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SHORT THOUGHTS

October 1, 2024

Quarter-end, or Something Else to Keep an Eye On?

A number of concerning developments

- The Fed's Standing Repo Facility saw its biggest ever use on Monday
- Repo rates remain high, although quarter-end could be responsible; still worth keeping an eye on
- Are reserves transitioning from abundant to merely ample, potentially imperiling QT?
- With lower bill yields and repo stress, MMFs' new assets are going into RRP

A number of developments in money markets in the days since the Fed cut interest rates by 50bps could lead to some concern that overall liquidity is getting tighter.

• On Monday, the Fed's overnight Reverse Repo Facility (RRP) swelled to $465bn, its highest level since the end of June earlier this year, which also corresponded to quarter-end dates.
• Overall, sponsored repo volume is the highest it's ever been, at nearly $1.6trn.
• Total bank reserves fell to $3.17trn last week, their lowest levels since October last year.
• The manager of the Fed's System Open Market Account (SOMA) suggested that "frictions" in the repo market – such as counterparty risk limits – have driven repo rates higher and may take some time to resolve (see the recent speech here).
• The New York Fed's Standing Repo Facility (SRF) was tapped for a record $2.6bn on Monday, as repo rates stayed elevated.

Most of these developments have rather benign explanations, if taken one by one. For example, one we've heard for a while relates to the counterparty risk limits in repo. Bank reserves might have fallen due to quarterly income tax payments that were due the previous week. The RRP often rises at month- and quarter-end and we may just be observing calendar affects.

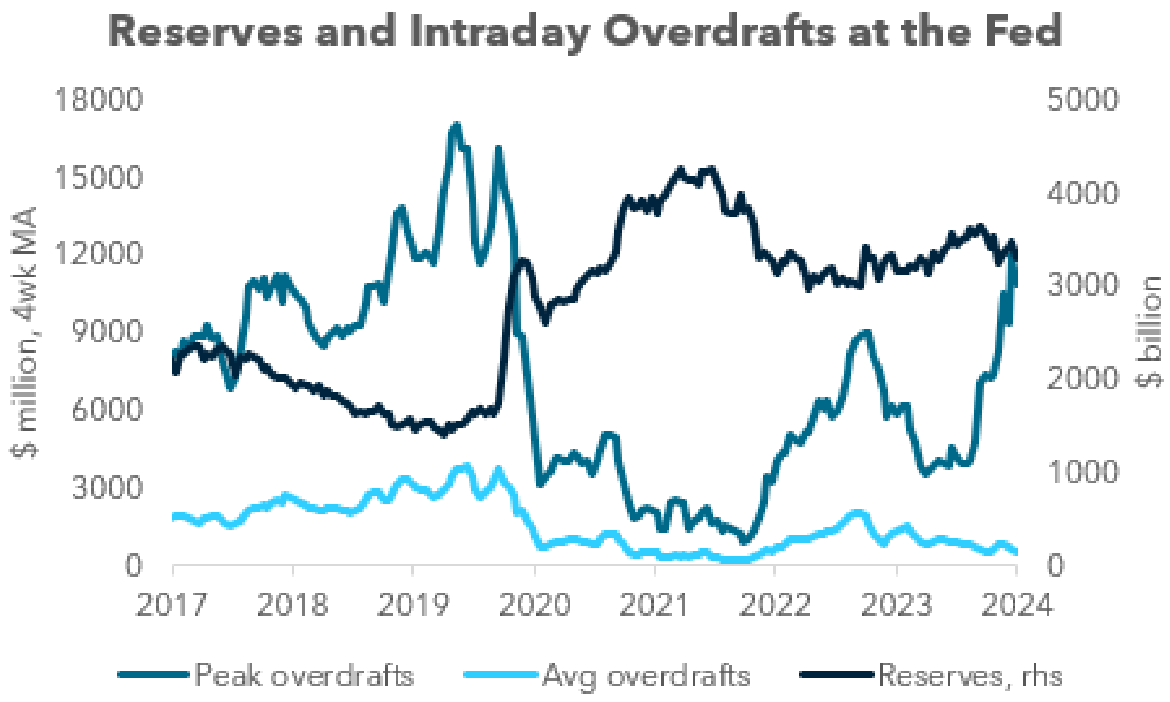
However, taken together, and in a context of continuing balance sheet runoff by the Fed via its QT program, it does raise concern. The usage of the SRF – which has not occurred during month- and quarter-end periods before – is particularly notable. $2.6bn is an amount some 25 times larger than any previous usage of the facility, which had been sporadic, and which has topped out at around $100m in the past.

