BNY
iFlow
SHORT THOUGHTS

July 16, 2024

T-bill Supply and Liquidity Concerns

Will Increasing Bill Issuance Hamper Market Liquidity?

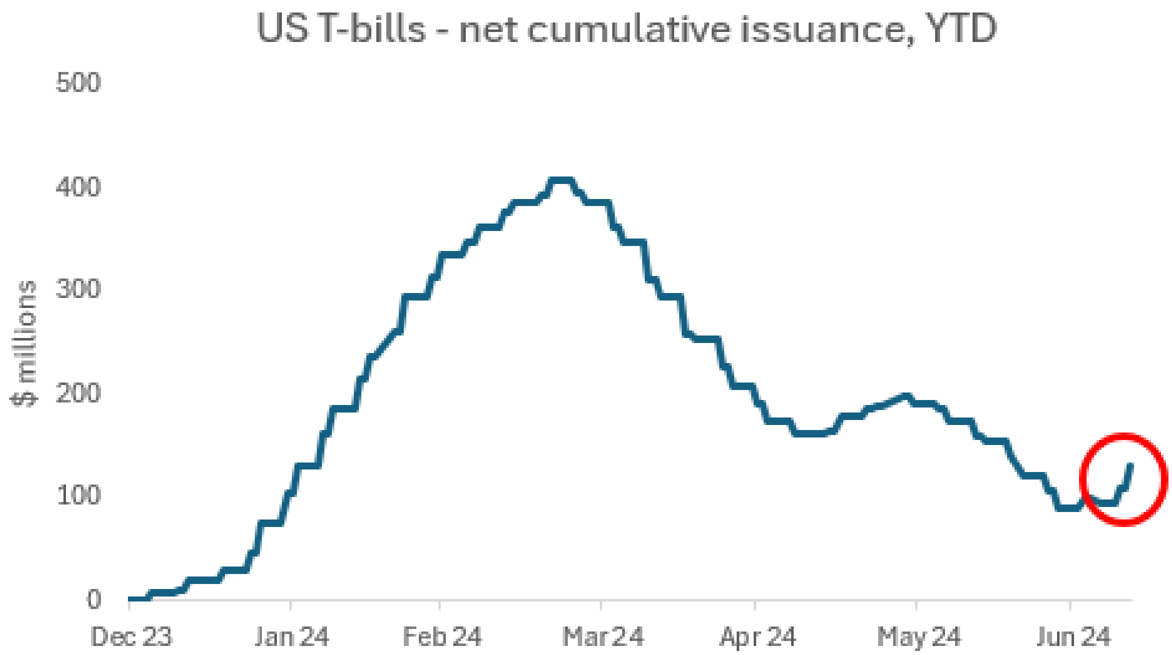
- Treasury is set to ramp up T-bill supply. Combined with likely lower rates, concern over liquidity is growing.
- iFlow shows investors selling short paper, and RRP drainage has stalled.
- SRF usage is also picking up – albeit lightly
- We feel system-wide liquidity is adequate

We're Monitoring the Situation but Aren't Ready to Sound the Alarm

US T-bill issuance is picking up again, after having fallen by over $300bn since the end of March through the beginning of July. At the same time, expectations are increasingly coming around to our view that the Fed will be cutting rates, likely as early as September. The combination of these two facts has made some market participants question if increasing bill supply can be absorbed by markets. Furthermore, with recent concerns about funding market liquidity (see here), there is also a question as to whether or not a shortfall in bill demand will increase funding strain.

The chart below shows cumulative net T-bill issuance (daily) since the beginning of the year. Note the large increase in supply in the first quarter, followed by a sizeable decline from the end of March through the beginning of June. Treasury has since been increasing auction sizes and is expected to continue issuing bills at a heavy clip throughout the summer.

