Taking Issue(ance) - Monthly Roundtable Transcript

Margaret Kerins:

This is Macro Horizons, monthly episode 24, Taking Issu(ance), presented by BMO Capital Markets. I'm your host Margaret Kerins, here with Ian Lyngen, Greg Anderson, Stephen Gallo, Dan Krieter, Ben Reitzes, Dan Belton, and Ben Jeffery, from our FICC macro strategy team to bring you our outlook for US Treasury bill and coupon supply in the context of historical supply trends and the potential market implications.

Margaret Kerins:

Each month, members from BMO's pick macro strategy team join me for a round table focusing on relevant and timely topics that impact our markets. Please feel free to reach out on Bloomberg or email me at Margaret.Kerins@BMO.com with questions, comments, or topics you would like to hear more about on future episodes. We value your input and appreciate your ideas and suggestions. Thanks for joining us.

Speaker 1:

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Margaret Kerins:

Treasury announced its financing estimates for the first half of 2021 earlier this week. They revised their net issuance down by a whopping 1.1 trillion over the next two quarters. This is a massive revision and it actually highlights the challenges of estimating issuance during these uncertain times.

Margaret Kerins:

So a few things happened here. First, the estimate does not include any financing that may be needed to fund another round of stimulus. Second, Treasury expects to have a cash balance of 500 billion by the end of June. The cash balance now sits at $1.6 trillion. So the $1.1 trillion pay down in cash is equal to the reduction in net issuance estimates. Also note that a decline in cash balances increase reserves. So US acknowledged that the quarterly refunding of message to pay down in the cash balance for several quarters, which has not been realized.

Margaret Kerins:

So why might this time be different? Well, first, some other programs under the CARES Act have expired and Treasury may no longer need to hold the cash. Second, the $2.4 trillion in net bill issuance that entered the market in April and May of last year increased bills to 25% of outstandings versus a pre-crisis average of about 15%. So net bill issuance has been negative for the past three quarters as Treasury works to term out their funding into the longer dated coupons, but they still have a way to go before reaching 15%. That said, there is substantial uncertainty as bill issuance would likely increase to fund another stimulus package. In other words, we could have a trillion dollar swing here.

Margaret Kerins:

So let's get back to the actual numbers. Coupon auction sizes are set. Simply holding coupons at the current auction sizes results in $1.4 trillion in net issuance in the first half of 2021. Now Treasury has told us that they only need $369 billion. So this implies a pay-down of let's call it a trillion.

Margaret Kerins:

The Fed is still purchasing $80 billion a month in Treasury coupons. So after the Fed purchases $480 billion in coupons in the first half, there will be over $900 billion available for the rest of the market. This is actually very similar to the amount of coupons issued into the market in the first half of 2010. In fact, in the four quarters beginning in the fourth quarter of 2009, Treasury issued $1.65 trillion in coupons, which is similar to the $1.8 trillion coupes expected for the full year of 2021. So while 2021 issuance projections are heavy, they're actually quite similar to the levels that we had absorbed in 2010.

Margaret Kerins:

So of course, back then, we not only had a flight to quality driven by the global financial crisis, we also had the European debt crisis. Back then the trade was to buy Treasuries along with the Fed and avoid credit risk. This time around, Treasury purchases were so strong out of the gate last March and April that they took $1.3 trillion out of the market, which crowded investors out, but also by backstopping the credit market, they made investors more comfortable moving out the risk curve.

Margaret Kerins:

So the question now becomes how does demand for Treasuries evolve over coming months? Treasuries must clear the market. They will find a home or there'll be held on dealer balance sheets until they find a home. So on the one hand we're facing heavy coupon issuance, but at the same time, the potential for a massive drain in Treasury bill supply.

Margaret Kerins:

So let's start with Dan Krieter today. Dan, how are you thinking about the evolution of demand and how it may impact the markets you cover?

