BNY MELLON

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SHORT THOUGHTS

December 19, 2023

Checking In On The Federal Reserve's QT

Staying Power Of "Abundant" Reserves Holds The Key

- Recent - if short-lived - strains in funding markets pose questions about QT longevity.
- Continued rapid drainage of the RRP could mean reserve depletion sooner.
- Real money is all-in on the long duration trade.

Watch For Money Market Strains

A little over a month ago, we argued that the Federal Reserve's quantitative tightening (QT) program could continue deep into 2024. That premise was based on our view that the current quantity of reserves in the system was sufficiently ample for the balance-sheet runoff to continue apace indefinitely. Reserves remain well above $3 trillion (currently $3.5 trillion) and have actually been creeping higher since the end of Q3.

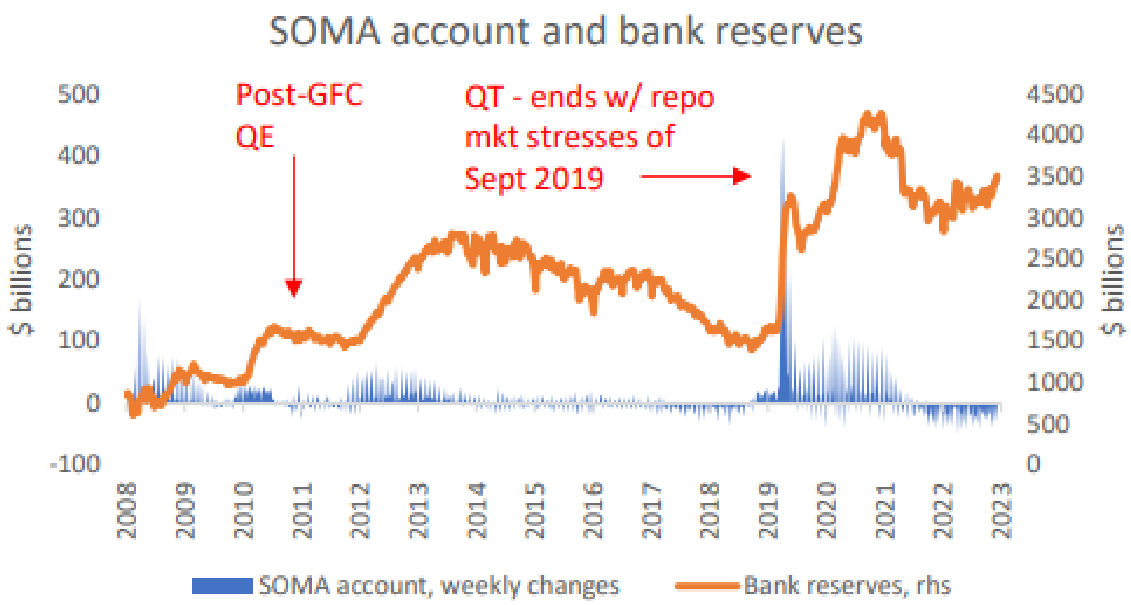
However, there is a well-subscribed-to view on the Street that the Fed will be compelled to cut or curtail QT at some point in early 2024. This appears to be based on views that liquidity in various corners of the Treasury market gets squeezed and forces the Fed to step in and offer relief. The short-lived but notable funding strains from a few weeks ago (see here) served as a reminder that the most liquid and deepest market in the world can face strains and, if they become acute enough, QT could meet a sudden end.

In September 2019 in response to a seize-up in the repo market (see this FEDS Note for a review of events), the Fed was compelled to step in and provide liquidity and cash in return for collateral via a hastily set up special repurchase operation, which it left open for several days. In addition, the Fed lowered the administered rates used to keep the federal-funds rate in the desired target range. The Fed ultimately suspended QT at the time and in early October, it pledged to purchase $60bn in Treasury bills through the second quarter of 2020. QT was effectively suspended in response to the destabilizing events in money markets.

