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iFlow

SHORT THOUGHTS

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Markets Seem Sanguine On Ceiling

X-date estimates converge on early June; markets don't seem rattled yet

RRP usage largely driven by SLR constraints on bank balance sheets

iFlow shows short-end demand outpaces that of longer maturities

X-date Approaches, Markets Remain Calm

At least as of this writing, anxiety around the debt ceiling seems somewhat subdued. With the exception of a rather modest kink in the front end of the T-bill curve and a widening in credit default swap spreads, markets appear relatively sanguine. Moreover, anecdotal evidence suggests that investors are content to assume that a deal will be made and implemented to stave off a potential default. In the meantime, as negotiations proceed at a fits-and-starts cadence, X-date estimates are converging. Most independent forecasters now expect the US Treasury will run out of funds somewhere between June 1 and June 10 in the absence of a deal. In the chart below, we plot maturing debt each day in June. In total, nearly $1.2trn is scheduled to be paid out over the course of the month.

As of Friday last week, the Treasury had $61bn in its General Account, and around $90bn in extraordinary measures that can still be deployed. There will be an expected influx of cash of around $80bn on June 15, after which, if Treasury could hold on until then, another approximately $140bn in extraordinary measures would become available. However, funds are dwindling. Secretary Yellen remarked over the weekend that “the

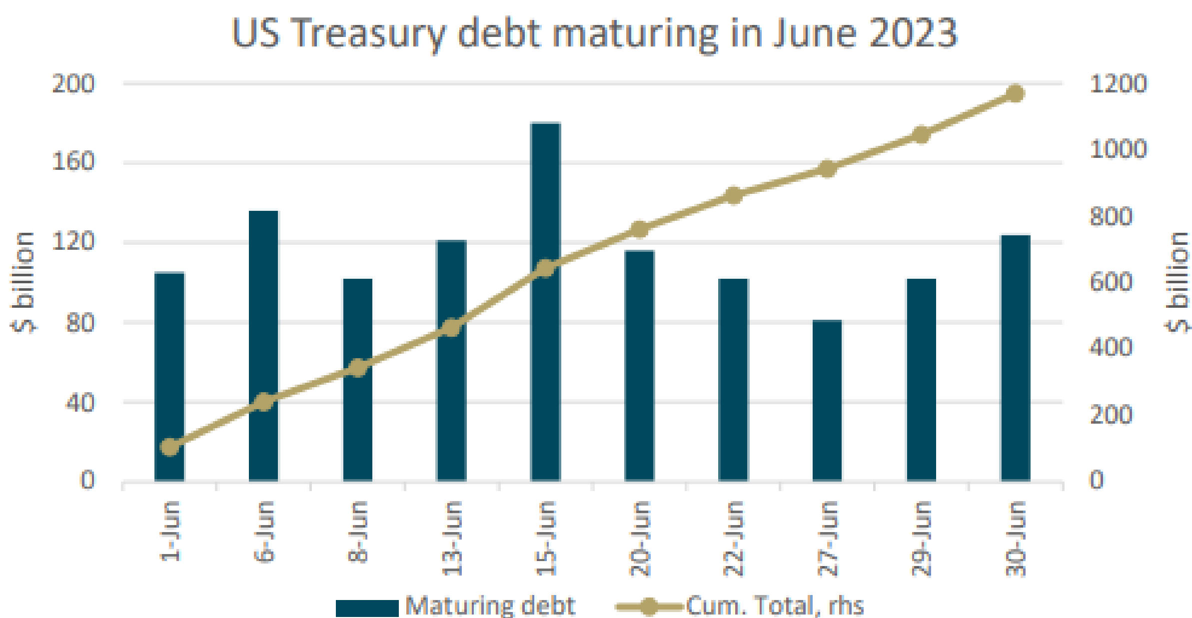
odds of reaching June 15th while being able to pay all of our bills is quite low."

X-date likely in early June; talks ongoing

Assuming, then, that the X-date is indeed sometime during the first 10 days in June and noting that, so far, negotiations between the White House and Congressional Republicans have not yielded a deal, we're surprised to see markets so sanguine at the moment. We again point to the summer of 2011, the last time the debt ceiling was so fraught with uncertainty. We remind readers that between July 7 and Aug. 7, the S&P 500 lost 16.6% of its value and the yield on the 10y note fell over 100bp. The agreement to raise the debt ceiling then was struck on Aug. 2, just before the X-date would have become binding, and yet markets continued to be risk-off until Aug. 7. At the time, it was thought that significant spending cuts would be anti-growth and possibly lead to a recession, which explains why markets continued to deteriorate for a few days after the agreement was reached.