After Declining, Bill Supply is Picking Up Again

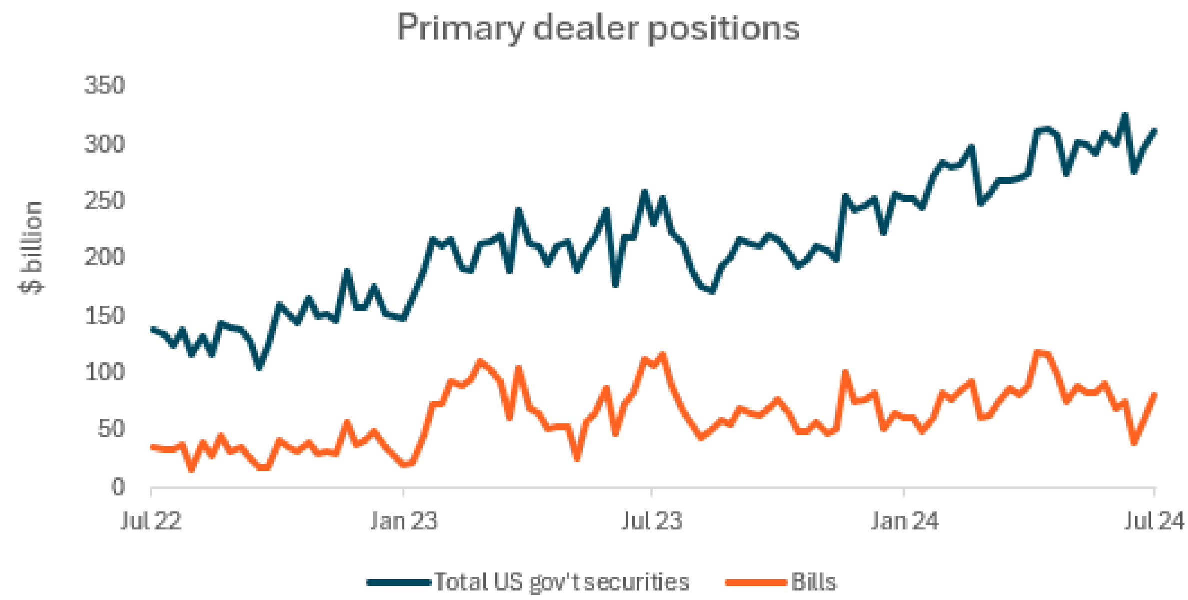


Source: BNY Mellon Markets, US Department of the Treasury

Typically, we would expect this increased bill supply to be absorbed by money market mutual funds (MMFs), transferring their assets from the Fed's reverse repurchase facility (RRP), which pays 5.3%, into more attractively yielding securities like bills. Don't forget that the RRP's decline has essentially halted since the end of March, coinciding with the decline in bills issuance. Over that period, the facility's take-up has been steady at just above $400bn, with only a few isolated forays higher or lower on individual days. Will RRP balances return to buying T-bills once supply increases? If not, who will?

Primary dealers, according to Federal Reserve data, currently hold over $300bn in overall Treasury securities, close to an all-time record (although only around $80bn of that is in bills). But some have mused that if MMFs don't switch their RRP allocations into bills, and dealer balance sheets are full up, there may not be a roster of potential buyers to absorb upcoming supply.

Primary Dealers Stuffed with Paper

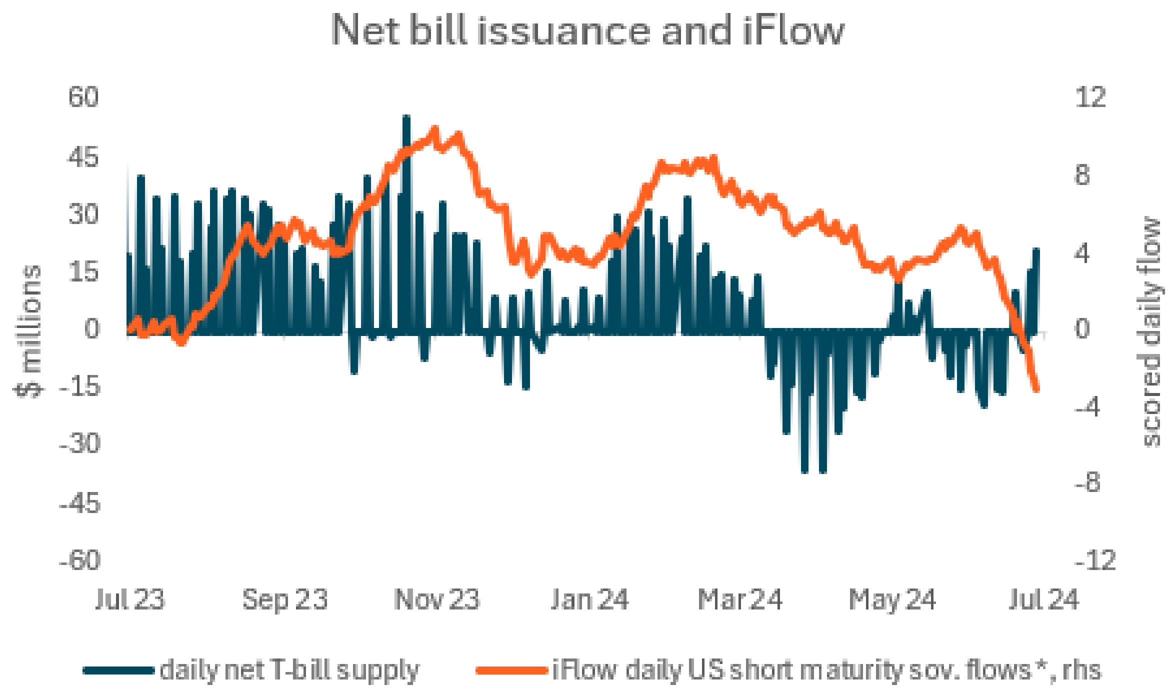


Source: BNY Mellon Markets, Federal Reserve Band of New York

Via our iFlow data, real money investors have also been reducing their buying of short-term government debt in the 0-1y bucket of the curve. The chart below actually shows outright selling recently. There does appear to be some relationship between supply and investor inflows, however, so we'll be watching for signs of a turnaround in flows as bill supply increases.

