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SHORT THOUGHTS

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US Treasury Market Supply And Demand

More Bill Supply, Less RRP Demand

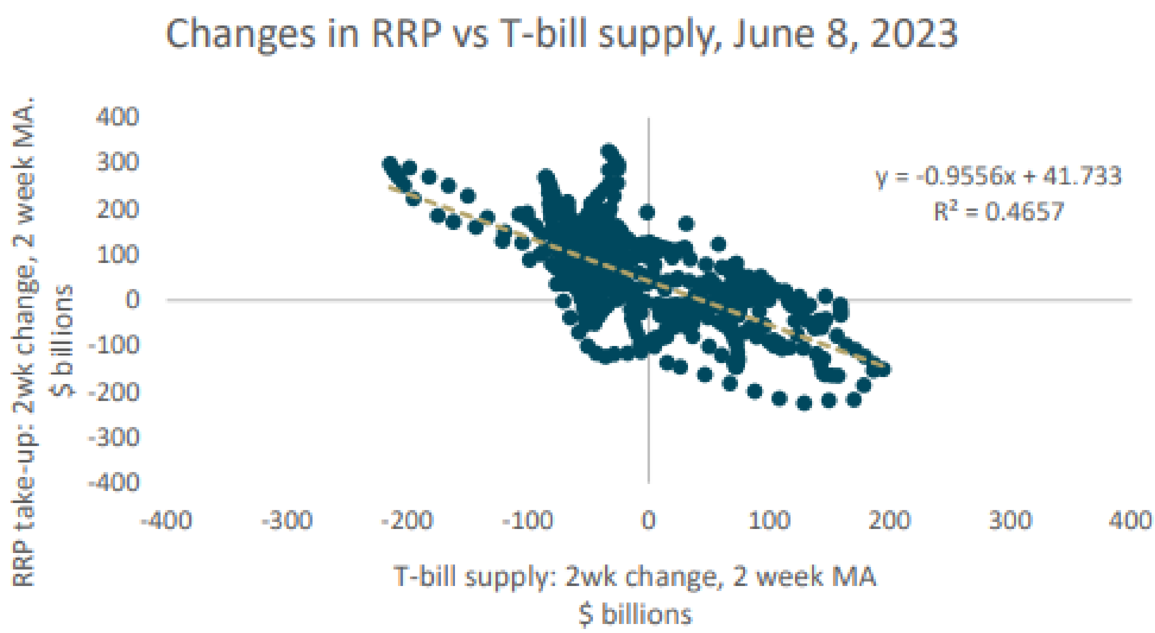
Take-up at the Federal Reserve's overnight reverse repo facility (RRP) has been steadily – if somewhat slowly – declining since resolution of the debt ceiling. This past Monday, usage tallied to $1.961trn, the lowest participation since May 2022. The average daily RRP balance for the first five trading days in June was $2.146trn. In the most recent five trading days, the facility averaged $1.918trn, representing a decline of over $160bn during that time.

Since the debt ceiling was put in the rear-view mirror, the US Treasury has come to market with $345bn in net bill issuance, and the bills curve has cheapened somewhat (see below). The Treasury General Account (TGA) was up $377bn this past Friday, well on its way towards reaching the Treasury Department's stated goal of $425bn by the end of June.

The relationship between bill supply and RRP usage is rather straightforward. The chart below, with its nicely downward-sloping trend line, confirms this empirically. We plot the 2-week change in net supply vs. the corresponding change in RRP, using 2-week moving averages to account for noise in the data. The regression coefficient is nearly equal to -1, which would imply that every dollar less of bill supply implies a dollar's worth of RRP take-up. The data start on April 1, 2022, roughly around when the Fed began rate hikes.

This suggests that additional issuance will see RRP drain in proportion. However, we wonder if the yield on alternative assets to RRP – which carry a longer duration than that of the overnight facility – namely T-bills, will be high enough to induce the shift out of RRP and into bills, especially if the Fed raise rates once or twice more.

One-For-One, Or So It Seems



Source: BNY Mellon, US Treasury and New York Federal Reserve

But Are Bills Cheap Enough?

