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iFlow

SHORT THOUGHTS

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Kink In The Curve

- **The T-bill curve is betting any potential breach of the X-date would be short-lived**
- **A brief breach of the X-date unlikely to impact money market funds**
- **iFlow shows that there may be an inflection in UST flows by maturity**

T-Bill Curve Kinks

The US Congressional Budget Office last Friday warned that "...there is a significant risk that at some point in the first two weeks of June, the government will no longer be able to pay all of its obligations” if the debt limit isn't raised. Treasury Yellen has indicated that she will update members of Congress and the public within the next few weeks on any change to her current forecast of a June 1 X-date. All the uncertainty around precisely when the X-date might fall owes to difficulty in estimating and forecasting short-term cash flows into and out of the Treasury. We have previously noted that if the Treasury’s funds manage to hold out until June 15, quarterly tax receipts could extend the X-date further into late June; and if Treasury manages to make it until June 30, another c.$145bn in extraordinary measures will become available, extending the ability to meet obligations into later this summer.

Nevertheless, under the current guidance, the US T-bill market is taking no chances. As the chart below shows, yields in early June have spiked higher, reflecting a lack of demand for securities on which payments could be missed in the event of a technical default.

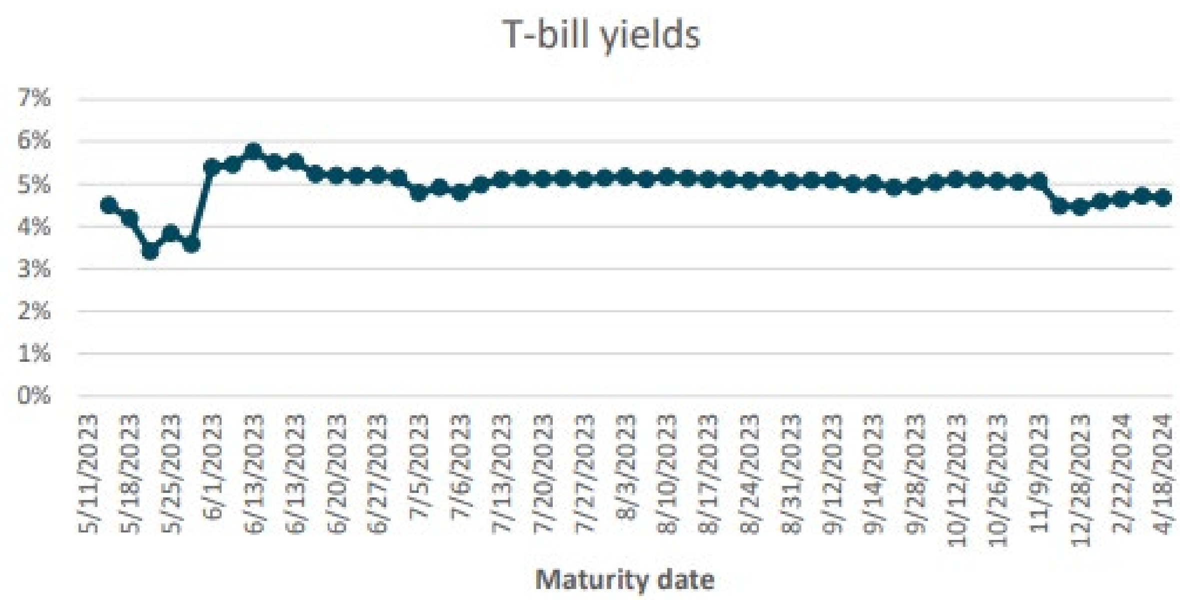
Early-June T-bill maturities avoided

In our Morning Briefing publication yesterday (see here) we pondered the potential impact on markets of crossing the X-date. While historical analogies don't really exist, we do think that as the X-date draws closer without resolution of the debt ceiling impasse, so-called risk assets should experience some stress. We would expect the June "spike" in bill yields to extend higher as those securities within the X-date window continue to be shed by the market. In 2011, Treasury bond prices rallied in a classic risk-off response.