SOMA Manager Roberto Perli gave remarks last week on the balance sheet and reserve regime. He updated us on the indictors he monitors to assess how abundant reserves are and whether or not the system is close to transitioning from abundant to ample reserves. One such indicator is the size and number of daily overdrafts by financial institutions.

Exhibit #1 shows the evolution of this data series relative to the size of the Fed's balance sheet. We plot both "peak" overdrafts as well as average weekly overdrafts. The data are current only through mid-June 2024. We can see that reserves declined in line with the post-GFC quantitative tightening that commenced in 2017 and ended with the money market blowup of September 2019. At the same time, both peak and average overdrafts began to climb, signaling rising liquidity risk.

So far in 2024, peak overdrafts have increased rather sharply, although average overdrafts have remained contained and well below pre-pandemic levels. Perli argues that average overdrafts are more relevant, as peak overdrafts could represent idiosyncratic factors at individual institutions. However, in the context of rising repo rates, falling reserves and rising SRF usage, we're concerned that these peak overdrafts might indicate some distributional challenges for reserves within the system.

Exhibit #1: Overdrafts – Peak Peaking, Average Steady



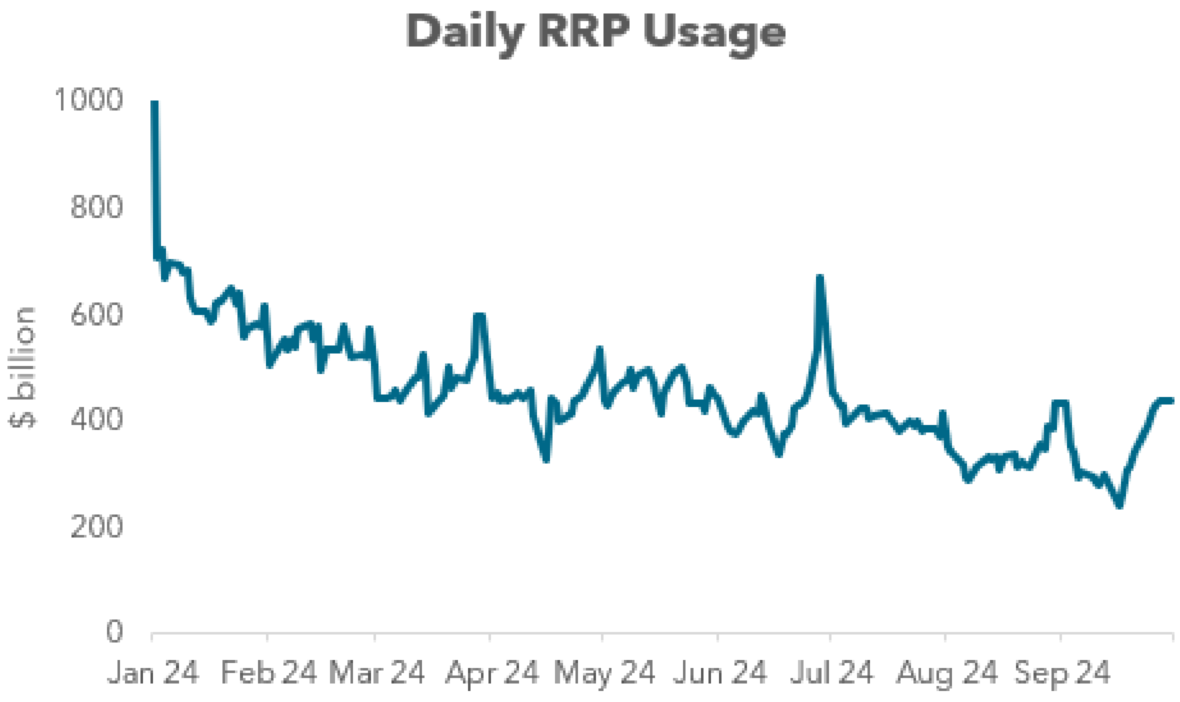
Source: BNY Markets, Federal Reserve Board of Governors

What of RRP balances, then? We used to think that RRP balances were another form of systemic liquidity that should be added to reserves (along with the Treasury General Account). The idea is that RRP balances represent cash that is tied up in the RRP facility, but that could flood into the system instead, should portfolio preferences induce it to. However, Perli – and others – have argued that RRP balances don't flow seamlessly into repo markets as liquidity, especially if counterparty concentration limits are present. In general, we don't find it especially odd to see RRP swell in recent days. See Exhibit #2.

