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iFlow

SHORT THOUGHTS

JOHN VELIS
FX AND MACRO STRATEGIST FOR THE AMERICAS

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After A Debt Ceiling Deal — Now What?

Waiting On Passage

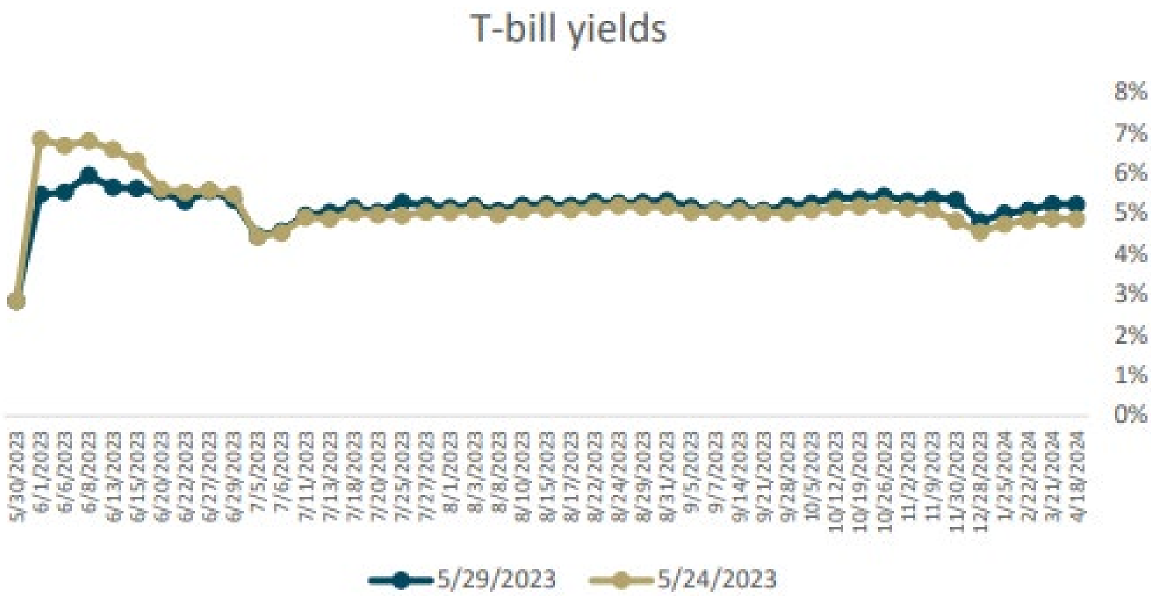
Over this past weekend, House Speaker McCarthy and President Biden struck a deal to suspend the debt ceiling until January 2025. This takes the issue off the table until after the 2024 presidential election. The agreement reportedly includes two years of discretionary spending caps, additional work requirements for food stamps and cuts to IRS funding, among other components. The White House claims that over the course of a decade, government spending would be $1trn lower than without such a deal. Pending passage by both houses of Congress, an update from Treasury Secretary Yellen pinpointed June 5 as the X-date. So the agreement must be passed and signed into law by next Monday.

> ***Passage in the House will require votes from both sides of the aisle***

The next step for getting the debt ceiling suspended by June 5 is, of course, passage of the deal by the House of Representatives and the Senate. Initial reports cite objections from both Republicans and Democrats, but there is cautious optimism that a combination of relatively moderate legislators in the House on both sides of the aisle will support it in sufficient numbers for it to pass. In the Senate it may face procedural obstacles but, we think, should pass in time. Nevertheless, we will be watching the vote counting over the next few days, hoping no insurmountable political obstacles impede its eventual passage.

The T-bill curve started to move already on Friday last week, as optimism on a possible deal ratcheted up. Note the difference in the June yields from Wednesday through Friday last week. Should it look as if the deal will move toward passage during the upcoming week, we would expect the curve to continue to normalize – just in time for a deluge of US Treasury issuance (discussed below) once the ceiling is formally suspended, as is our base case.

Kink Recedes



Source: BNY Mellon, Bloomberg

UST Deluge Coming

As of Thursday last week, the Treasury General Account (TGA), the US government's operating account out of which it handles daily public transactions, was down to a paltry $38.8bn thanks to the debt ceiling drama. Back in December 2021, the last debt ceiling near-miss, the TGA fell as low as $42bn. At that time, after the debt ceiling was finally raised on Dec. 16, the TGA was replenished quickly – growing to over a half trillion dollars in size by the end of January 2022. Once the borrowing shackles were removed from Treasury via the debt-ceiling extension, T-bill issuance went from -$82bn in November and December 2021 to $285bn in January and February 2022.

