BNY
iFlow
SHORT THOUGHTS

July 9, 2024

Liquidity Strains?

We don't think so currently

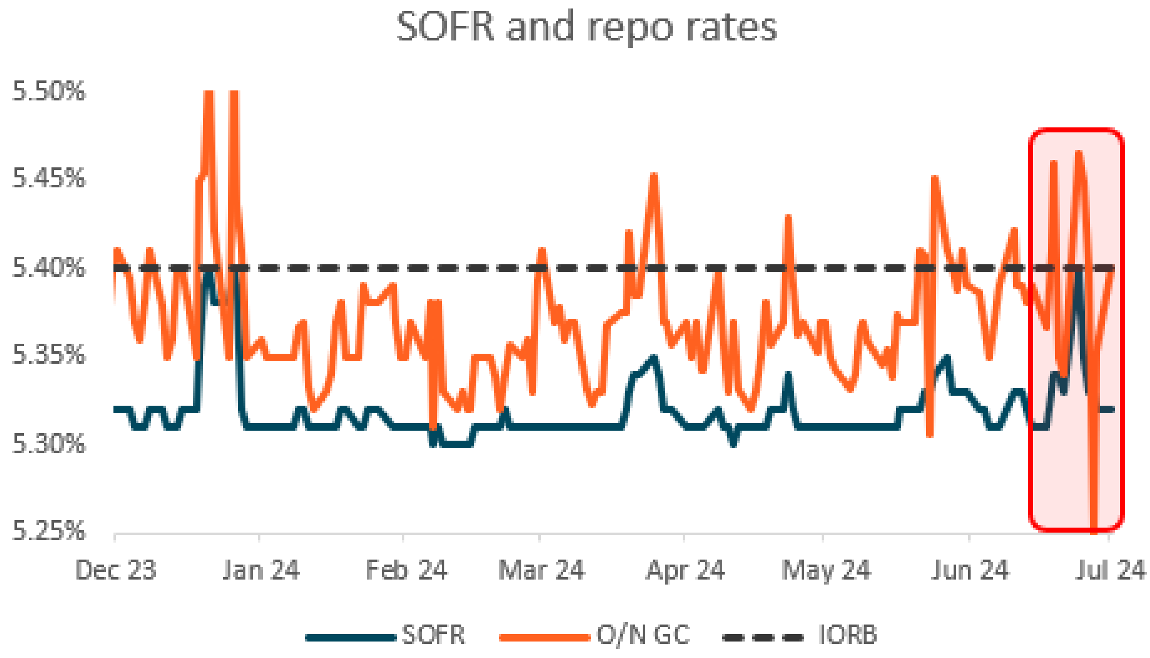
- Fund rates spiked at the end of June and have taken a while to settle down
- We don't think we're at a pain point for now, but investors need to be alert this summer
- An in-house empirical investigation shows liquidity at the back end is unchallenged

Front and Back End Considerations

End-of-June funding rates displayed noticeable volatility two weeks ago and haven't yet fully recovered from the elevated levels that were attained during that period. At the same time, usage of the Fed's overnight reverse repurchase facility (RRP) jumped to $684bn on the last business day of June. This might suggest poor liquidity in the front end, even though such end-of-period gyrations aren't uncommon. This prompts the question: Are these phenomena merely indicative of a calendar effect, or is something more worrying afoot in the markets?

SOFR printed at a high of 5.4% on July 1, a day after month-end, and overnight GC repo went as high as 5.46% on the same day. In the 10 days (including this past Monday) since June 25, the repo rate has printed at or above 5.4% six times. This level is key, as it is equivalent to the interest paid on reserve balances (IORB) offered by the Fed for excess balances. One of the so-called "administered" rates, IORB is intended to prevent the effective federal funds rate from moving too high within its targeted band. Thus, short term rates over 5.4% should draw in cash since at these levels, it's more attractive to lend to the market than to place reserves on deposit at the Fed.