We note that bank reserves had shrunk to a low of just over 9% of GDP right around those repo market stresses. Today they are at much-less-scarce at 11%. However, we know neither when the current regime of "abundant" reserves might become an "ample" regime, nor how the well-functioning Treasury market – at both ends of the curve – will remain so.

In the most recent Senior Financial Officer survey done by the Board of Governors of the Fed, over one-third of respondents said they prefer to hold additional reserves above their lowest comfortable level of reserves (LCLOR). Around 75% of bank finance officers indicated that they would not let reserves dip below their LCLOR. There is clearly a view that reserves could become scarce into 2024 – and something we remain attentive to.

The QT Lesson From 2019



Source: BNY Mellon Markets, Bloomberg

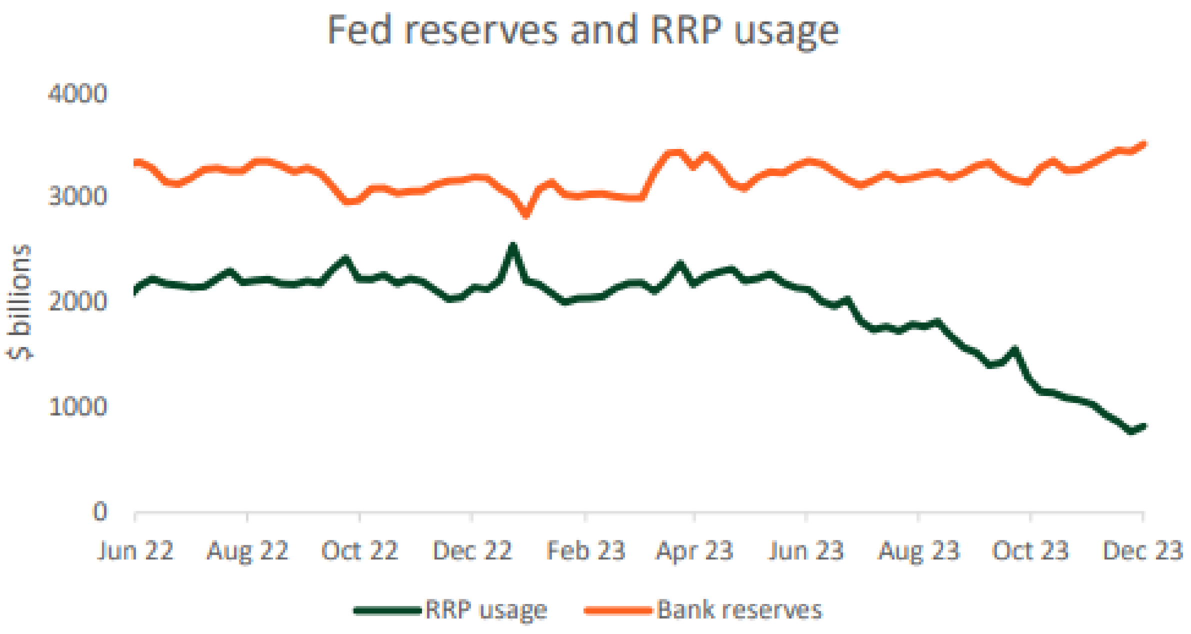
Drainage from the Fed's Reverse Repo facility (RRP) is proceeding quite rapidly. Usage of just $683 billion at the end of last week was a far cry from the approximate $2.2 trillion at the end of May. This decline has not yet been met with a similar decrease in bank reserves. The T-bills presently being purchased by money market funds (MMFs) are going to fund a relatively large increase in the Treasury's general account (TGA) at the Fed.

However, given the rapid drain, we estimate that the facility will be down to a half-trillion dollars early next year, and almost entirely depleted by the end of Q2. At that point, or perhaps even earlier, we might see a meaningful decline in bank reserves, as well. We should point out, as the chart below shows, that bank reserves are still quite high at over $3.5 trillion, the highest level reported since April 2022.

Questioned on this point at his post-FOMC press conference last week, Chair Powell admitted the RRP drain could end and reserves could start to dwindle. "The reverse-repo facility has been coming down quickly, and reserves have been either moving up as a result or holding steady. At a certain point,…they'll be at a level where the reverse-repo facility levels out. And at that point reserves will start to come down."