Given that this time around the debt ceiling itself was actually reached back in January, and with the TGA so depleted, once an agreement is finally signed Treasury will doubtless unleash a significant wave of issuance. Estimates range from $1trn to $1.5trn during H2 2023. Treasury needs to replenish the General Account – perhaps up to a stable level of around $500bn – as well as to top-up funds that were borrowed from as part of extraordinary measures deployed once the debt limit was reached back in January.

Increasing the TGA almost axiomatically means reducing reserves in the banking system. Both items are liabilities on the Fed's balance sheet. Funds come out of reserves and – via T-bill auctions – wind up in the TGA. There is almost a one-for-one and opposite change in reserves for every increase in the TGA. The contours of this relationship are apparent in the chart below. A regression analysis of weekly changes in the TGA on weekly changes in reserves (going back to May 2020) yields an R^2 of 20%, which is quite high for weekly data. Examining the same relationship at a monthly frequency gives us an R^2 of nearly 70% and a coefficient near -1.

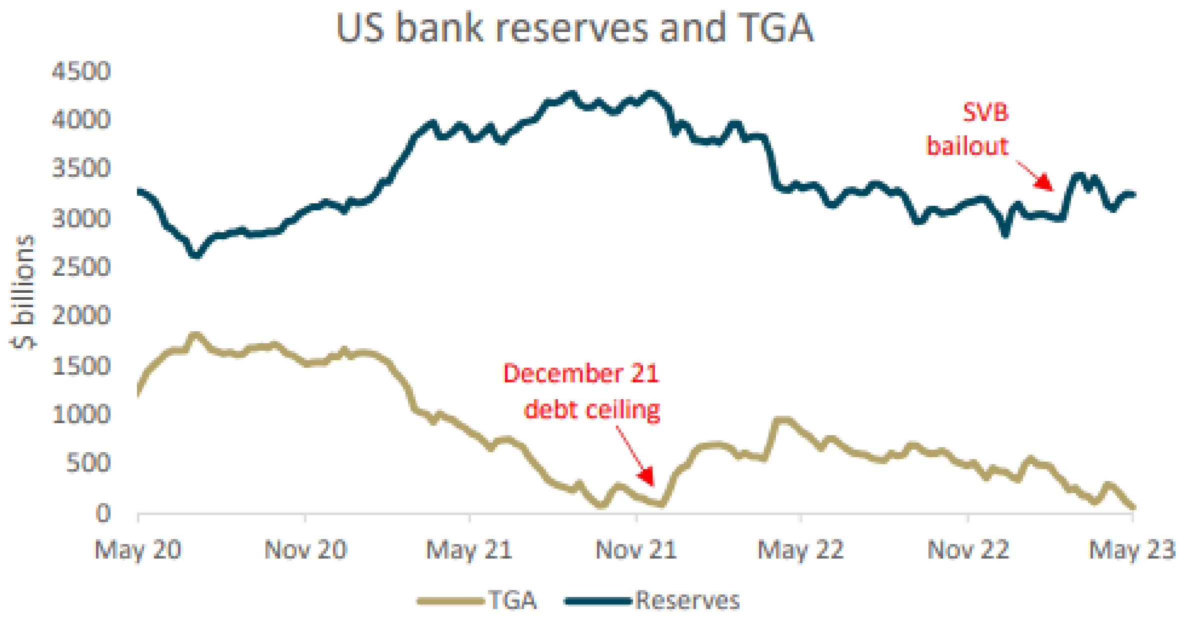
Replenishing the TGA will drain reserves

Thus, the impending crush (or is it rush?) of Treasury supply will reduce overall liquidity in the US financial system by reducing reserves at an almost proportionate clip, especially if the majority of the TGA rebuild comes of bank deposits. It does depend to some degree on who purchases this impending supply. Money market mutual funds (MMFs), which have been avoiding June paper and investing in the Fed's overnight reverse repurchase facilities as we got closer to the debt ceiling deadline, could be players in this transaction.

Since RRP is also a liability of the Fed, current usage of the facility is between $2trn and $2.3trn, there is chance then that RRP will start to finally come down, as MMFs move back into T-bills. It's therefore possible that the hit to reserves could be much less than 1-to-1 with TGA, depending on how much cash is converted from RRP (reducing its size) into T-bills.