Likely upcoming rate cuts add to the fears, with yields on bills expected to fall in concert with lower policy rates, making them less attractive. However, we are less concerned about this potentiality. The RRP reward rate is currently 5.30%, 20bp below the upper level of the target federal funds rate's range. This 20% gap has been consistent throughout the policy cycle. As the funds rate rose, the RRP rate climbed correspondingly. A rate cut of 25bps to 5.25% would almost certainly be matched by a change in the administered RRP rate, down to 5.05%. This would continue to make RRP usage less attractive than the likely rate of return in the bills market. To us, increasing bill supply will dominate over the lower policy and administered rate.

Will Investor Flows into T-bills Resume with Increased Supply?



Source: BNY Mellon Markets, iFlow

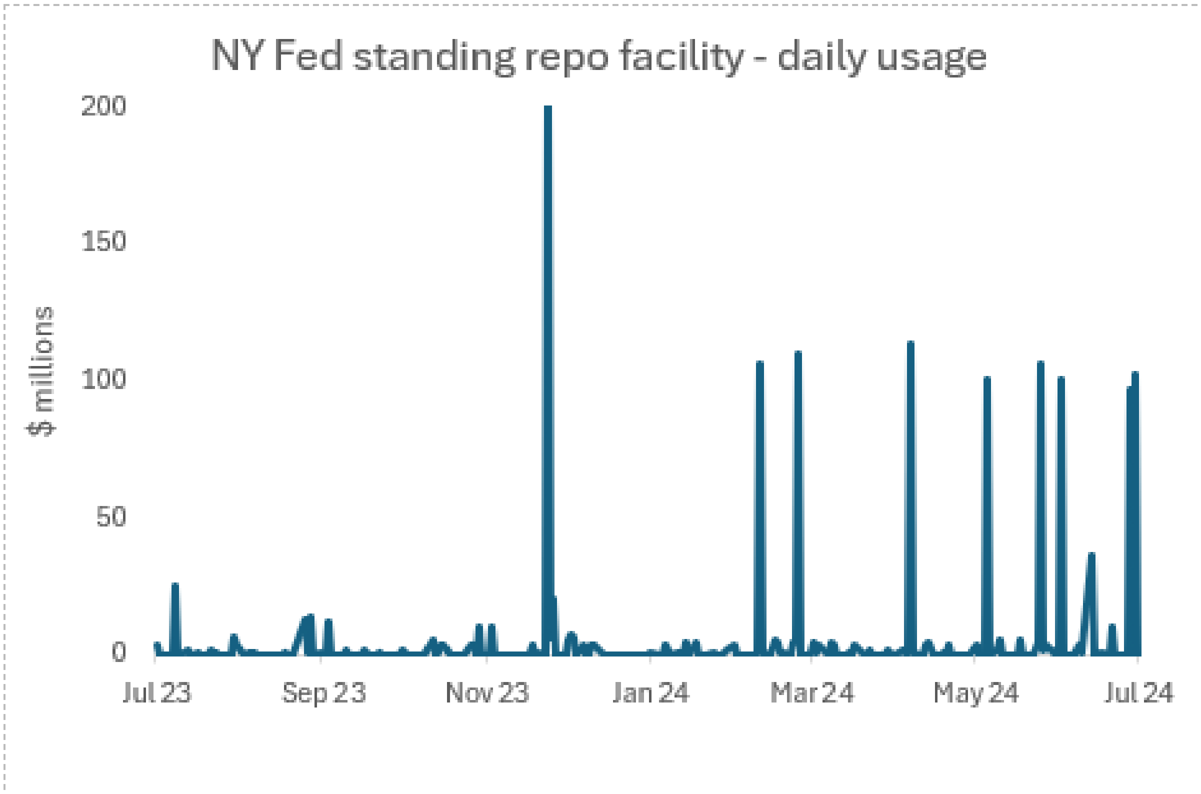
*Flows into 0-1y maturity sovereign debt

Furthermore, although funding market rates like overnight repo and SOFR have been elevated since the quarter-end in June, there is a combination of explanations that don't imply the worst-case scenario of a money market squeeze. Treasury settlements have been chunky in recent weeks and promise to be so in the coming days. This takes cash out of the system as investors fork over money to the Treasury for their bond purchases.