Quarter-End Challenges

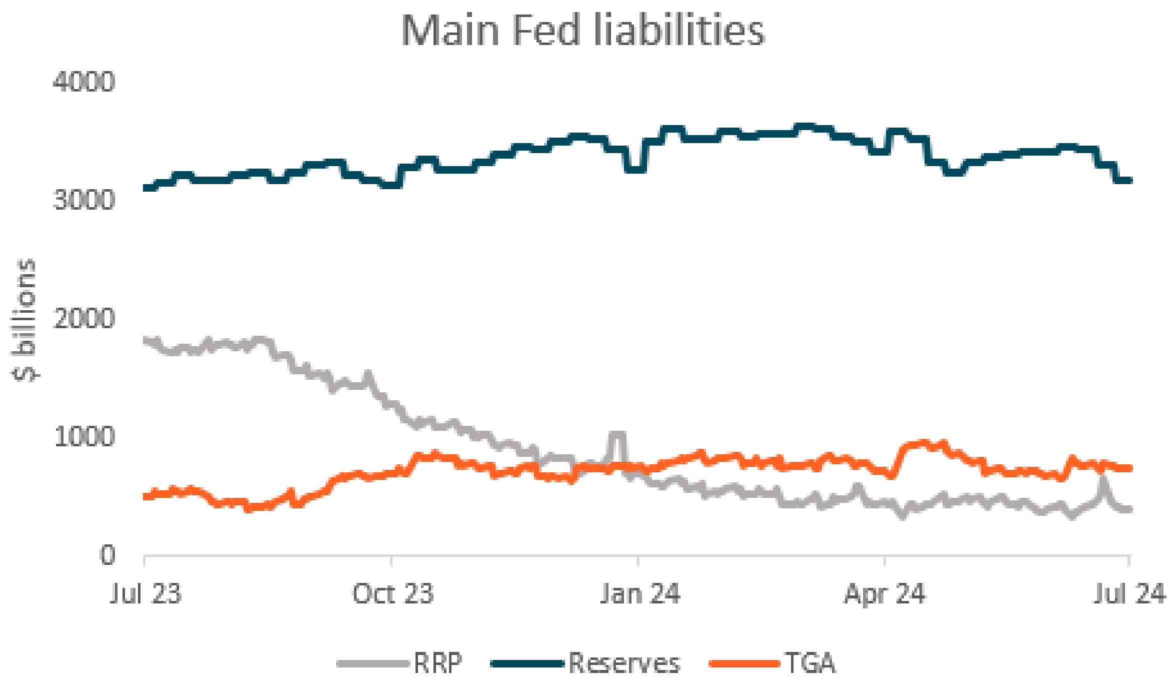


Source: BNY Mellon Markets, Bloomberg

Not that month- and quarter-ends have always been sleepy in the past, of course. The chart below plots the last 7 months of data for the SOFR overnight rate and the O/N GC repo rate. Note that at the end of December last year, for example, we saw a similar spikes in GC repo and even larger spikes in SOFR. The March 2024 quarter-end was similar, although less pronounced. Still, this most recent volatility at the end of June has taken longer to settle down than either of the previous two periods. Furthermore, on Tuesday and Thursday this week, $36bn in Treasury settlements will take place, pulling more cash out of the system. What's going on?

We're not ready to start banging the drum about liquidity shortages yet, but we do note that total system-wide reserves have fallen from $3.43trn two weeks ago to $3.18trn on July 3, a $259bn drop. Liquidity will be challenged if reserves continue falling at such a pace. RRP usage on Monday dropped back into recent historical ranges, at $415bn, suggesting cash is still present in the system. An increase in bill auctions, announced by the Treasury will put some downward pressure on RRP. However, we expect repo and SOFR to settle down by the end of the week, and don't suspect that there will be any major ructions in funding markets in the short term. We also note that the effective federal funds rate has been steady at 5.33% for the entirety of the year. Nevertheless, this summer will require close scrutiny in terms of front-end liquidity.

Reserves Lower, RRP Higher, TGA Static



Source: BNY Mellon Markets, Federal Reserve Board of Governors

One other market where there have been questions about liquidity is in the UST market. Commonly cited liquidity indicators are flashing warning signals, and our own fears of uneven supply and demand dynamics in the coupon markets are concerns. While it's beyond the scope of this note, we do view off-the-shelf liquidity measures as having flaws, in some cases major ones. And supply and demand dynamics in the UST market – while probably of longer-term concern as fiscal developments deteriorate – don't seem to be an issue at present. Note, as we pointed out last week, demand for duration in US Treasuries has recently been inexorable.

