

Short-End Notes

Make way for FRNs

- **First FRN auction in Jan 2014** –Treasury announced the first auction of 2y floating rate notes (FRNs) linked to the 3m T-bill auction rate will be held in January. Auction sizes will range between \$10-15 billion and we expect larger quarterly new issues with smaller monthly reopenings. The initial spread to 3m T-bills may be as high as 5-10bp, but we think it will compress as liquidity builds in the product.
- **Expect CMB in late Nov. and Dec.** – We expect around \$55 billion in cash management bills to be issued in late November and early December.
- **Low T-bill issuance in Jan. heavy in Feb.** – Treasury may need to drop the size of bill auctions in January as it seeks to match cash balance at the end of the debt ceiling suspension period (Feb. 7) to that at the beginning (Oct. 17). Bill issuance would then ramp up dramatically over the remainder of February.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Make way for FRNs

Expect \$120-140 billion in FRN in 2014.

This week Treasury announced its near term issuance plans. As expected, Treasury will begin issuing floating rate notes (FRNs) in 2014 with the first auction scheduled for January 29.¹ FRNs will mature in 2 years but have close to zero duration since FRN interest rates will reset each week to the clearing rate in the 3m T-bill auction.² New issues will be issued once each quarter (at the end of Jan., Apr, Jul and Oct.) and the on-the-run issue will be reopened at the end of each of the other 8 months. FRN auctions will range in size between \$10-15 billion/mth or \$120-140 billion/yr, which will displace that much T-bill issuance. We think Treasury will set larger new-issue auction sizes (e.g. \$15 billion) with smaller reopenings (e.g. \$10 billion). FRNs will accrue interest daily and pay interest quarterly.

A number of factors go into determining the spread at which Treasury FRNs will trade relative to T-bills:³

Liquidity premium may be less than 10bp.

1. **Liquidity premium** - We expect FRNs to be less liquid than T-bills and investors to demand higher FRN yields as compensation for the relative illiquidity. When TIPS were first introduced, the small market size and absence of a natural institutional buyer caused the securities to trade with a significant liquidity premium. Similar to TIPS, the market for FRNs will be relatively small, totaling at most \$140 billion at the end of 2014, less than 10% of T-bills outstanding. However, in contrast to the TIPS launch, we expect strong demand for FRNs from the money market mutual fund (MMF) community. While we could see somewhat wider spreads initially, we think liquidity premium on FRNs will quickly move to levels more comparable to spreads we see in the agency discount note market, implying a liquidity premium of less than 10bp.

Lower duration implies -2bp yield adjustment.

2. **Duration difference** – FRNs have a lower duration than even 3m T-bills. Typically 3m T-bill yields will be slightly higher than expected average overnight rates as investors demand compensation for bearing duration risk. Historically, we estimate that the term-premium in 3m yields has averaged around 2bp. If anything, term premium is probably lower in the current environment given that 3m bills are yielding only 5bp. Hence the lower duration of FRNs should lead to lower yield levels, but not enough to fully offset the liquidity premium.

Zero floor probably is not a major driver of the spread

3. **Zero rate floor** – If a 3m T-bill auction clears at a negative rate, FRNs will accrue interest at 0bp. This floor is valuable in a low rate environment. While we expect the Fed's reverse repo facility to help put a floor on the level of overnight repo rates, we note that strong demand for cash bills can cause T-bill rates to trade through repo rates. While this floor offers some value, it is unlikely to be very large. Even if investors expect a 50% probability of a 6 month period of -10bp 3m bill rates, the floor would be worth about 2.5bp. Given current expectations are not this extreme, we think the floor is likely worth less than 2.5bp.

Taken together these considerations imply an initial spread of FRNs to T-bills of 5-10bp might be reasonable. As the FRN market expands in size and liquidity picks up, the spread may compress substantially.

¹ See [tentative US Treasury auction schedule](#). A [sample term-sheet](#) for FRNs is also available.

² FRNs are technically daily reset securities with the rate resetting daily to the most recent 3m T-bill auction rate. This technical distinction is important as it allows MMF to count the securities as 1-day instead of 7-day securities for the purpose of WAM calculations. Under rule 2a-7 MMF must keep portfolio WAM under 60 days.

³ For a similar discussion with some additional details, please see our piece from [Dec. 2012](#).

T-bill Issuance may be volatile in early 2014

Expect \$55 billion in CMB in late Nov. / early Dec.