The biggest users of RRP are, of course, money market funds (MMFs). Since the Fed rate cut almost two weeks ago, total AUM in these funds increased by $150bn between September 17 and September 27, according to Crane data. RRP balances increased by nearly the same amount, some $130bn. Good evidence, therefore, to suggest new cash in MMFs is simply going to the RRP, and not finding its way into repo.

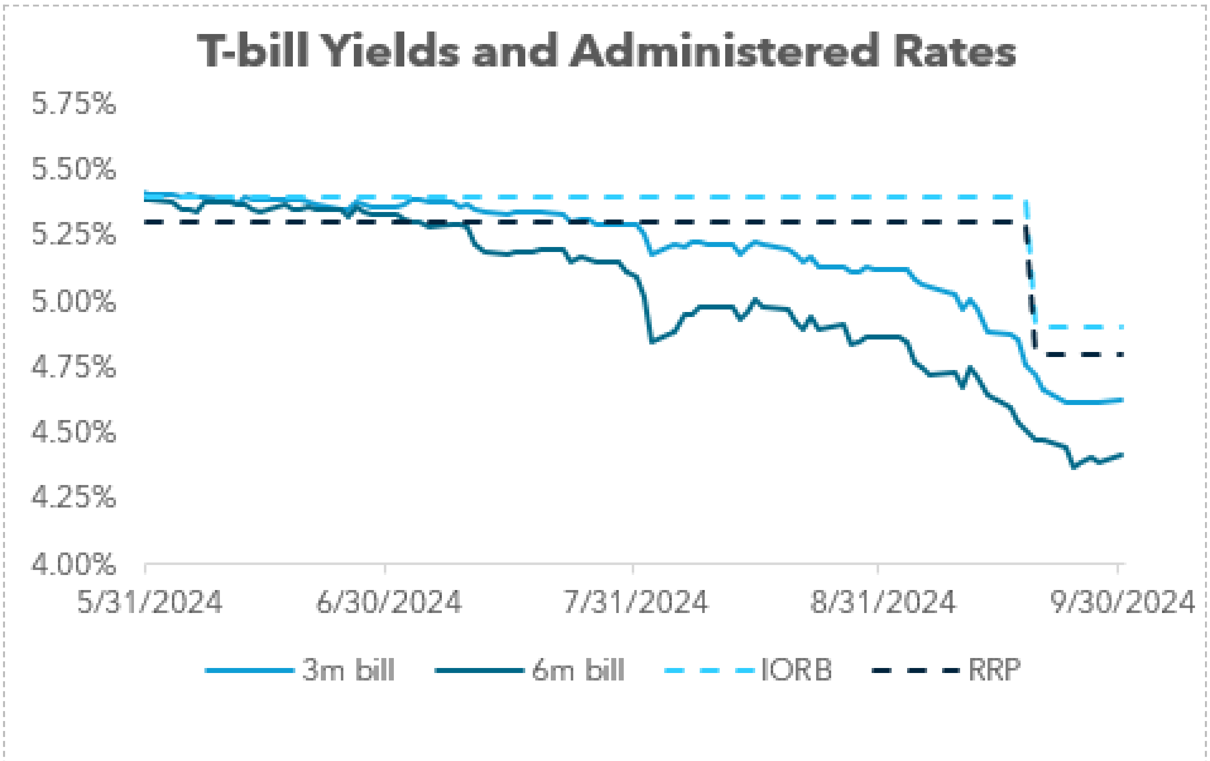
We know that T-bill yields have tumbled, and the bills curve is now inverted, making them an unattractive asset into which to deploy the MMFs' growing cash pile. See Exhibit #3. This is one reason why the RRP drain has gone so slowly since the middle of the summer. Bill yields started to fall below the RRP rate in early July, about when RRP stalled at just around $300bn. This is not coincidentally around the same time that MMFs began reducing the duration of their portfolios; Weighted Average Maturities (WAMs) peaked in the initial days of August at 38 days and have fallen down to 30 most recently. See Exhibit #4.

Exhibit #2: Rising RRP – Quarter-end or Something Else?



