Beneath the Surface

January 2025

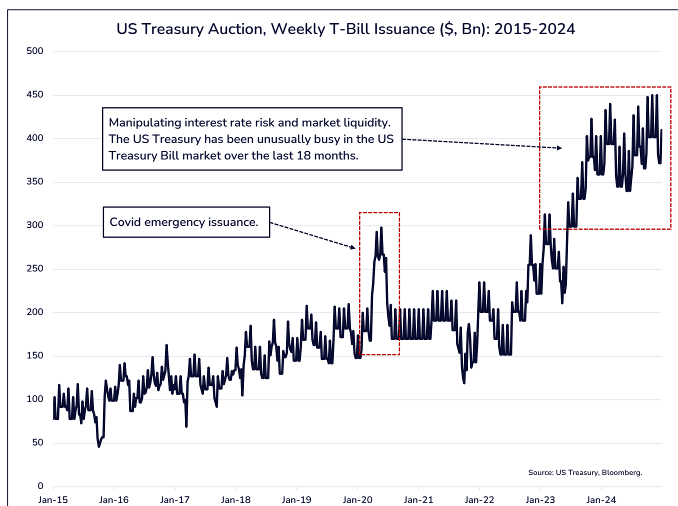
SIGNET

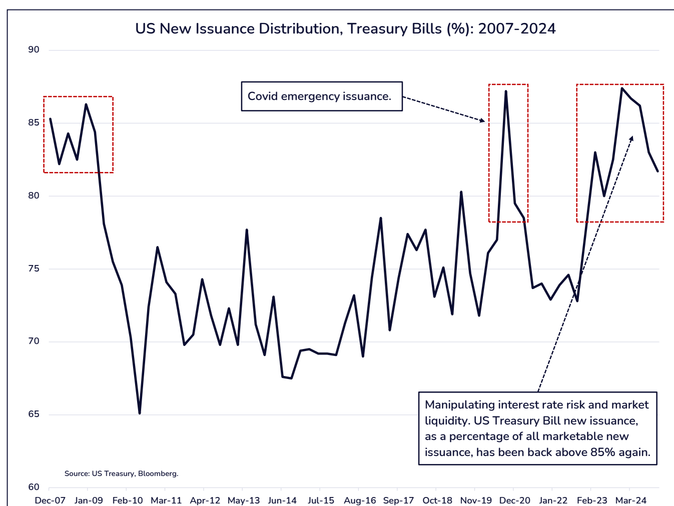
Stealth Liquidity

- US non-financial debt grew by $3.5 trillion to $76.4 trillion from Q3 2023 to Q3 2024. Most of it ($2.3 trillion) was federal government debt. Nominal US GDP grew by only $1.4 trillion over the same period. Lower interest rates will be required to service the rising debt levels, relative to GDP, probably in conjunction with a non-commercial balance sheet to carry it, if federal debt is not to crowd out productive private enterprise elsewhere. The US government has been operating a pro-cyclical fiscal policy for the last few years and this became more apparent heading into the presidential election. The federal deficit hit a staggering $1.83 trillion (6.2% of GDP) for the 2024 fiscal year. This is the third largest budget deficit in history, exceeded only in 2020 and 2021 during Covid. By Q4 2024, the government interest expense on its debt came to $1.13 trillion, or 23% of total 2024 fiscal year federal revenue.

- There is a further angle to this counter-cyclical fiscal policy that can be highlighted. Suggestions have been made that the US Treasury has been exploiting the maturity profile of its debt issuance over the last year to further 'juice up' growth. US Treasury (TBAC) guidelines recommend that total marketable debt should normally comprise Treasury Bills in the 15%-20% range, and where Bills are used more as a residual in issuance planning. Historically, issuance taking this range higher, relative to Treasury Notes and Treasury Bonds, has only been seen during moments of market stress, such as Covid or during the Great Financial Recession. However, since November 2023, Bills as a percentage of total marketable debt have been ranging 21.5% to 22.5%. We can visualise this dynamic using the weekly Treasury Bill auction, which has seen a noticeable pick-up in size, from averages of $200 billion a week in 2021-22, to $400 billion a week in 2023-24 (chart, below left). Alternatively, we can see the shift to Bills via the new issuance distribution (chart, below right), where Bills have recently represented 85% of all new issuance.

- Why is this important? If the Treasury has been manipulating the maturity profile of its debt issuance, and the aggregate interest rate risk the market is forced to consume, then the Treasury has been temporarily easing financial conditions and the economy. The liquid nature of Bills makes them a close substitute for bank reserves, and more Bills represent more pristine collateral, which is used for rehypothecation purposes. Through the 'portfolio balance channel', investors' government duration (risk) is lowered, freeing up precious balance sheet capacity to extend duration risk by other means (corporate securities, loans and credit). This stealth liquidity has been called Activist Treasury Issuance (ATI) by Nouriel Roubini and Stephen Miran (Hudson Bay Capital). The accusation suggests the Treasury has been neutralising the Fed's recent quantitative tightening (QT) efforts. Roubini and Miran submit that ATI has been a major market driver over the past year, and they expect it will continue to play a significant role in the years ahead. While the Treasury denies any strategy to manipulate maturity profiles, the high level of Bill issuance may have provided the banking and shadow banking industry with extra liquidity, which is asset price supportive. Recall, the yield curve has been inverted. A sudden reversal of issuance towards Notes or Bonds, all other things being equal, may impact market exuberance and place greater upward pressure on longer-dated interest rates.





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