Dan Krieter:

Yeah, Margaret, I think you make the very key point that really the main takeaway from yesterday for me is that we're going to have a significant extension in Treasury's debt profile away from bills and into coupons. And the timing for that may not be ideal. We just saw how heavy demand is for cash products. At the short end with repo rates trading around zero for the last couple of weeks. Clearly there's a need for more short end collateral, but the Treasury is instead going to be terming their issuance out in the coupon market. Now coupons ultimately are collateral that can be used for the repo market to meet short end demand, but before they can be repoed, there has to be someone that ends up buying that Treasury out the curve. And the question is who's that going to be?

Dan Krieter:

You make the comparison to heavy Treasury supply following the global financial crisis and I agree that's the most applicable time period. And if we look at flow of funds data from around that time, three main buyers emerge. The first is The Fed. The second is foreign investors and the third are US banks. And using those same three investors in the current environment, we know what The Fed is doing. They're buying it. They're $80 billion a month, and we don't expect that to change the foreseeable future, but significant questions exist for the other two main borrower types that helped sponsor the debt following the global financial crisis.

Dan Krieter:

On the foreign investor front, and I'm sure Stephen and Greg will have more to add on this later, but ongoing trade tensions at the very least may imply that foreign investors won't be such large buyers this time around and on US banks, which back then were cleaning up balance sheets and ultimately implementing Basel ratios, this time, not only is the regulatory environment not going to increase bank demand for Treasuries, but it might actually decrease it. And here I'm referring to the pending expiration of exemptions for reserves and cash for bank supplementary leverage ratio calculations.

Dan Krieter:

To get some numbers around it, I went and looked at most recent financials for the major G-SIB in the United States and found that almost $150 billion, $146 billion to be exact, is currently being excluded from SLR calculations that, at the end of March, unless the extraordinary exclusion is extended, that's going to have to be reduced on bank balance sheets, either via deposits or via Treasury holdings. And as we know, deposits can be very difficult to ultimately reduce. So at the very least, it appears that banks, while they may not be sellers, they don't look like they're going to be net buyers of Treasury as if this SLR exclusion does expire. So the key question for me becomes who is ultimately going to buy these Treasuries. And more importantly, what does heavy coupon supply mean for the markets that we track really specifically, beginning with US rates. Ian and Ben I'll guess I'll give that question to you. Do projections for heavy coupon supply impact Treasury yields upward.

Ian Lyngen:

Well, I'd certainly argue that increased Treasury auction sizes will lead to moments of upward pressure on rates. It's very difficult to argue against. What I have seen historically, however, is that the outright level of yields is more determined by the macro influences at play in the market rather than any incremental supply or demand event.

Ian Lyngen:

Now, as we have seen throughout the course of the last several months, when there are 10 and 30 year auctions on the table, we see a bit of cheapening and steepening in the Treasury market, very consistent with the classic supply accommodation trade. I'd also add that one of the defining adages that I grew up in this business with that continues to hold to this day is that there's no such thing as a bad bond, just a bad price. And so if we translate that through to today's market, that implies, we will find a clearing price for rates and I'll suggest that it might be 10 or 15 basis points higher than it would have otherwise been, but it won't be a hundred or 200 basis points higher. Now we spend a lot of time analyzing and thinking about the absolute dollar amount of net Treasury issuance coming to market. We currently have penciled in $1.8 trillion of net new issuance after Fed purchases for 2021. That's after Fed purchases for 2021. That's a significant number. But for context, every day in the Treasury market, half a trillion dollars trades when we look at just on the run coupons. Add in off the runs and TIPS, and that number is pretty big. So it's extremely liquid and it's a deep market. One of the questions that we're not asking is who's buying a quarter of a trillion dollars worth of Treasuries every day where there's not an auction. And for that, I think we need to look at the broader macro environment. So if we look at the correlation between higher Treasury issuance and the performance of 10 year yields, I like to break it down into three distinct episodes.