The Treasury Department appears confident that it can prioritize Treasury principal and interest payments over other non-debt payments. Although ratings agencies have indicated that the government not paying all its obligations in full and on time would be classified a technical default, it's not clear if a delay in payments of, say, a few days would be sufficient to merit actual downgrades. It's also important to note that technical default would be security-specific, and so not require mass selling of US debt.

Still, markets are betting on a resolution prior to the X-date being crossed, or in the extraordinary event of not meeting the deadline, that the impasse would be resolved quickly. This presumes that a few days of market chaos would force the parties to agree to an extension, of course. We obviously hope that such an expensive lesson can be avoided – we don't need to see the experiment of a default.

Betting On Any Disruption Not Lasting Long



Source: BNY Mellon Markets, Bloomberg

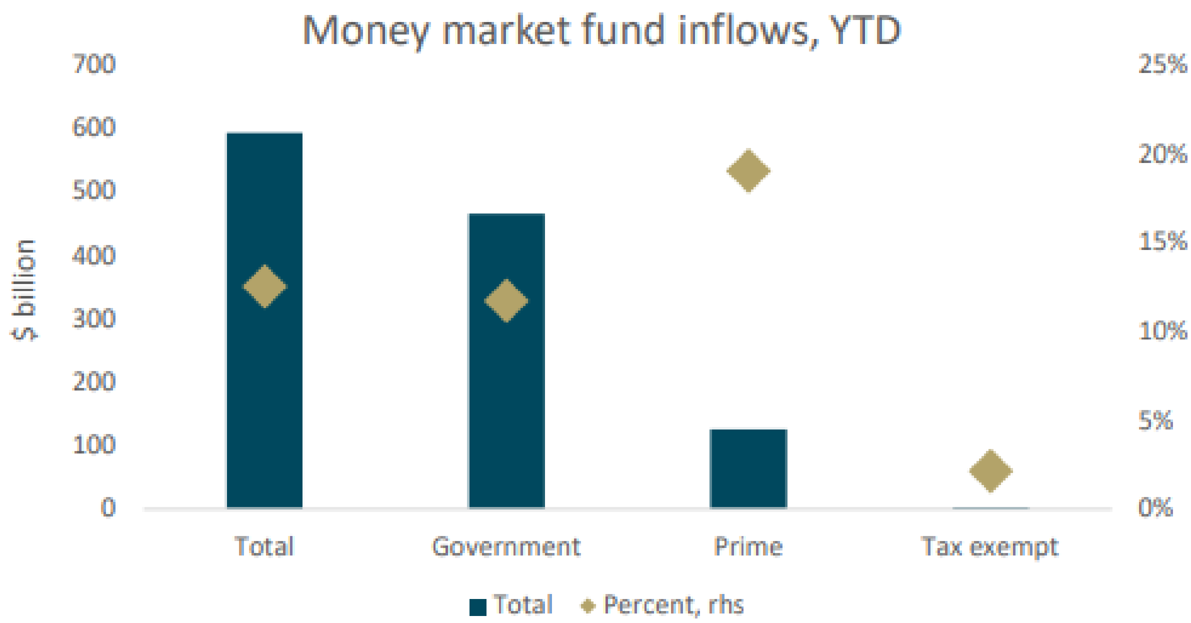
Money Funds Preparing For Worst, Hoping For Best

Money market funds, which have seen significant increases in assets since the beginning of the year, are of particular interest in relation to the X-date. Last week we chronicled the increase in MMF assets since the banking-sector stresses broke out in March (see here). This week we look at the increase in size of these funds since the beginning of the year. As the chart below shows, nearly $600bn has found its way into money funds, with the vast majority ($465bn) going into government funds, precisely those instruments that will come under scrutiny should the debt ceiling issue become dramatic.