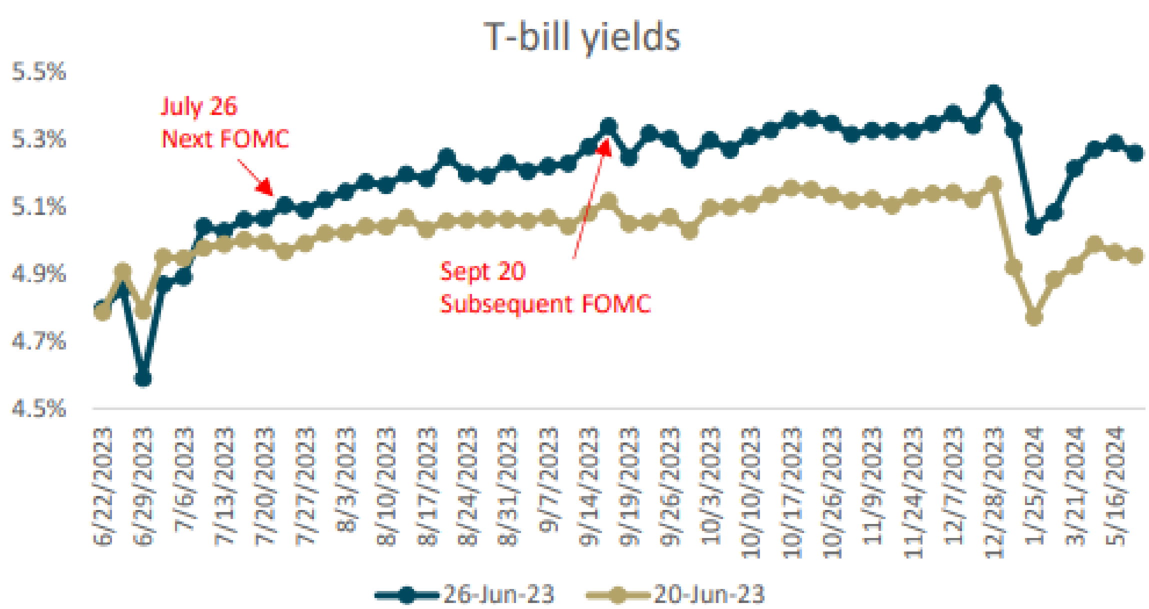
The argument had always been that a glut of cash at the front end, with unattractive bill yields and paltry supply, was keeping RRP balances elevated, and that rising rates as the Fed pressed on with tightening would draw money out of RRP and back into short-term securities. The debt ceiling exacerbated RRP usage – drawing money out of bills potentially subject to default risk. Uncertainty about the course of Fed rate policy, making money market mutual funds (MMMFs) resist extending maturity, also contributed to elevated balances. The lattermost condition remains in effect. As Treasury continues refunding itself via significant bill sales, most of the MMMF demand is concentrated at the very front end. With the market now pricing nearly a 75% chance of a rate hike at the July 25-26 FOMC meeting but almost nothing thereafter (we agree – see here), the question is whether or not money funds are comfortable extending duration past the end of July.

The bills curve has cheapened significantly in the last week or so, as the chart below illustrates. Indeed, depending on which point of the curve one examines, the change in yields from one week to the next is in some cases as much as 20bp. Are bills maturing after July 26 cheap enough to entice additional transformation out of the RRP going forward? Not quite, in our view. Presumably, RRP will pay 5.3% after July 26, and bill yields for August are still appreciably below that, although the curve is exhibiting a nice-looking upward slope. Unless and until these maturities offer a handful of basis points above 5.3%, we think RRP usage will eventually reach a plateau, unless the market's – and our own – view of Fed policy beyond July solidifies and/or the Fed indicates it's done with the cycle.

We think that the Jackson Hole Symposium over Aug. 24-26 will offer the Fed (presumably Chair Powell, as the Chair usually speaks on the opening day) a chance to indicate that rates by then will have become sufficiently restrictive. This should finally induce MMMFs to venture further out the curve and buy what will likely by then be "cheap enough" (especially compared to RRP) bills, which promise to be in large supply.

Therefore, if our Fed view is correct, we see a two-step decline in RRP: the current trend persisting until the end of July, and then another move lower post-Jackson Hole. If we're wrong and the two rate hikes indicated in the June Summary of Economic Projections wind up being delivered, this dynamic will take longer to play out. In either case, we expect that RRP balances will really start to decline in the latter part of the year, once the Fed's cycle is likely to finally come to an end.