Ian Lyngen:

We have the 2010 experience where we saw a run-up in deficit spending and a run-up in net issuance. And at the same time, we saw 10 year yields go from 4% to 2.3%. Now, we all know that that's a function of a dimming global economic outlook, but who's to say there's only upside for the global economic outlook from here? If we look at the experience of 2004 in April, we had that reflationary issuance driven impulse that brought 10 year yields from 3.6% in March of '04 to 4.9% in the middle of May, but then ultimately resolved in a drift lower that brought tens back to 4%, let's call it call 4.25%.

Ian Lyngen:

And again, April 1992, very similar dynamic. Peaked at 7.6% as issuance started to increase, but ultimately saw a retracement below 6%. And I'd suggest that the underlying influence here is that when do we find ourselves in a situation where the federal deficit is elevated? That's when tax receipts are low and we need to increase net borrowing. When are tax receipts low? Not when the economy is in the middle of a recovery or an expansion, but rather when the economic outlook has been ratcheted lower. And if we layer in the realities of the pandemic, increasing spending at this particular moment in time makes sense, but doesn't necessarily mean that we're going to have growth back to 2019 levels, as soon as the end of this year.

Ben Jeffery:

In those historical instances versus the context of today, wouldn't you say the reflationary outlook that we're looking at in 2021, and even beyond, makes this time at least somewhat different?

Ian Lyngen:

I certainly think it does. And in that context, I draw your attention to the price action that we saw in January of 2021. In the beginning of the year, we had this reasonably meaningful re-steeping and 10 year yields got as high as roughly 1.19%. But more importantly, if we look at tenure breakevens, they shot back to multi-year highs well above 2%, very consistent with the idea that all of the stimulus that's currently in the market is ultimately going to translate through to realized inflation, if not this year, then in 2020 or 2023.

Ian Lyngen:

And what I find most striking about that is the subsequent rally that followed into the end of January, where 10 year yields dip below 1% yet again, didn't see a reversal of those inflation expectations. Rather, what we saw was an unwinding of some of the pro-growth narrative that was in place, whether it was a quick route to stimulus or chatter about potential tapering, et cetera. As it stands, we still have 10 year breakevens near multi-year highs. And that implies that the reflationary trade or the risk of higher consumer prices later is still priced in, even though we've seen that retracement. Can we get to 2.25% in breakevens? I think so. I think 10 year breakevens at 2.25% is very doable, although certainly at the upper end of the range we've seen for that gauge of inflation expectations in a very long.

Ben Jeffery:

And Ian, there's a really good historical example of this, which illustrates the point you're making, which is that it's really up to macro and inflation expectations to set the level of rates. And that's the episode of the massive Chinese selling of Treasuries we saw in the second half of 2015 and into 2016. So circling back to Dan's earlier point on who's going to buy all this net issuance, the fact that uncertainty has picked up as it did in that episode of Chinese selling that correlated with 10-year yields falling to their record low at that time really points to the fact that even though flows matter domestically and abroad, the macro backdrop is more consequential for setting the outright level of yields.

Greg Anderson:

As the FX guy from the corner of the room, I'm glad that analog periods of 2010, 2004 came up and glad there's recognition that foreign buying is a key component of Treasury demand. Indirect bidders, which is foreign central banks, very often biggest takers of Treasuries. And I think it's so critical to tie in here. 2010, in that time period, the dollar was about 10% weaker than it is today. And foreign policy makers were a little panicked about that. They're worried about their competitiveness and the dollar was still declining in a downdraft. And so in the first nine months or so of 2010, foreign central banks, we know this from my IMF data, that they added $800 billion and change to the reserves account. And typically, they hold about 60% to 65% of their reserves in dollars and presumably all of that in Treasuries.

Greg Anderson:

So that means that they took down $500 billion in supply all by themselves. Add that on to Fed QE. We're in a situation right now where in the fourth quarter of 2020, kind of a similar dynamic, declining dollar, not as weak, but a declining dollar and pretty clear that foreign central banks were intervening and buying dollars and buying Treasuries. If the dollar continues its downdraft, they will continue that same process. And there will be this Treasury demand. If the dollar bounces and starts to reverse, then we've potentially got something different. So in 2004, kind of different environment and the dollar rallied some during that time period. And so, there wasn't the need by foreign central banks to intervene. They did anyway. It was curious, but they did. They took down an awful lot of that supply on their own, call it their contribution to the Iraq War. But that intervention probably prevented the bounce in yields from being worse.