Finally, it bears watching the Fed's Standing Repurchase Facility (SRF), which offers a place for banks to lend collateral to the central bank in return for cash liquidity. The SRF has been little used since it was set up in July 2021 when the Fed announced QT would commence. However, in recent days and weeks, it has seen numerous small value take-up, typically around $100mn or less. These actions don't seem to be evidence of a liquidity squeeze, but more likely "test" trades by counterparties to make sure access to the facility works. Still, it might make one wonder if these tests are for a reason – could counterparties be testing in preparation for the SRF to be actively used to address a liquidity shortfall?

We don't think so, to be frank. SRF appears to be associated with a stigma, much like the discount window is, although the Fed has been strident in encouraging its use if necessary. Recent data from the Fed's Senior Financial Officer survey, in which bank CFOs reply to a series of questions on balance sheet policy, rank the SRF quite low in attractiveness.

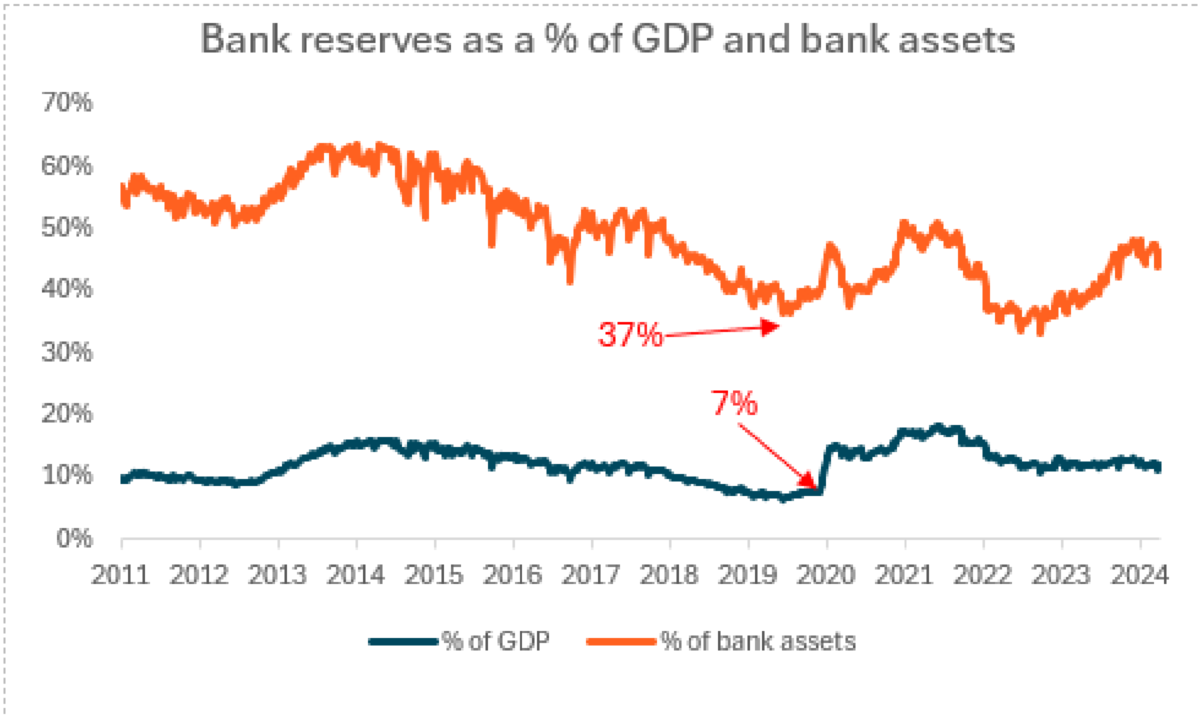
SRF Testing



Source: BNY Mellon Markets, Federal Reserve Bank of New York

Moreover, the amount of overall liquidity in the banking system is currently – and still – abundant. Total bank reserves amount to over $3.4trn. In terms of total bank assets, that's about 44%, still rather high. As a percentage of US nominal GDP, reserves are about 11%. This compares with ratios of 37% and 7%, respectively, at the time of the September 2019 repo market episode, when markets seized up, causing the Fed to undertake extraordinary liquidity operations.

Abundant Reserves



Source: BNY Mellon Markets, Federal Reserve Board of Governors, Bloomberg

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In conclusion, we’re not yet worried about bill supply meeting inadequate demand, nor do we anticipate funding market stresses on the horizon. Nevertheless, we’d like to see repo rates settle down and RRP usage to resume its decline. We are – as the Fed might say – monitoring these developments for signs we’re wrong, but so far, we don’t see reason to panic.

Disclaimer & Disclosures

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

John Velis
AMERICAS MACRO STRATEGIST

CONTACT JOHN

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