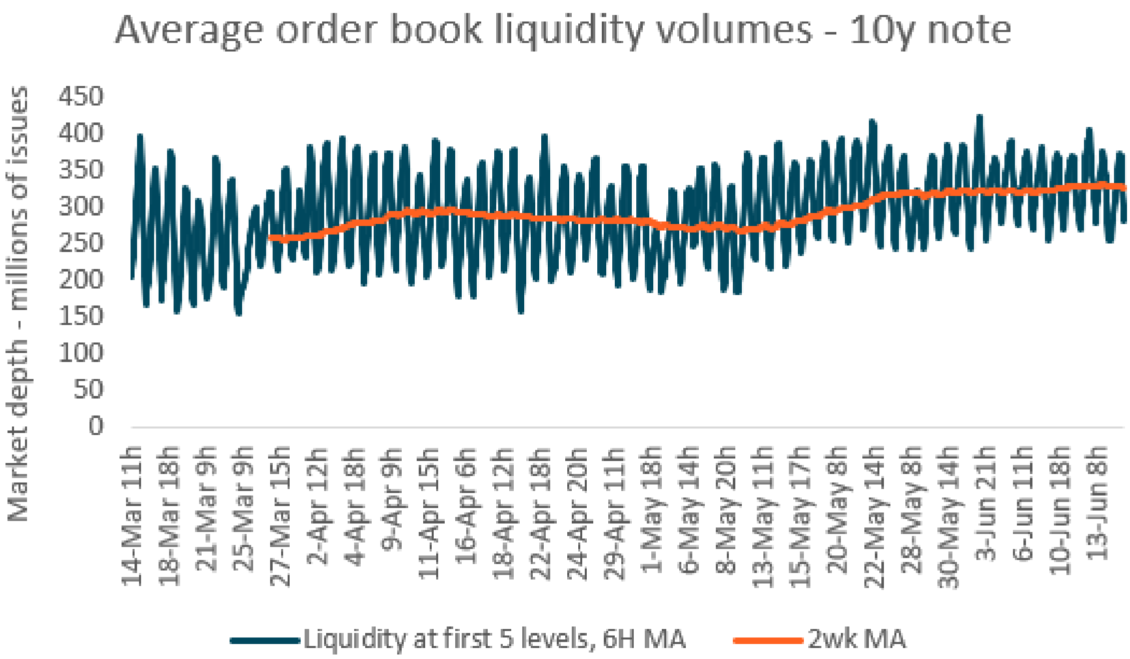
With the help of our colleagues on BNYs Treasury trading team, who empirically investigated market depth in the Treasury market between mid-March and mid-June, we quite simply don't see any recent deterioration in UST liquidity. We find even if one went deeper into the order book, market liquidity remains robust.

The blue line on the chart below is calculated from looking at how many bonds (in millions) are available for sale for the first five levels of bids & offers for US 10y Treasury notes. The data are computed for every trading hour from several trading venues, over the course of each trading day between March 14 and June 13 this year. We examine market depth as defined over every hour during each day and take a 6-hour moving average, for the first five levels of bids & offers. Obviously daily data display clear cyclicality, oscillating throughout the day, even smoothed with the aforementioned 6-hour moving average. A 2-week moving average of those 6-hour intra-day moving averages shows that over the three months ending in mid-June, depth of market – a measure of liquidity – has actually increased slightly.

Subsequent discussions with our trading desk confirm that conditions over the weeks since mid-June are similar. Furthermore, while our chart specifically examines the 10y note, our colleagues' work is consistent across tenors and trading venues.

Bottom line: Liquidity in the front end is showing some signs of being challenged, but not yet to worrying levels, and we feel there still is sufficient cash in the system to preclude any seizures of liquidity for the next few months or so. In the longer part of the curve, our in-house investigation reveals liquidity concerns to be a mirage.

Bond Liquidity Sufficient



Source: BNY Mellon Markets, Internal Calculations*

*We thank Lee Griffin and Marke Tejada for their work on this study

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Disclaimer & Disclosures

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

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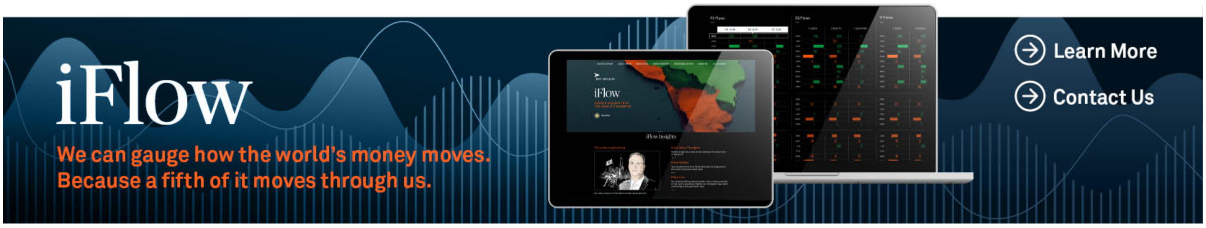

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