Curve Cheapening And Steepening



Source: BNY Mellon Markets, Bloomberg

Lacking The Foreign Element

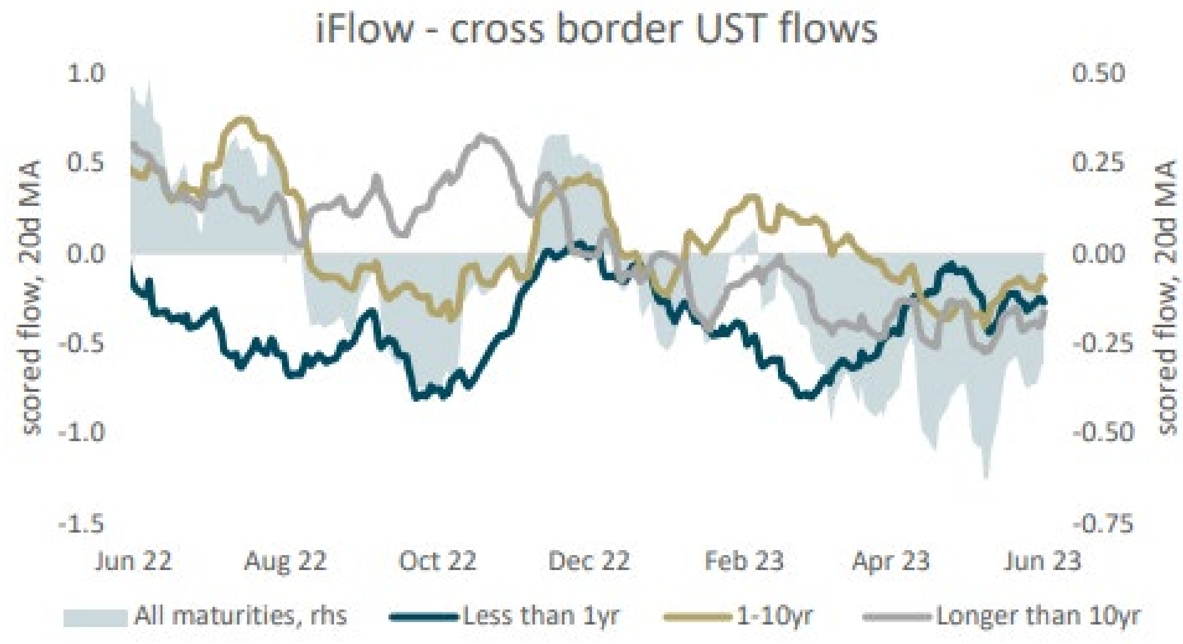
One place we don't see demand for T-bills – or any US sovereign paper, for that matter – is from the foreign real money sector (not including official institutions). Our latest check of this data continues to show the same phenomenon: cross-border flows in US Treasuries of all maturities are negative, and have been for some time. The chart below shows total (scored) flows into/out of US government bonds, as well as a breakdown of those flows by maturity buckets (i.e., less than 1 year, 1-10 years, and greater than 10 years). In all cases flows remain negative, meaning selling by foreigners.

This is not an insignificant set of circumstances. With foreign investors not willing to participate in the market, this means the additional issuance expected from Treasury will have to be funded domestically, either by money funds allocating out of RRP, by banks, or by corporates and state/local governments increasing their holdings of securities.

We have already discussed above what we expect from the MMMFs. Likely through the summer, the money funds will take up a great deal of that supply. Banks, however, are balance sheet-constrained and unlikely to warehouse much of the issuance. That leaves state and local governments and corporates, and we really don't have much visibility on what they will do. Note that after the summer, it's likely that issuance will include coupons and bills, putting additional pressure on the market to absorb paper further out the curve.

We suspect foreigners are out of the US market because yields around the world are equalizing, and dollar hedging costs are materially higher now than they were even a year ago for most major currencies. We wonder if the glut of bill – and later, notes and bonds – supply will drive yields high enough to induce foreigners to return to picking up Treasuries, or if duration risk will have risen sufficiently to dissuade re-entry into the market.

Still Selling



Source: BNY Mellon Markets, iFlow

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

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