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SHORT THOUGHTS

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T-Bill Supply & Demand In Flux

Net T-bill issuance has been ~$270bn ytd; RRP usage declines as a result — but watch debt ceiling

Dealer holdings of USTs move inversely to yield slope; absorbing USTs will become difficult

As foreigners decumulate USTs, pressure on dealer balance sheets increases

Deluge Of T-bills Now, But A Dearth Soon

Daily usage of the Fed's overnight reverse repo facility (RRP) remains high, averaging just above $2 trillion over the last 10 days. This is, however, much lower than in the previous several weeks: between December 2022 and for most of January, RRP take-up averaged closer to $2.2 trillion. Is this beginning of a new downtrend in usage of the facility? We think not, and instead fear it's a temporary lull due to various machinations in the money markets related to the debt-ceiling process that continues to simmer in the background.

Let's review a bit. It's been argued – by us and others – that RRP usage in such large numbers has been driven by a combination of factors. That includes declining T-bill issuance post-pandemic and COVID-related spending packages, low deposit rates, which have continued to lag the Fed's rate hiking cycle, regulatory constraints on bank balance sheets, which push cash into the facility and out of interest-bearing securities, general uncertainty about the policy and economic backdrop, and declining Treasury General Account balances.

T-bill issuance is ~$270bn year-to-date; it won't stay that way for long

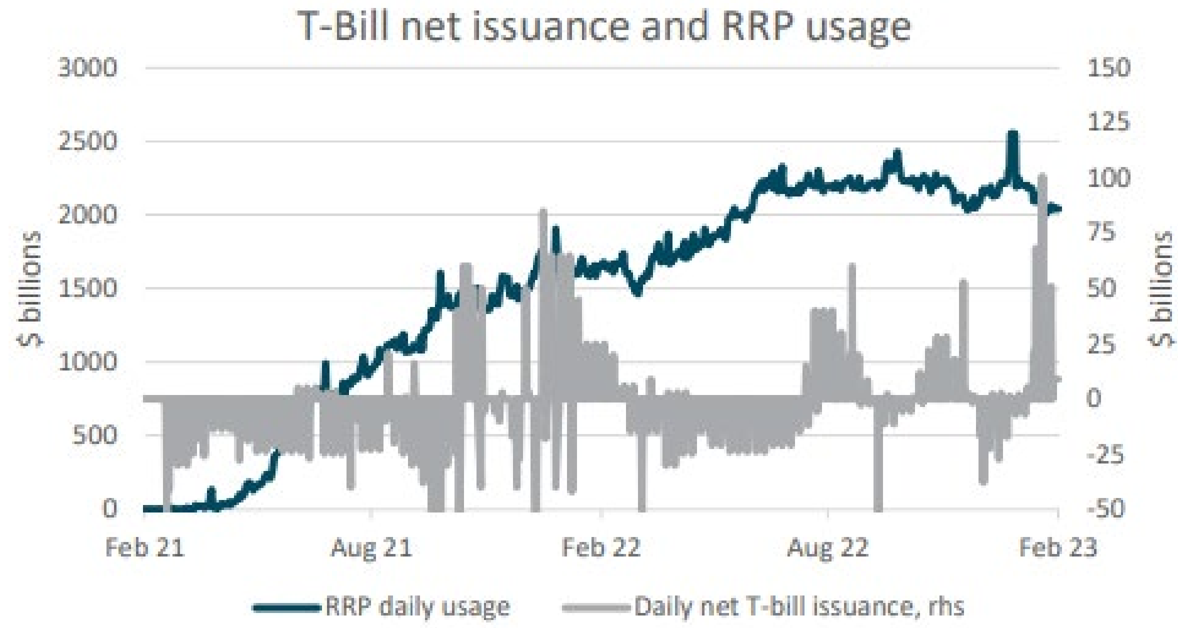
We would argue that the current drop of approximately $200bn per day in usage is due primarily to recent net T-bill issuance as the Treasury tries to replenish the TGA in anticipation of drawing it down as the debt limit approaches the eventual X-date. In the chart below, we plot daily net T-bill issuance against daily usage of the RRP facility. A couple of discussion points clearly emerge. The most important and one of the more general observations is that, unsurprisingly, RRP usage tends to rise during periods when net T-bill issuance is negative. Examples include the first half of 2022, and almost all of 2021. Conversely, usage declines during periods of positive net issuance.