Even though we are not ready to change our view on QT running well into 2024, developments in RRP and the implications for reserve balances bear watching.

RRP Drainage Has Been Quick



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

Checking In On The Duration Trade

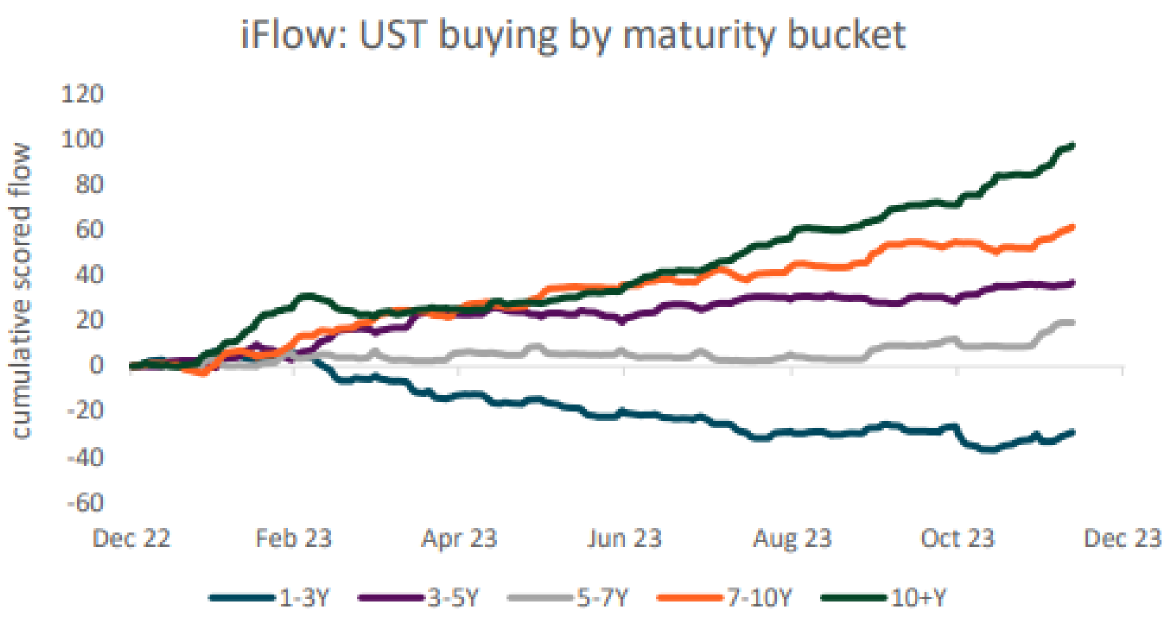
The approach of year-end is a good time to check in on real money investors' behavior in the Treasury market. We had been impressed by their unrelenting demand for Treasuries all summer and into autumn. In this section, we examine such behavior across the curve. In a nutshell, our data continues to show a rotation out of the shorter end of the coupon curve and into longer-dated securities. The long duration trade continues.

In the chart below, we plot cumulative scored flows (setting Dec. 30, 2022, to zero) across the main duration buckets for which we calculate the data. Note how the 10y+ and 7-10y buckets continue to see fairly unrelenting flow, but not the 1-3y bucket. We aren't surprised to see flows into the belly of the curve much more subdued, especially in the 5-7y maturity bucket, as this is a part of the curve often shunned by investors.

This is an expected consequence of where we are in the monetary policy cycle now. Going long duration is a common trade when rate cuts become the market focus. Certainly, with the decline in yields across the curve, the long duration trade has been a winner.

We’re more cautious on the back end of the curve, however. Entirely separate from the policy-related argument to go long duration, we continue to fear that supply concerns into 2024 will begin to exert an opposite effect on the curve. For the time being, however, we can’t really stand in front of this trade until the supply issue moves front and center of the market’s mind. We think that's a story for 2024 – stay tuned.

Still Going Long



Source: BNY Mellon Markets, iFlow

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