Stephen Gallo:

Greg, you raised a number of interesting points. And what I would say is that while China will no doubt be a buyer of US Treasuries in the year ahead, particularly if the dollar continues to weaken, the amount it will buy is perhaps not as straightforward as it used to be. Let me give you two reasons for that.

Stephen Gallo:

One is convertibility of the RMB. The RMB, as I see it, is much more of a hybrid currency today than it was at the start of this century. So if you go back and look at the TIC data and China's balance of payments data, you can clearly see that during the first decade of this century, China's Central Bank played a much more active role in absorbing the country's trade surpluses through the accumulation of US Treasuries. And there tended to be a much higher level of volatility in China's FX reserve account as a result.

Stephen Gallo:

One of the problems Chinese regulators ran into with this approach was of course, that it tended to flame financial stability risks. So today, in contrast to that period of time, local banks play a bigger role in the foreign currency asset and liability sides of China's external balance sheet. The other issue to consider of course is that China's trade surplus is typically aren't as large as they used to be, at least as a share of GDP.

Dan Belton:

Stephen, I think that it offers an interesting segue into the corporate credit market, which has really been anchored by strong foreign demand, largely due to the attractive yield profile for US dollar credit. Now, of course, arguably a stronger tailwind for credit spreads has been the Fed in the way that as Margaret discussed at the beginning, the Fed has really forced investors out the credit curve through quantitative easing by sapping up most of the Treasuries issued over the past year.

Dan Belton:

Now, if we do see this heavy Treasury coupon issuance, ex-Fed purchases like we're expecting, it could likely have the opposite effect on credit spreads, and it could end up crowding out corporate borrowing to some extent, which would send spreads wider. Now, the closest proxy that we have to this coming heavy Treasury supply that we have in the corporate market is likely the early 2018 story, where Treasury bill issuance flooded the market at the same time that corporate issuers were increasing their supply of CP. Now, the Treasury bill market grew by about 16% in just about eight weeks in February and March of 2018, and that ultimately sent LIBOR-OIS to about 60 basis points, which we view as a proxy for the amount of funding that corporate borrowers have to pay up for just three-month unsecured funding. Now, it's important to note that this wasn't really a credit episode, but just a supply and demand imbalance, and it wasn't even limited to just money markets. Credit spreads out the curve ended up leaking wider over the first half of 2018, just due to the strong Treasury issuance crowding out corporate borrowing. And we think that we could have a similar episode this time around as Treasury issuance ex-Fed starts to really increase in crowd out corporate debt.

Dan Krieter:

Listening to all you guys, the observation that sticks most clearly in my mind from all of your comments is that it seems to be really difficult to try to divorce the impact of Treasury supply from the broader macro narrative. We've talked about a few different environments, 2018, where we were in a pretty muddling economic environment. There was no observable flight to quality. In fact, the market was pretty bullish, given Trump tax cuts, and then we see heavy Treasury supply may be having a crowding out effect on corporate spreads while the market tries to digest Treasury supply. But then if you look back at other episodes, 2015 was mentioned, when most alternative economic indicators of China's economy indicated that there was a pretty significant economic slowdown in EM around that time, and maybe emerging market central banks had to jump in to defend the currency and prevent capital flight.

Dan Krieter:

Well, that's going to spark a flight to quality, and you're going to see rates drop whether or not there's heavy supply. Similar episodes that Ian and Ben discussed in 2010, 2004, and 1992, we see this move lower because at the end of the day, despite heavy Treasury supply, if there's going to be a flight to quality, and global investors are going to be looking to the Treasury market, you're not going to have any problem placing Treasury supply. So to me, it almost feels like the question is, "Okay, we know the Treasury supply is going to be heavy and it could be a problem if the macro narrative doesn't cooperate."