While we're not privy to where negotiations stand or their chance of success, we do think as the X-date nears without a deal markets will start to feel the stress and begin to express disapproval of the situation. This could focus the two parties' minds to the point where they come to an agreement, but it could be a costly way to achieve clarity. However, we cannot responsibly claim that we're sure a deal will be arrived at in time. We think this nonzero probability of crossing the X-date will begin to weigh on market sentiment in the meantime.

$1.2trn Due In June



Source: BNY Mellon Markets, Bipartisan Policy Center

RRP Driven by SLR Regulations

In a recently posted entry on its Liberty Street Economics blog, the New York Fed examined bank balance sheet costs and usage of the Overnight Reverse Repo (RRP) facility. We have written a great deal on RRP usage over the last 12 months or so, arguing that a dearth of T-bill issuance, policy uncertainty, and excess cash liquidity in the system have conspired to push RRP daily usage to extraordinary levels. RRP daily take-up has been over $2 trillion since June 2022, recently fluctuating between $2.2trn and $2.3trn.

The blog post cited above, drawn on a larger set of research in an associated staff paper (more technical and comprehensive), tests various potential drivers of RRP take-up and concludes that balance sheet costs, in the form the Supplementary Leverage Ratio (SLR), have been behind much of the impressive growth in RRP usage. In short, the SLR is a US implementation of the Basel III leverage ratio, which became effective in 2018. It requires banks to hold capital against assets, and essentially disincentivizes banks from expanding their balance sheet – it's a cost imposed on banks based on the size of their balance sheets.

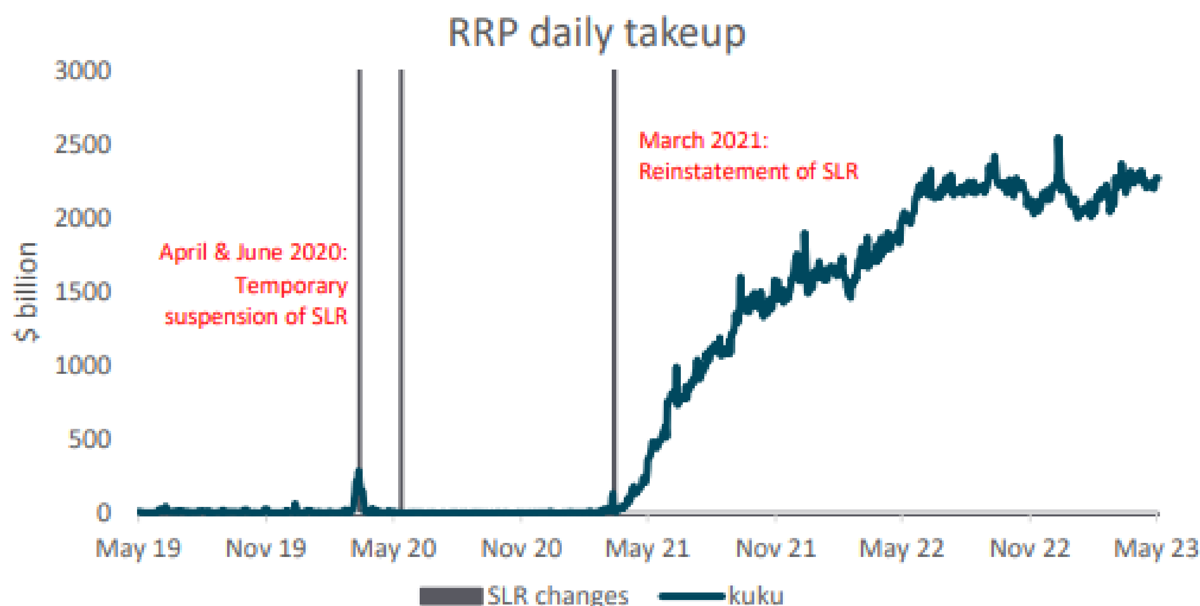
Regulatory relief unlikely for a long time

In April 2020, among many emergency measures it set up to help mitigate the economic and financial downside of the lockdowns, the Federal Reserve eased the SLR for bank holding companies to allow them to expand their balance sheets without incurring the additional costs of the leverage ratio. In June 2020, this relief on SLR was extended to depository institutions. The actions exempted central bank reserves and US Treasury securities from the SLR calculation, essentially allowing for the effects of quantitative easing to be transmitted through the banking system. A year later, on March 31, 2021, the Fed ended the temporary relief and balance sheet constraints were again imposed.

