Treasury to follow a similar playbook to the one followed in 2008-2009: meet the initial surge in issuance with a dramatic increase in bills, and then over time smaller deficits and higher coupon auctions should keep bill supply in check. As in 2018, the front-end/belly of the curve should experience the largest increases. Beginning in May and ending in July, we look for $2 billion increases per month for the 2Y, 3Y, 5Y and 7Y. At the long end of the curve, we look for $4 billion one-time increases to the 10Y and 30Y monthly auctions, applicable to subsequent reopenings. In addition, we now expect the 20y auction new issue/reopening split to be $14 billion/$11 billion, with the first auction occurring in May. Finally, we expect a $4 billion one-time boost to the 2Y floating rate note, also applicable to subsequent reopenings.

We look for a smaller increases in August with the 2Y, 3Y, 5Y and 7Y increasing $1 billion per month through November. In addition, we think the 10Y and 30Y will receive one-time increases of $2 billion, applicable to subsequent reopenings. The 2Y FRN gets a one-time boost of $1 billion applicable to subsequent reopenings. We have $3 billion in increases to each TIPS offering penciled in for August. This would be a notably faster boost to TIPS auctions compared to how Treasury handled the big increase in borrowing needs in 2008-09. However, the fiscal and monetary responses to the current crisis have been much swifter than the slow drip of actions taken during the financial crisis.

Figure 7

	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	40	42	44	46	47	48	49	50	50	44
3y	38	38	38	38	40	42	44	45	46	47	48	48	40
5y	41	41	41	41	43	45	47	48	49	50	51	51	42
7y	32	32	32	32	34	36	38	39	40	41	41	41	32
10y	24	27	24	24	31	28	28	33	30	30	34	31	25
20y	0	0	0	0	14	11	11	15	12	12	16	13	0
30y	16	19	16	16	23	20	20	25	22	22	25	22	16
2y FRN	20	18	18	20	22	22	24	23	23	25	24	24	0
5y TIPS	0	0	0	17	0	15	0	0	0	20	0	19	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	228	261	263	272	285	285	296	304	299	297

Note: 30y TIPS introduced at $8 billion in Feb 2010, 5y and 10y TIPS continued increasing through 2013

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

While these increases are substantial, they are not unprecedented. In late 2008/early 2009, Treasury found itself in a similar situation attempting to deal with the financial crisis. **From July 2008 to November 2009, the 5Y auction doubled in size to $42 billion. This doubling occurred after Treasury had already brought the monthly 5Y auction up from a low of $13 billion in December 2007.** Treasury also reintroduced the 3Y note, began offering a 7Y note, introduced a second reopening to the 10Y note and introduced the first and second reopening to the 30Y bond between Q4 2008 and Q2 2009.

It would not surprise us if Treasury introduced a new security (other than the 20Y) by the end of the year. A 1Y floating rate note linked to SOFR has been discussed at length at recent quarterly refundings and would be a prime candidate if the kinks can be worked out in a timely fashion. Due to heightened uncertainty, we do not explicitly forecast the introduction of a new security outside of the previously-announced 20Y. If a new security like a 1Y SOFR floater were to find its way into the mix, we doubt it would debut before August.

Our Forecast Is Much More Uncertain Than Usual

The Congressional Budget Office has yet to score either the Phase II or Phase III bills passed by Congress, and the ultimate deficit impact from some of these lending programs is unclear. The economic outlook over the near- to medium-term is highly uncertain, and the Fed's open-ended commitment to quantitative easing makes it impossible to say just how many Treasury securities it may eventually buy. Thus, **the confidence intervals around our forecasts for both net and gross issuance are unusually large.** As the May 6 refunding announcement nears, some of this uncertainty may dissipate, and we will update our forecasts as necessary.

A few key implications for rates. We expect T-bill yields to return to positive territory in the next few weeks. Demand probably will remain strong, but it is unlikely to keep pace with the torrid pace of issuance we expect. Even so, we doubt that T-bill yields will increase materially above the interest rate on excess reserves (currently 0.10%). Over a longer period, we expect Treasury's shift in issuance to longer-term securities following the tsunami of T-bills to put steepening pressure on the curve. We look for 2s/10s to steepen from roughly 40 bps as we go to print to 65-75 bps by year-end. The 10s/30s area should also steepen, in our view, as historically large deficits have correlated with a steep back end of the curve.

Figure 8

	Historical Q4 2019	Projected Q1 2020	Projected Q2 2020	Projected Q3 2020	Projected Q4 2020
2y	120	120	126	141	149
3y	114	114	120	135	143
5y	123	123	129	144	152
7y	96	96	102	117	123
10y	75	75	83	91	95
20y	0	0	25	38	41
30y	51	51	59	67	69
2y FRN	56	56	64	70	73
5y TIPS	33	0	32	0	39
10y TIPS	12	26	12	29	15
30y TIPS	0	8	0	10	0
Total					
Net Coupons	295	236	303	408	481
Net Bills	58	141	1,085	254	-106
SOMA Purchases					
Coupons	51	813	560	255	85
Bills	163	133	240	45	15
Net Coupons to the Public	244	-577	-257	153	396
Net Bills to the Public	-105	9	845	209	-121
Cash Balance (quarter-end)	404	400	400	400	400
WAM	69.7	69.4	70.5	71.0	71.0

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

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