> **If X-date is breached, markets are betting the impasse would be resolved quickly**

In case of crossing the X-date, if as assumed above any impasse would be settled within days, it’s not expected that NAVs would plummet or that any threat of “breaking the buck” would be significant. Likely recovery rates on any defaulted securities would be 100%. Again, we stress that these relatively rosy scenarios are under the assumption of a speedy resolution after breaching the X-date. If the impasse were to become prolonged, however, conditions could get much more difficult. Even under prioritization of payments to bondholders, at some point expectations of default would increase, driving yields higher and securities prices lower. If Treasuries begin to lose buyers as default probabilities increase, the Treasury could find it difficult to roll over maturing debt and downgrades would become more likely. As above, this also is an experiment we do not wish to see run.

Government Money Funds Flush



Source: BNY Mellon Markets, ICI, Bloomberg

Could UST Flows Signal Curve Steepening Ahead?

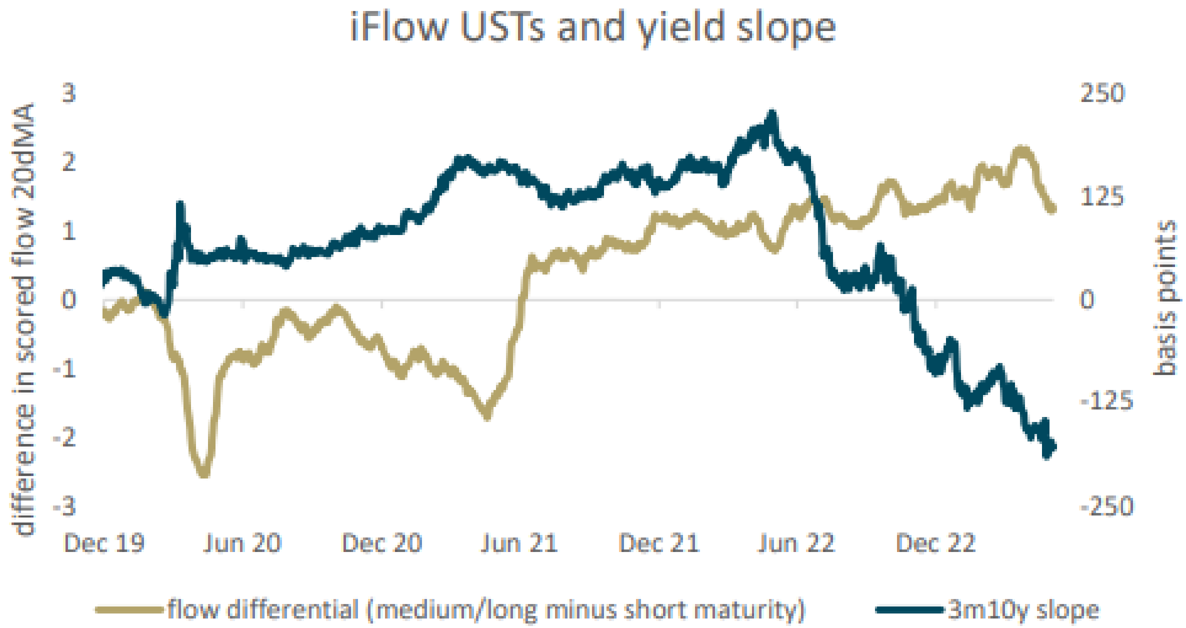
US government bond flows in iFlow could be signaling further curve steepening. For US sovereign debt, we can present flows across three different maturity buckets: sub-1y, 1y to 10y, and longer than 10y. In the chart below, we look at the difference between flows into the 10y+ bucket and those from the sub-1y bucket. There is evidence that the broad trend in this measure is related to the 3m-10y yield slope.

> **There could be a shift underway in the term structure of US government bond flows**

During most of 2022, longer-maturity bond flows were increasing relative to those of short duration, matching the general flattening and subsequent inversion of the curve. Prior to 2021, flows into front-end securities were higher than those into the long-maturity bonds, corresponding to curve steepening. These broad observations are intuitive, as well.

Lately there has been some recovery in short- relative to long-end flows. There is a long way to go before sub-1y flows eclipse long-maturity flows, but there has been an inversion in the trend. We're watching this to see if it heralds any steepening in the curve.

A Shift In Government Bond Flows?



Source: BNY Mellon Markets, iFlow

Please direct questions or comments to: iFlow@BNYMellon.com

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