The periods of heavy bill issuance in October/November 2021 and again in late December/early January 2022, correspond to the last two times the debt ceiling was close to being breached. In both cases, after extensions were agreed to by Congress and the White House, T-bill issuance took off as the fiscal authorities were able to re-fund themselves.

The TGA has increased by nearly $220bn in just the last few weeks as Treasury replenishes it coffer for what is expected to be a period of zero, or even negative, net bill issuance. This topping-up has resulted in nearly $270bn of total net issuance since the beginning of the year. This has given Money Market Mutual Funds (MMMFs) a chance to stash cash holdings in relatively high-yielding bills and reduce the overall need for RRP deposits.

We expect, however, that this net issuance will turn negative quite soon, as Treasury eventually begins to pay obligation from the TGA, perhaps as early as next month. Depending on how long it takes to resolve the impasse between the legislative and executive branches, we expect bill supply to remain low until a resolution is (hopefully) agreed. This means higher RRP balances are likely, and that they will endure until a resolution of the debt ceiling is (hopefully) agreed, after which we expect a flood of supply.

Less RRP Usage Corresponds To Higher Net Issuance



Source: BNY Mellon Markets, Bloomberg, US Treasury

Dealer Accumulation Of USTs - Who Else Will Buy?

An update to the New York Fed's Liberty Street Economics discusses the accumulation of Treasuries – in particular coupons – on primary dealer balance sheets (see here). Although the piece examines the relationship between UST holdings and long-term swap spreads, identifying what is dubbed the "inconvenience premium", it also examines the evolution of these holdings in relation to the yield spread between short- and long-maturity Treasuries.

We replicate part of one of the charts in the piece in the chart below. It plots the level of primary dealer holdings in coupons versus the slope of the 3m10y Treasury yield curve, which as we know is currently highly inverted – to the tune of nearly 120bp. The relationship is inverse; inverted curves lead to high dealer positions, and vice-versa.

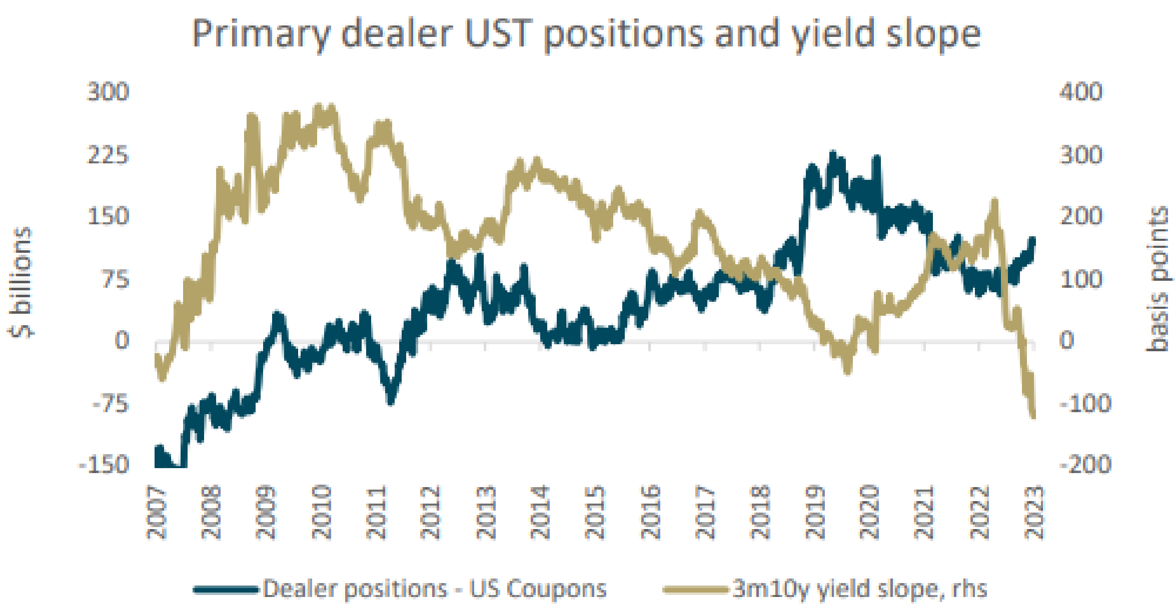
> **Dealer positions in USTs are almost the inverse of the yield slope**

This is because as the monetary cycle finds itself in a period of rising policy rates, the yield curve tends to invert, and because of the attractiveness of long-end bonds to mutual funds and foreign investors. This causes primary dealers to keep more bonds in inventory.

