US deficit: Time to pay up

The cost of the macro shutdown was always going to be big. In the US, there is a $3trn funding gap to be filled in Q2. That's massive for an economy that had a size of $21trn at end 2019 (it's lower now). Pressure for more long-dated bond issuance is forcing up long rates. Important that this is contained, as it acts against the other emergency measures

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The deficit numbers are big and scary

This is a macro freeze like no other.

Economies have been brought to a stand-still. Governments have had to fill the vacuum with massive spending increases. The size of this job is in the region of $3trn for the US. Add to that a typical deficit in the area of $1trn, and we are staring down the barrel of a near $4trn funding requirement. That is a massive number.

The size of the US economy at the end of 2019 was $21trn. It's lower now, and a near $4trn funding requirement is the equivalent to almost 20% of that.

And it shows up in the funding requirement for the period ahead

The regular monthly and quarterly funding activities are slow-moving and less receptive to swift change. The target for the next instalment of this was announced this morning at $96bn.

On the one hand, this is a record high for the 3yr, 10yr and 30yr mid-month instalment. On the other, it is not a massive uplift from the $84bn that has typically been done. The nuance is the extra issuance in the longer tenors, and moreover an extra $20bn to be done in a new 20yr, as a separate exercise a week later.

In 1Q20 the Treasury raised $477bn in bonds and in 3Q they estimate $677bn. The latter is more indicative of the underlying issuance in bonds to be expected in 2Q (but could be higher). Well up on what was done on 1Q, but not dramatically so. It can't be, at least not all in one go. There will be increases in auctions sizes for all maturities and bond types (with the small exception of inflation-protected securities).

A SOFR-linked floating rate note is also being explored as another avenue for extra financing raising.

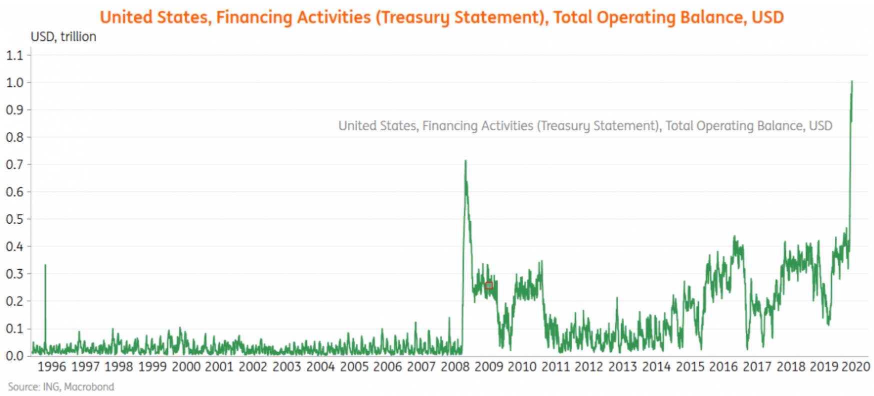
Bills are taking the pressure, but so are longer dated bonds

That still leaves a funding gap however, as the funding requirements for 2Q alone is in the region of $3trn. That can only mean that the Treasury will continue to build liquidity using other additional means.

One of the most pertinent and flexible instruments is bills issuance, and in particular cash management bills. These can be turned on and off practically at will, and there is good demand for them. Previous crises saw bills take the weight of emergency issuance requirements; the same is playing out here.

Latest data show that the Treasury had already built up a $1trn cash balance, with the bulk of that coming from additional bills issuance (coming off a $400bn base). That will have to morph out the curve though, else there is a big roll-over job to be done. That is not a big issue for now, especially given how receptive the market is for bills. But that is also not a permanent solution.

Hence the extra lifting now being required from longer issuance, and the pressure for a steeper curve from the back end.



Important that long rates remain relatively low; they likely will

While pressure for high long tenor rates makes sense if there is more supply being pushed out there, it is also important that it does not become a persistent pressure. Low rates are part of the solution here. Cheap funding costs are a requirement for all players, and the US Treasury curve sets the base funding cost.

Given the dis-inflation environment that we have, there is no huge risk here. But at the same time, it is one that needs monitoring. For now, the most likely outcome is a moderately steeper curve from the back end, with the 2yr still anchored on the front end (in fact still could get to zero before we're finished with this mess).

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