This rush to issue debt quickly and in such size will lead to an overall liquidity drain in the system, absorbing the large cash piles that have been amassed. The Fed's balance sheet and the functioning of the Treasury market are very likely to be profoundly impacted, too.

TGA, RRP and Reserves



Source: BNY Mellon Markets, Federal Reserve Board of Governors

Short Duration Still Lures Foreign Buying

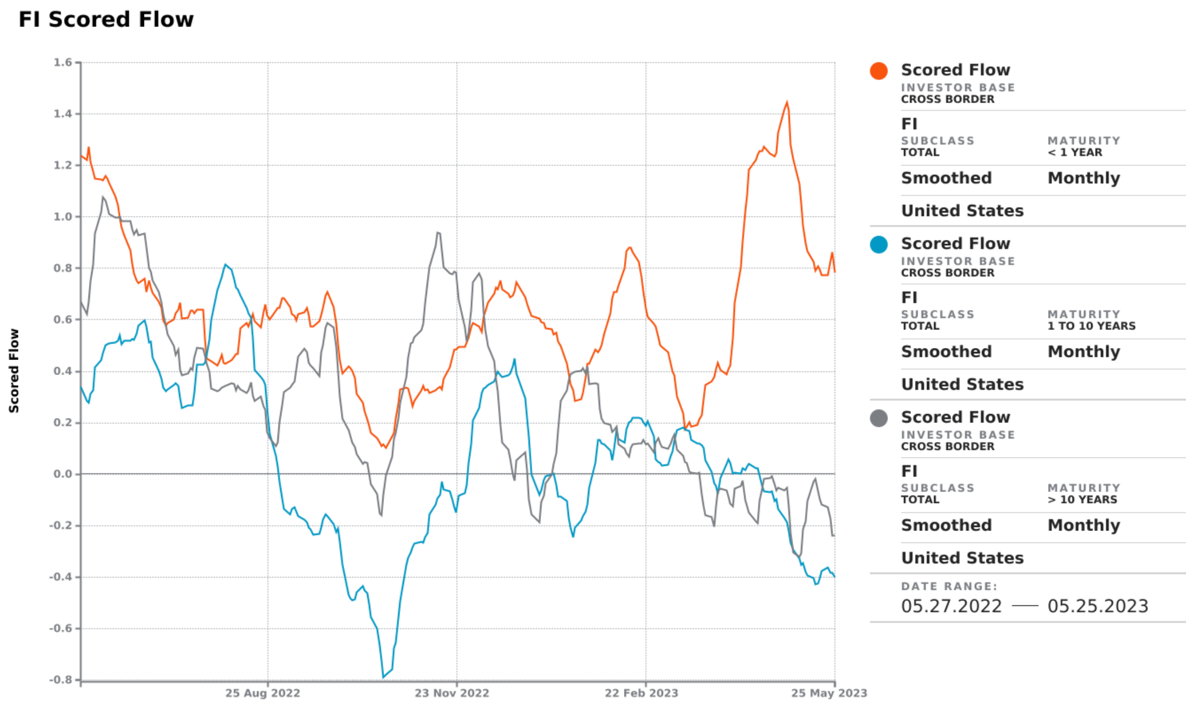
We have written about foreign demand for US Treasuries (see here). Our iFlow data have shown significant and accelerating cross-border outflows from USTs. This, along with more structural liquidity issues in bond markets, has us wondering who will absorb all the issuance we just wrote about. Looking deeper at the data, which allows us to segregate demand for all US bonds (corporate, government and other) into broad maturity buckets, we can see that one segment has been enjoying steady inflows from overseas. The chart below shows cross-border flows for US bonds across less than 1y, 1-10y, and over 10y in maturity.

> ***While shunning longer-dated paper, cross-border investors are hiding in cash-like instruments***

It's clear that foreign interest in short paper (orange line) has been quite strong and positive over the last 12 months, with a noticeable and rapid increase from already strong levels since around March this year. Note also the selling in the longer maturity buckets. This is consistent with what we have been seeing with total (i.e., cross-border plus domestic) flows – heavy buying of short-maturity securities dominating since the beginning of 2022.

With the expected changing dynamics at the front end and in the Fed's balance sheet, these flow dynamics will be interesting to watch. There may be enough demand from real money for the rapid increase in T-bill supply to prevent too many changes in balance-sheet trends.

Hiding Out In The Short End



Source: BNY Mellon Markets, iFlow

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

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CONTACT JOHN

bnymellon.com