"CLARK…COULD YOU MAYBE SPARE A LITTLE EXTRA CASH?"

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I've written a couple of posts about the pending debt ceiling debate over the last few weeks, but let's move past that topic and assume the U.S. government will be able to resume its borrowing needs in full, come the fourth quarter. What will investors find when Treasury has the ability to come to market with its full arsenal of t-bill and coupon issuances? The latest press briefing from the nation's debt managers reminded me of the scene from the movie National Lampoon's Vacation when Cousin Eddie asks Clark, "Could you maybe spare a little extra cash?"

The Details

For the period of July through September, Treasury estimates it will borrow $96 billion in net marketable debt, but its financing requirement will then ramp up to a hefty $501 billion in the fourth quarter. Remember, the calendar's fourth quarter is actually the first quarter of fiscal year (FY) 2018. To put the fourth quarter number into perspective, the figure would be more than the projected $426 billion for all of FY 2017 combined, underscoring the added burden for the upcoming quarter.

The "Whys"

What's causing such a huge increase in the government's borrowing needs? First, the underlying budget deficit will need to be addressed. For the record, thus far in FY 2017, the red ink total has come in at -$523 billion through June, leaving one-quarter of the current fiscal year still remaining. For FY 2018, the Office of Management and Budget is projecting the deficit to come in at -$589 billion, up $149 billion from the prior estimate. Second on the list is Treasury's goal to lift its quarter-end cash balance back to a more "normal" level of $360 billion for the end of December. The debt managers foresee their September quarter-end balance dropping down to a low of $60 billion, compared to $353 billion a year ago. This drawdown reflects outlays that will be needed as a result of the stagnant debt ceiling. Along those lines, Treasury stated that it "expects to be able to fund the government through the end of September."

The Final Piece

The final piece of the puzzle involves the Federal Reserve (Fed), or the effects that will be forthcoming once balance sheet normalization begins. Treasury, like the fixed income markets, anticipates the Fed beginning this process in October and lasting throughout FY 2018 and beyond, based on the most recent addendum to the Federal Open Market Committee's "Policy Normalization Principles and Plans." As I discussed in an April 2017 On the Markets, since the Fed has included Treasuries in the reinvestment phasing-out process, Treasury will now need to issue additional debt to the public to make up for what the U.S. central bank is no longer rolling over at auction, a point highlighted at the quarterly press briefing.

For the current quarter, the debt managers intend on keeping coupon issuance sizes t their present levels. However, they readily acknowledge that will have to change going forward and plan on boosting t-bill amounts first, and then nominal coupon auction amounts as the Fed's redemption process unfolds. For the record, there was no mention about ultra-long

(50- or 100-year) bonds, a step the Treasury Borrowing Advisory Committee (TBAC) did not "see evidence of strong or sustainable demand" for back at the May quarterly refunding. Interestingly, TBAC did recommend the reintroduction of the 20-year bond at that time, if Treasury needed an additional instrument to help fill the Fed redemption shortfall.

Conclusion

The bottom line is that Treasury supply considerations are usually not the primary driver of interest rate trends. However, they can affect rate direction on a broader scale, and that is why the Fed's balance sheet normalization process could end up being "the gift that keeps on giving the whole year."

Unless otherwise noted, data source is the U.S. Treasury, as of August 2, 2017.

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Treasury Bill : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).

Federal Reserve : The Federal Reserve System is the central banking system of the United States.