

January 7, 2025

No, the Debt Ceiling Hasn't Gone Away

- Bill issuance will slow as the debt ceiling binds
- TGA drawdowns will potentially obscure declining liquidity and keep reserves flush
- Once the debt ceiling is resolved, the TGA rebuild might reveal lower-than-comfortable reserve levels
- iFlow continues to show a retreat from USTs by cross-border investors – a concern with yields at these levels

Debt Ceiling Dynamics Could Return

With funding markets calming down after some short-lived volatility at the end of the year, attention turns to what's next in money markets. We're likely facing a period of slowing – eventually becoming negative – bill issuance in the first part of the year, as the debt ceiling returns as an issue. In addition, and relatedly, the drawdown of the Treasury's General Account (TGA) while “extraordinary measures” are deployed will keep reserve levels buoyant, possibly obscuring a decline in systemwide liquidity.

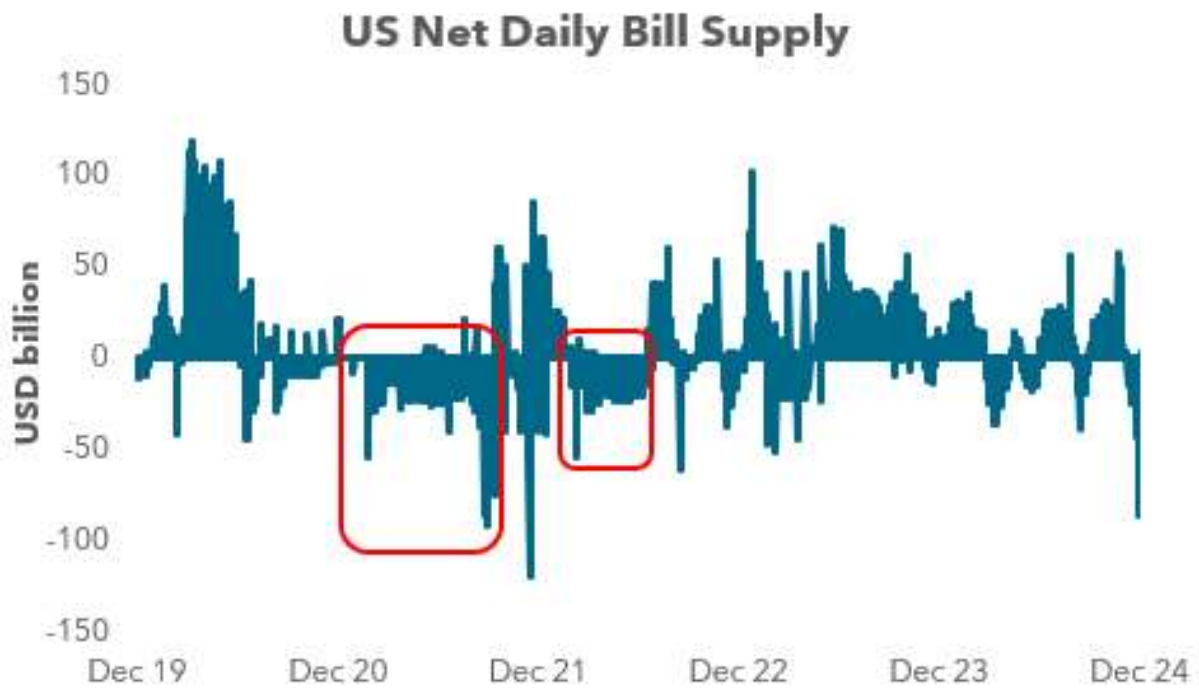
Yes, the debt ceiling, which bound at \$36.1trn on December 31 last year, is yet again an issue for the new Congress to contend with. Many might have presumed that raising – or even eliminating – the ceiling would be a straightforward affair, given Republican control of the executive and legislative branches of government. However, in the last-minute negotiating to avert a government shutdown at the end of December, over three dozen Republicans in the House voted against a continuing resolution which included eliminating the ceiling.

Currently, Treasury – as stated in a letter in late-December – doesn't see the need for extraordinary measures until the second half of January, and market consensus is that the X-date will occur sometime in late summer of this year. Still, if the new administration truly wishes to enact an extension of the 2017 tax cuts and/or additional reductions in taxes, the debt ceiling will have to be raised alongside any legislation dealing with fiscal policy. Something to keep an eye on in the coming months.