Using proprietary data, the NY Fed study indicates that after March 2021, banks pushed deposits toward affiliated money market mutual funds (MMFs), that is, to MMFs sponsored by an asset manager belonging to a bank's holding company. The chart below shows the explosion in overall daily RRP usage that occurred immediately following the re-imposition of the SLR constraint on banks.

Without regulatory relief, we think RRP usage will remain high. Much has been discussed about the expected deluge of Treasury security issuance once the debt ceiling is (hopefully) resolved. As much as $1trn or more in new supply is expected to hit markets in the immediate aftermath of a resolution. While this should help drain RRP by offering alternative assets for MMFs to invest in, we think the SLR story is more important, although we don't expect regulatory relief to be swift in coming.

Watch The SLR



Source: BNY Mellon Markets, Bloomberg, NY Federal Reserve

Short-End Flows Outpace Longer-Duration Flows

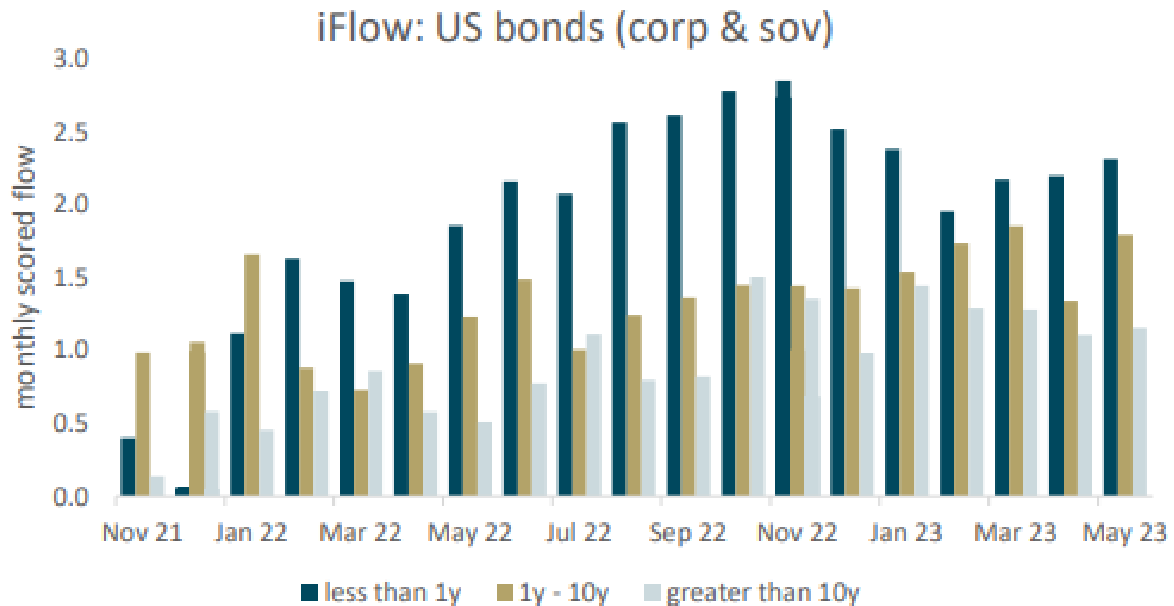
We have frequently pointed out that according to our iFlow data, investors in US bonds are piling into the short end of the yield curve, eschewing duration risk. This has been the case since the beginning of last year, coinciding more or less with the Fed's policy tightening cycle, which began in March 2022. Looking at the chart below, we can see that the increase in demand for sub-1y maturity US paper spiked in January 2022 (dark blue bars), a few months before the Fed's first hike, and this demand has remained elevated ever since.

> ## Short-duration paper still in high demand

We also plot – using monthly averages of daily scored flow – flows to bonds with between

1 and 10 years in maturity (amber bars) and those over 10 years in maturity (light blue bars). Note that flows into the short-maturity paper have exceed flows into either of the two longer-duration buckets for the entire period from the beginning of 2022. Also note that there is a small, steady increase in flows into the medium-duration paper, while flows into 10y+ paper have been steady and well below the level of flows into the very short-date bonds. We think this demand for short-dated paper will persist as long as investors are avoiding duration, which coincides with general risk-aversion in the bond market.

UST Demand At Various Maturities



Source: BNY Mellon Markets, iFlow

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

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