BNY MELLON

iFlow

SHORT THOUGHTS

April 16, 2024

New Rate Call & New iFlow Indicator

- We changed our interest-rate call, now see first FOMC move in September
- Introducing a new iFlow-derived metric: Factor Centrality
- Entirety of US fixed income flows increasingly driven by one common factor

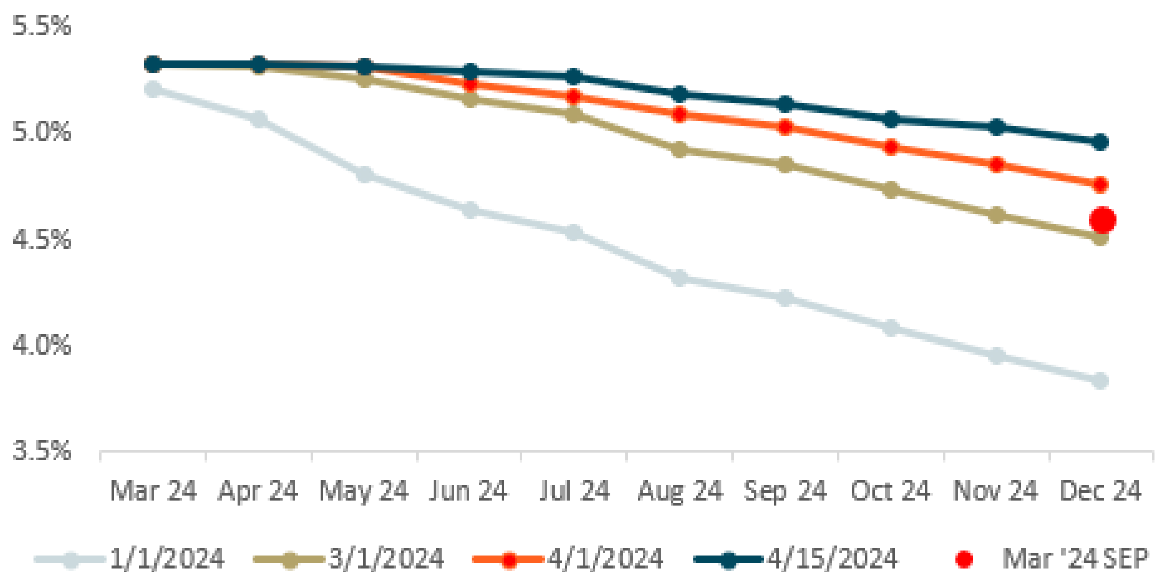
September FOMC Cut

Yesterday we updated our US policy-rate call: we now think the Federal Open Market Committee will initiate its first rate cut in September, rather than in June. This Macro Morning Briefing lays out our rationale in detail, but the simple facts are, first, that inflation – particularly services – has not been behaving in a manner commensurate with a June cut; and second, the economy is not slowing fast enough for us to envision better inflation data in the two months between now and the June 11-12 FOMC meeting.

The market is already there. Current pricing has just two 25bp cuts by year-end, the first expected to occur in September. If we – and the market – are right, we would expect bond yields to stay elevated across the curve. As T-bill yields have repriced towards a September cut, we also expect usage of the Fed's reverse repo (RRP) to continue to decline, probably faster than in March, when balances in this overnight facility remained relatively steady.

When uncertainty over the path of interest rates reigns, money market mutual funds (MMFs) tend to be more conservative and unwilling to move further out the T-bill curve, leaving either repo or RRP to provide a home for their assets. While it’s probably not the best time to infer too much from RRP take-up and MMF flows given the immediacy of the April tax season, we would expect MMFs to eventually extend further out the curve as the higher-for-longer narrative reasserts, thus further reducing RRP balances in turn.

Market Pricing More Hawkish Than Fed's Recent Dots



Source: BNY Mellon Markets, Bloomberg

Factor Centrality Explained

iFlow gathers and reports high-level flow data – aggregated and anonymized – from BNY Mellon's underlying custody data, approximately $48trn of assets under custody and administration. In the past six months, we introduced our extended iFlow for fixed income dataset. This enables us to report fixed income flows by asset type (corporate, sovereign, and other bond channels), maturity, and geographic region.