Margaret Kerins:

So Dan, you're pointing out some of the differences in the backdrop during past episodes of heavy Treasury issuance, and I think Ian did it a little bit earlier, where the economy is suffering and you get deficits and heavy issuance followed at the same time by a flight to quality. This time, of course, we've had a risk on rally at the same time. So right now we've been talking about heavy Treasury coupon issuance.

Margaret Kerins:

Dan Belton, you mentioned the bill supply in 2018, and we could be in for the exact opposite of that. On the one hand, it looks like we could have a trillion dollar pay down in bills, maybe a little bit more. At the same time, the decrease in Treasury cash balances will add $1.1 trillion to reserves, and just having gone through this most recent episode where had this wall of cash in the market and what it did to repo rates, how should we be thinking about a net decline of a trillion dollars in bills over the next few months?

Dan Belton:

Yeah, Margaret. You bring up a good point, and I think that the uncertainty that Treasury's issuance projections now bring with respect to bill supply have to lead to some wide ranges around our expectations for credit spreads. But as Dan mentioned earlier, the likely outcome that we're going to see is a terming out of Treasury's issuance. So I do think that while I brought up the story of 2018 bill supply as a potential precursor to what's going to happen in the corporate market, we are going to see a flood of Treasury supply further out the yield curve, and I do think that could crowd out longer dated corporate debt.

Dan Belton:

Now, with respect to bill issuance and its implications for the repo market, that is a lot less certain. I think the implications for repo and therefore swap spreads will depend a lot on these uncertainties with respect to Treasury's issuance projections, namely fiscal stimulus, and what that will mean for bill supply, as well as Treasury's cash balances. Will they run down these cash balances to the extent that they say, or is it going to be like previous quarters where they projected a rundown of cash balances that is ultimately not realized?

Dan Belton:

And I think the bottom line here is that the Treasury bill issuance projections that we are gleaning from Treasury's refunding announcement yesterday should act as a lower bound for what Treasury bill supply will likely be, with the potential for fiscal stimulus and continued elevated cash balances likely to lead to heavier bill issuance.

Margaret Kerins:

So I think, Dan, you raised a good point. If we get a trillion dollar stimulus package, we would expect a trillion dollar swing in bill issuance. These are big numbers with big implications for short-term markets, where we have had flows into government only money market funds that buy bills. So I think you hit it on the head, just quite a bit of uncertainty with regard to these projections, and the net negative trillion dollars in the first half of the year should be the lower bound, like you said.

Margaret Kerins:

I guess turning to the TBAC, and looking at some of the charges that Treasury has given the TBAC over the past few refundings, there has been a focus on how to decrease the percentage of bills outstanding relative to total outstandings. And bills historically represented about 15% of issuance. With the heavy issuance last year, got up closer to the 25% range. I think Treasury is concerned about how quickly they take bill supply out of the market, how quickly they reduce the bill auctions, and take outstandings down, and concerned about maintaining market functioning in the front end. It's clearly a concern, and I think that would argue for them to go a little slower with regard to bill reduction than what is implied by the refunding numbers that were released yesterday. That said, coupon issuance will remain heavy in 2021.

Ben Reitzes:

In Canada, we have kind of similar issues in the front end, in that there is also an excess of cash that is really overwhelming the market. Bill issuance in Canada has fallen notably, and that has created some front end issues that Bank of Canada has done their best to deal with that so far, or definitely could be coming on that front. But the issuance generally in the coming year is going to be down pretty much across the board. Just the better macro backdrop means lower issuance. And looking at the bond issuance in Canada, on a net basis, it is going to increase a little bit, just based on less Bank of Canada buying, but you're going from net negative issuance of about $20 billion last fiscal year to about plus $20 billion in the coming fiscal year.

Ben Reitzes:

So it's just a $40 billion swing, and relative to what we're going to see in the US, that is a minuscule move, to put it kindly. And one of our main thesis this year is that Canada will outperform in the ten-year sector, through at least the first half of the year. So the issuance part of that is a big theme, and so that's something we definitely expect to play out in the coming months.