With coupon auction sizes set to decline only slightly over the remainder of Q4 and then remain unchanged in Q1 2014, T-bill issuance will have to adjust as Treasury's cash needs rise and fall with seasonal factors. We project that cash will begin to run low in late November and expect Treasury will issue about \$55 billion in cash management bills (CMB) to bridge the gap. We think this might come in the form of two bills, one issued the last week of November and the other the first week of December. CMB would mature on or around Dec. 16 when tax inflows are expected.

Cash will build in December.

Between late December and the end of January we expect cash balances to build considerably as cash needs are relatively light. Cash balance at the beginning of 2014 will be particularly high as FHLMC announced it will pay a \$30 billion dividend to Treasury on Dec. 31. We note that this will not extend the ["hard" debt ceiling](#) deadline as it will occur prior to the Feb. 7 end of the debt ceiling suspension period.

Treasury may need to match \$46 billion Oct. 17 cash balance on Feb. 7.

Counterintuitively, the large cash stockpile may present a challenge for Treasury. When the debt ceiling was suspended on October 17, the legislation instructed Treasury only to issue debt to cover current obligations until the suspension period ends on February 7th. Treasury has interpreted this in the past as implying that cash balance on Feb. 7, the end of the period, should not exceed the cash balance at the beginning of the period (Oct. 17). On October 17, cash balance stood at \$46 billion much lower than the over \$150 billion cash balance we expect Treasury to end the year with.

Issuance may drop in January, then rise significantly in February.

This means that Treasury may need to cut T-bill issuance substantially in January. We would not be surprised to see the 1m bill auction size drop as low as \$20 billion and the 3m bill reduced to as low as \$25 billion. While reductions in 6m and 3m bills could start as early as late December, we think most of the cuts would come in January. Following hitting its Feb. 7 \$46 billion mark, Treasury will need to rapidly ramp up issuance to cover tax refunds and we could see the 1m, 3m and 6m auctions taken back up to around \$35bln, \$34bln and \$30bln respectively. Treasury would also likely need to issue a large CMB shortly after Feb. 7, followed by one or more smaller CMB issues. The swings in issuance are likely to impact short-term rates with periods of higher issuance implying higher repo and T-bill yields.

Figure 1. Treasury may need to bring cash down ahead of Feb. 7

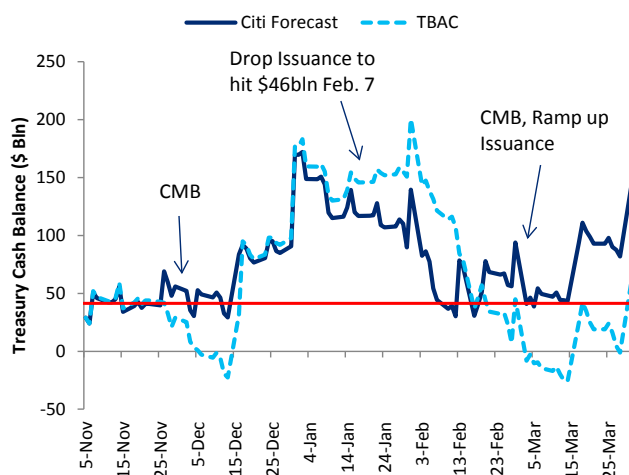
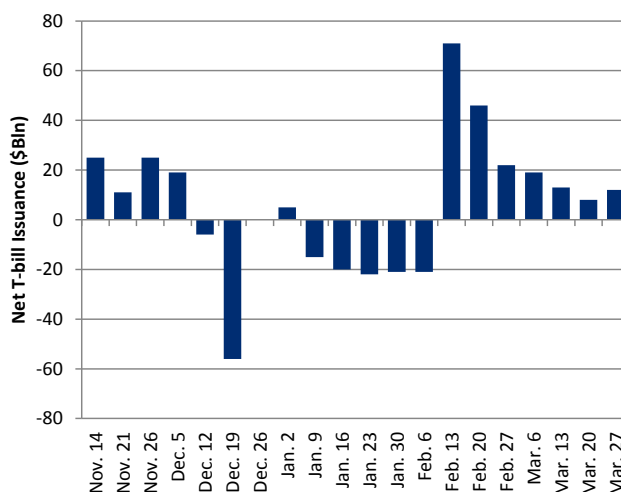


Figure 2. Negative issuance may rapidly switch to positive in Feb.



Source: Citi Research, Based on Citi or TBAC issuance forecasts and Citi forecasts of Treasury daily cash needs

Source: Citi Research, Citi Forecasts, includes CMBs

Appendix A-1

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