Given regulatory constraints, such as the Supplementary Leverage Ratio (SLR), which includes UST holdings as risky assets, dealers need to hedge interest-rate risk in the swap market.

This relative "re-allocation" of UST holdings from foreigners and mutual funds towards dealers is something we have discussed in the past (see here, for example). These factors continue to add to Treasury market fragility, something we have also discussed in recent pieces. Given the lack of bill issuance we expect to see, as discussed above, and the SLR constraints that do not exempt Treasury holdings from leverage calculations, the ability of intermediaries to absorb bonds can lead to such market fragility. The NY Fed's piece concludes that "primary dealers' Treasury inventory and various intermediation spreads should be closely monitored by policymakers and market participants". We agree, heartily.

Dealer Positions In USTs Are Nearly Full



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

Foreigners Sell Across The Curve

Relative to waning foreign demand for USTs, which puts additional pressure on dealers to expand inventory, we had a discussion last week in which we showed that cross-border (i.e., overseas) demand for USTs was declining, and had been doing so for some time.

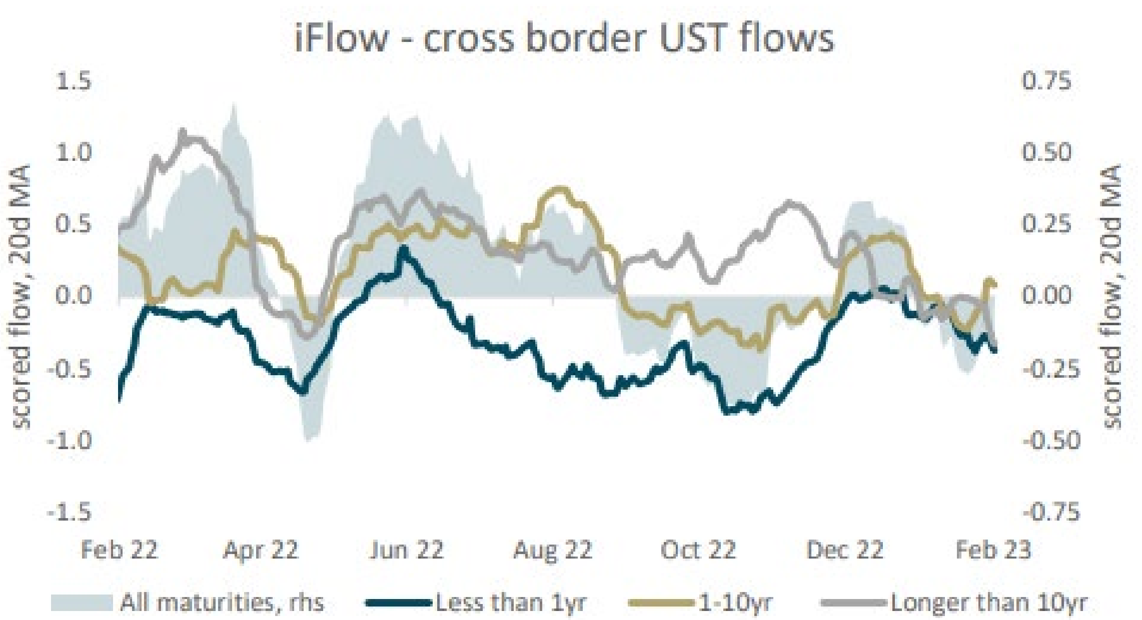
We now provide additional evidence on this point, showing the various maturity buckets for which we have iFlow data. We can currently examine Treasury flows across three broad maturity categories: sub-1y, 1-10y and greater than 10y. In all three cases, as the chart below depicts, we can see negative flows for most of the past six months.

Continued lack of cross-border demand for USTs is clear

This jibes with one of the points raised above: foreigners are reluctant to hold hedged USTs during an inverted yield curve regime. Expected rates of return are too low and hedging costs too high. So they are exiting holdings instead. This of course puts more pressure on dealers to hold inventories, as discussed, and inverts the cross-currency basis.

All of this adds to a troubling set of conditions in the bond market, which is exacerbated by QT. Again, another potential flash point in an increasingly fragile bond market.

Not Buying



Source: BNY Mellon Markets, iFlow

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

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