Having built out the abovementioned capabilities, we have begun to construct sophisticated analytical tools to help us identify key relationships between, trends within, and properties of the data series we've established across fixed income and equities. One of those is Factor Centrality. In a nutshell, for any set of asset class flows, we can determine how much those flows are "centered" on a common factor. This common factor is generally unidentified, but when it explains a proportionally larger share of the joint variance of all the asset class flows within a set, we infer that the flows are primarily being driven by this one factor.

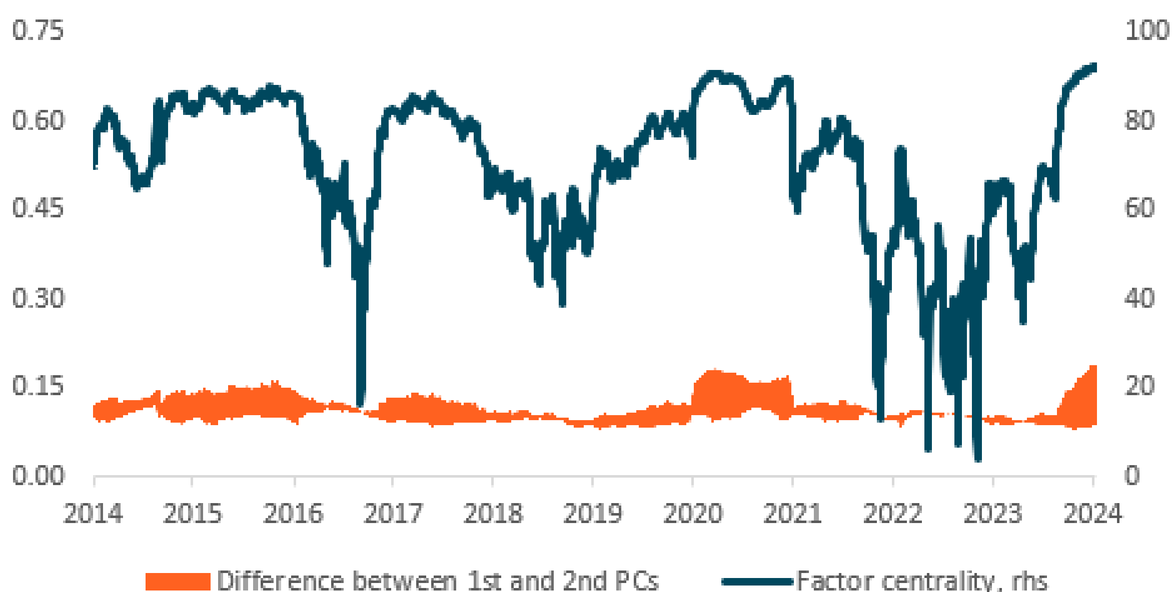
Specifically, for the mathematically inclined, we build Factor Centrality using the first and second principal components of the set of flows. The difference in the amount of variance explained by each is then mapped to a quantity that is bounded by 0 and 100. The closer to 100 the Factor Centrality index is, the more the flows into or out of the underlying asset are explained by one unknown factor, rather than by two or more. When the difference between the first and second PCs is large, there is very little influence from the second factor, and the system's joint variance is explained more and more by the first PC.

Let's examine the chart below. We report Factor Centrality as well as the arithmetic difference between the 1st and 2nd PC for US sovereign and corporate bonds, plus MBS, ABS, and Munis by their maturities. Since the beginning of this year, factor centrality has been high (generally above 85) and its most recent reading is 92.3, the highest this quantity has been since our dataset began in 2014. Furthermore, the difference between the 1st and 2nd PC in US fixed income markets is also at record highs.

The inference: investor flows across the whole range of US fixed income securities are increasingly being driven by the same single market view. The first factor dominates the second one significantly; flows can be mostly explained by one common theme, which we interpret to be the evolving view that reference rates are going to be higher than expected into the year, and that any reduction in said rates is looking further and further away.

Two conclusions emerge from this observation. First, the federal-funds rate question continues to dominate fixed income investing for the time being (although recent geopolitical events might introduce new factors into the mix). Second, any change in factor dominance could lead to some significant reorientation of flows across all US fixed income assets, as the new factors that could emerge as important get incorporated into investor behavior.

One Factor Drives US Fixed Income Flows



Source: BNY Mellon Markets, iFlow

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