Treasury T-bill issuance has already been reduced in December 2024, and if we get deep into extraordinary measures to stay under the debt ceiling, we expect supply to be further curtailed. Exhibit #1 below shows that during the two most recent debt ceiling standoffs daily net bill supply was negative. The red boxes in the chart highlight bill issuance during these episodes. This decline in bill supply could indeed prevent RRP from falling significantly as

long as the period of uncertainty lasts, given the lack of available bills for money market mutual funds to buy.

Exhibit #1: Bill Supply Set to Dip



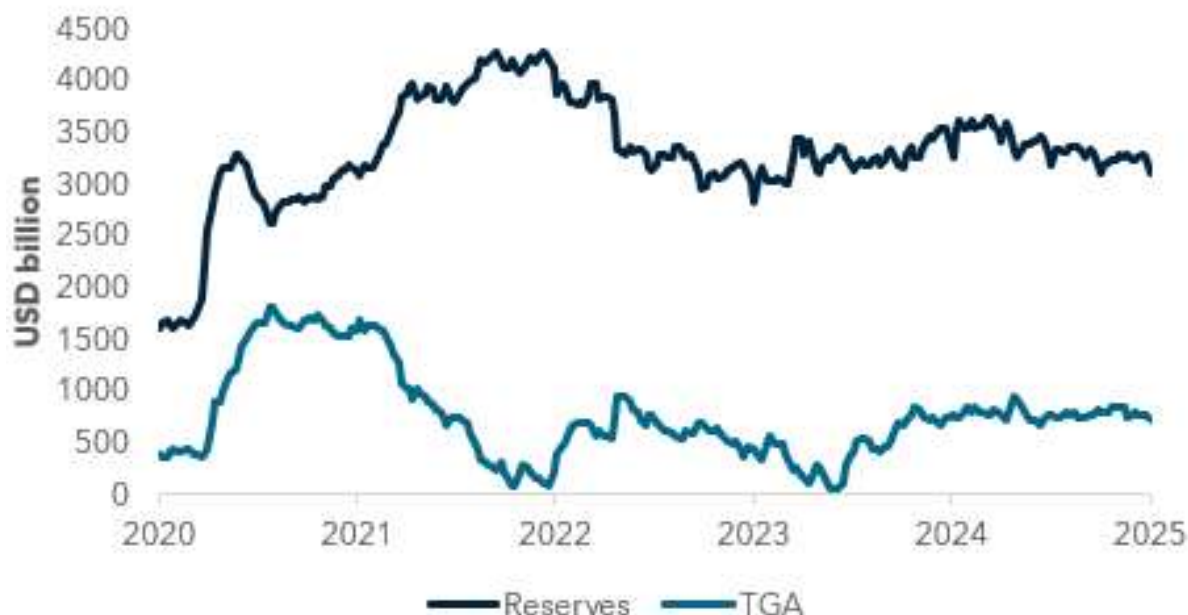
Source: BNY Markets, Bloomberg, US Treasury

Furthermore, the TGA, currently over \$700bn, will be drawn down, as it was during the two previous debt ceiling debates, as Treasury spends accumulated funds to avoid issuing new debt until the ceiling is eliminated or raised. There is an inverse relationship between the TGA and systemwide reserves. When TGA falls, these monies primarily find their way into reserves, as money is employed in the economy.

This process would have the effect of keeping overall reserve levels elevated, potentially concealing a more systemwide decline in system liquidity. This means that once the ceiling is resolved in whatever manner, the rebuild of the TGA that would follow could drain reserves quickly from the system, potentially creating volatility in funding markets at that time, imperiling quantitative tightening (QT). Exhibit #2 shows how the TGA reacts during debt ceiling episodes, and the subsequent rise in reserves – especially visible during the end of 2021, when the debt ceiling came close to being breached.

Exhibit #2: TGA Flush, Reserves Steady

US Total Reserves and TGA



Source: BNY Markets, Federal Reserve System Board of Governors

Cross-border Investors Still Shunning USTs

Since our last report published before the holidays, the US 10y yield has risen to around 4.6%. This compares to around 3.6% in September, and a local low of around 4.2% in early December. It is tempting to ascribe this increase to a dialing back of Fed rate cut expectations, and a change in the Summary of Economic Projections from four cuts for 2025 as seen in the September SEP, to just two cuts implied by the December projections. However, given the relative stability of the 2y yields at around 4.2% over the last several months, we dismiss this explanation.

We feel that the long end's behavior is relatively divorced from Fed rate expectations, and more likely due to concerns over likely expansionary fiscal policy. The 10y TIPS yield, mirroring real rates, has moved up from 1.5% in early October to 2.6% now, probably reflecting a combination of expected administration policies, including tariffs, immigration policy, and fiscal expansion. The term premium for the 10y note is now up to nearly 50bp, the highest such level since 2015.