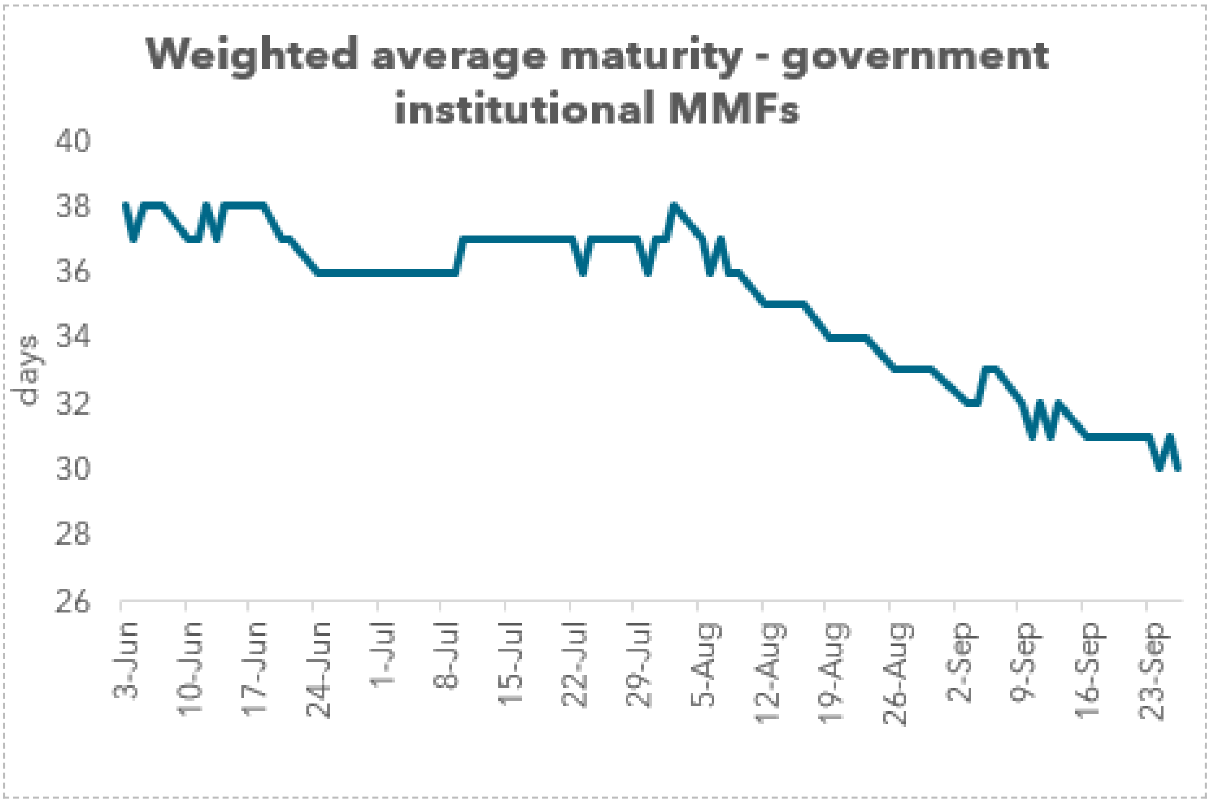
Source: BNY Markets, Federal Reserve Bank of New York

Exhibit #3: Bill Yields Not Compelling



Source: BNY Markets, Bloomberg

Exhibit #4: WAMs Coming Down



Source: BNY Markets, Crane Data

This means RRP should stay elevated even after quarter-end has passed. While they probably won't stay above $400bn, balances at the RRP should begin to stabilize, with a slightly declining trend. This doesn't mean that what's left in the RRP should be counted upon as readily deployable cash – due to the frictions mentioned above and the preference for the one-day duration that RRP provides. This also means that cash in the system could be getting scarcer, moving away from abundant toward ample. SRF usage at the end of the month against the backdrop of high repo rates is another potential signal. At the point abundant reserves transition to ample, the Fed's current QT would be terminated, and balance sheet reduction halted.

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

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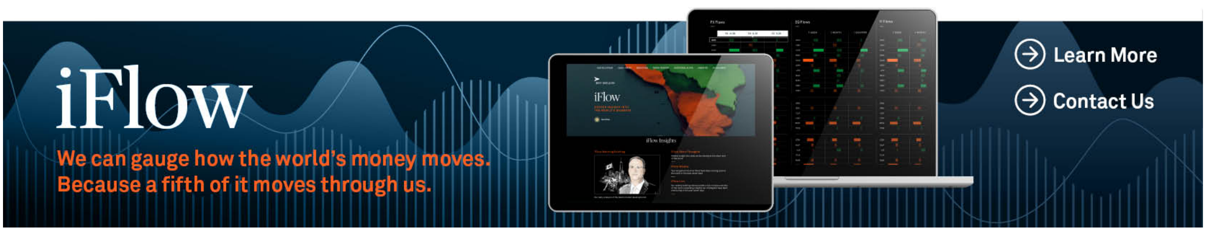

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