Margaret Kerins:

So thanks, Ben. Let's summarize our outlook here. We've talked quite a bit about heavy coupon issuance, the possibility for a large swing negative in net bill issuance in the first half of the year, and just based on the Treasury quarterly refunding numbers. So we've discussed quite a wide variety of topics with regard to that, and so what I'd like each group to do is to summarize your high level points. What are your takeaways here? Let's start it off the way we started the podcast, with Dan Krieter and Dan Belton.

Dan Krieter:

I think for our market, there's really two main things to keep an eye on. And that's going to be the evolution of primary dealer inventories and Treasuries, and ultimately repo, because for us, looking at both swap spreads and credit spreads, the question is going to be, do risk assets begin to be crowded out by heavy Treasury supply? And if that's going to happen, it stands to reason that you'll see an increase in dealer inventories and potentially an increase in repo rates beforehand. That's what we observed in 2018, where there was a significant move higher in dealer inventories that precipitated the crowding artifact on credit spread. So if we start to see a similar pattern this year, I'll become more worried about credit spreads going forward.

Dan Belton:

And with respect to swap spreads, Treasury's bill issuance projections are going to be key, and we'll be looking at both fiscal stimulus and Treasury cash balances to see when and by how much Treasury bill issuance increases or decreases over the first half of this year.

Ian Lyngen:

So from the rates side, I would say that the primary near-term focus will be the extent to which the Biden plan can come to fruition, and what that means for immediate borrowing needs. However, when we put it in a broader context, what global central bankers have managed to achieve over the course of the last several decades by way of forward guidance and transparency is to largely remove a reasonable amount of volatility further out the curve, thereby compressing the outright yield curve in terms of levels. This doesn't mean that within this narrower regime, we won't see backups related to supply and rallies related to flight to quality. However, I think it's important to keep in mind that in the current global rate environment, outright nominal levels are low and will remain so until we break through to a higher plateau of real growth and inflation, and for that, I will be watching the path forward out of the pandemic and any ramifications related to the vaccination process over the next several months.

Greg Anderson:

So, in FX, I think what we need to be watching is the momentum of the dollar, and what I would call the dollar risk correlation. So, second half of last year, equities rallied a lot commodities rallied, and the dollar declined, which is kind of the normal relationship of the U.S. dollar and risk appetite. We had an expectation of the same, still do, for 2021. So, drift lower in the dollar, but that has not realized in the first month of the year. So, we've had equities are still bid, commodities still bid, but the dollar has drifted a little bit higher, and that's something that we need to keep an eye on.

Stephen Gallo:

I think my final remark will be that China's central bank effectively slowed the pace of RMB appreciation in January. It effectively parked dollar RMB and let it trade sideways and in doing so, it also paused dollar depreciation against other major currencies as well. So, what China does with its currency next will have a bearing on where the U.S. dollar goes versus its trade-weighted basket and how quickly it gets there. The other thing worth pointing out is that China's demand for U.S. assets and the pace of RMB appreciation will depend on how geopolitical risks evolve and the extent of moderation in China's own credit cycle. Clearly if the credit cycle slows rapidly, or more rapidly than expected, and China experiences fewer inflows, its demand for U.S. assets will also ebb.

Ben Reitzes:

Moving on to Canada, we're watching what's similar to the U.S. The macro backdrop is key here as well, and while Treasuries aren't likely to sell off significantly. For those with a bearish bent, I think getting long Canada against the U.S. services a soft short in the rates market, and then you add on the additional issuance profile with Treasuries having significantly more issuance in the coming year versus Canada's. Those are things we'll be watching.

Margaret Kerins:

Thanks, Ben. So, that's a wrap. Thank you to all of our BMO experts, and thank you for listening. This concludes Macro Horizons monthly episode 24, Taking Issuance. Please reach out to us with feedback and any ideas on topics you'd like us to tackle.

Margaret Kerins:

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