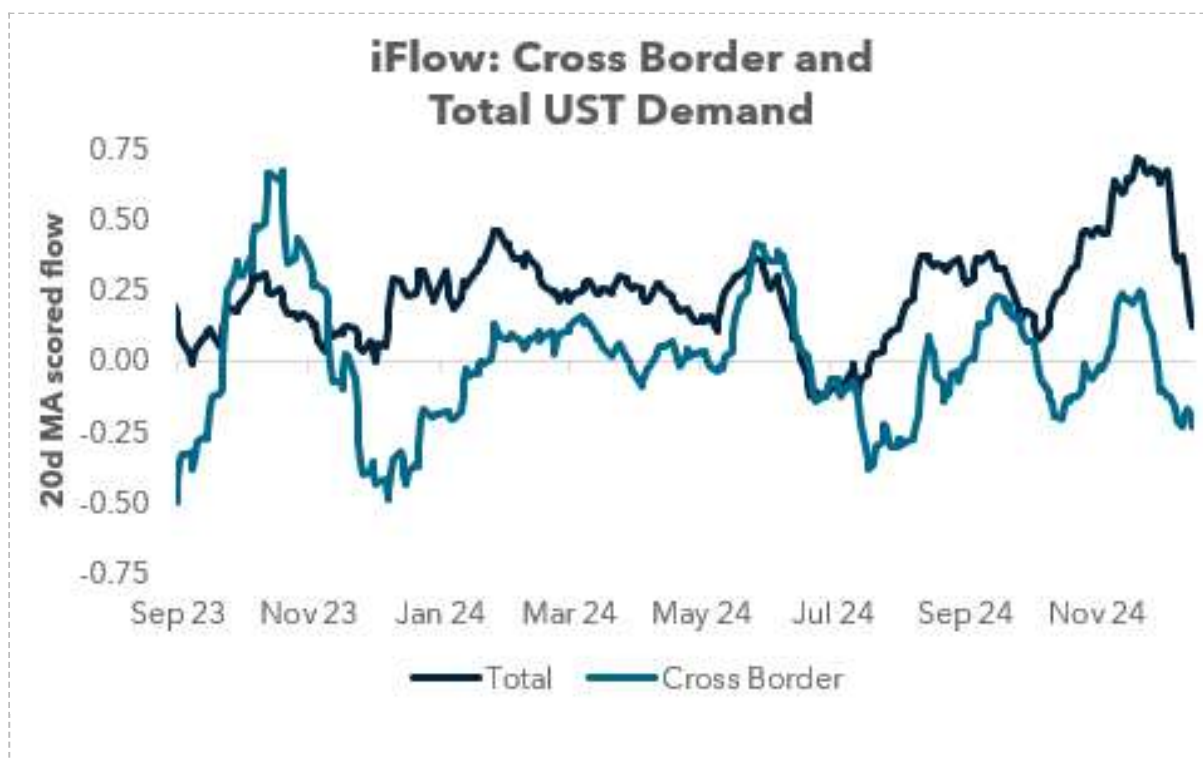
iFlow continues to show broad-based cross-border sales of USTs, almost across the entire curve. Exhibit #3 plots a time series of the 20-day moving average of scored flows into all Treasuries. It shows an overall decline in all flows (total and cross-border combined), along with perceptible outright sales by overseas investors.

Exhibit #4 shows the term structure of flows across the six maturity buckets we break out. With the exception of the 1-3y segment, cross-border flows are negative. This is something we have been warning about since the election, with bear steepening as the likely outcome. Foreign demand is waning even while the reward for buying Treasuries at these levels keeps rising (in the form of a positive term premium). In recent episodes of rising 10y yields, when the term premium became sufficiently positive, cross-border investors have returned to US bonds, clipping a much more attractive coupon.

We haven't come close to receiving any concrete details about the administration's fiscal and other plans, yet the curve keeps steepening. If the news – when it does come – conforms to

what we have been told regarding tax cuts, tariffs, and immigration, we think 5% yields are not out of the question. Whether or not that level is sufficient to attract cross-border investors back into the market will be key to determining the limit of curve steepening we expect. In the two recent periods when yields approached 5%, we saw such a shift in allocations. This time could be different, especially if the ambitious tax-cutting agenda endures and is enacted.

Exhibit #3: Retreating from Treasurys



Source: BNY Markets, iFlow

Exhibit #4: Foreign Neglect



Source: BNY Markets, iFlow

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

Disclaimer & Disclosures



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