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iFlow

SHORT THOUGHTS

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Asset Transformation, Deposits & Reserves

RRP-to-Bills Shift Leaves Deposits, Reserves Unscathed

From June 1 to date, net T-bill issuance has totaled about $1.6trn. Over that same period, usage of the Fed’s overnight reverse repurchase facility (RRP) has declined $1.3trn. Furthermore, since May 31, new assets under management in the money market mutual fund complex have increased by some $300bn. The arithmetic is neat and strongly implies that most of the net purchases of new T-bills have been by MMFs. While we can’t say with complete confidence that every dollar of bill issuance has been absorbed exclusively by MMFs, it seems pretty clear that there has been a great asset rotation out of cash and into bills over the last five-and-a-half months, with much of that cash coming from MMFs.

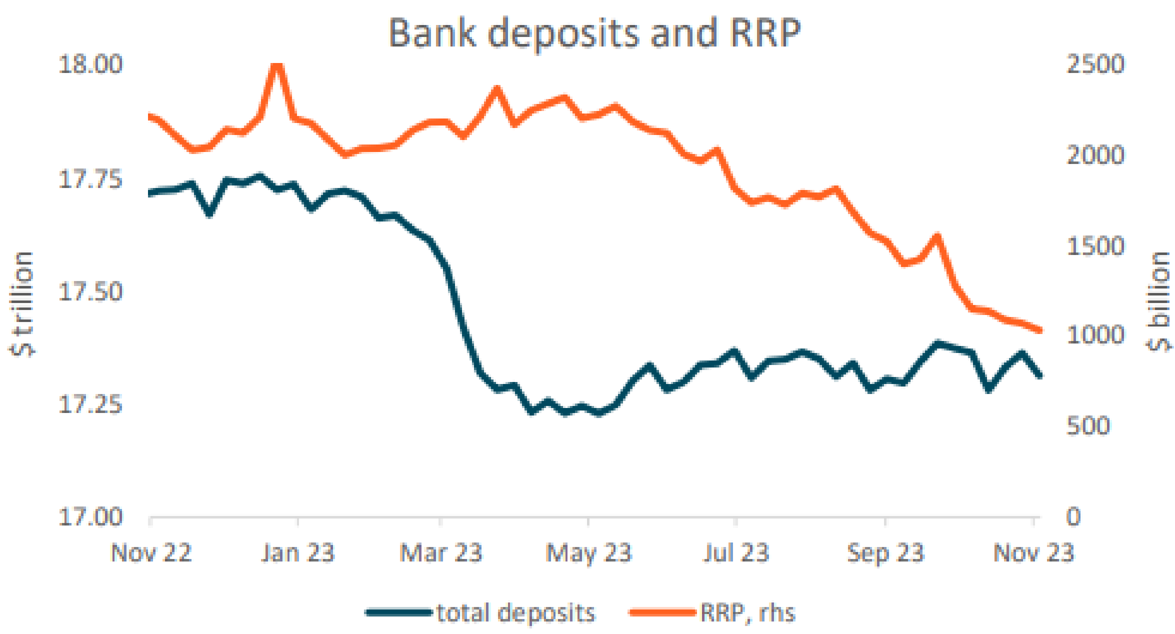
There is more than a convenient arithmetic process underway. One behind-the-scenes implication of this asset transformation is that deposits at commercial banks have been steady. After plummeting during the regional bank stress earlier this year – deposits fell nearly $400bn between end-February and end-April – total system deposits have been relatively steady since. Small bank deposits in particular have recovered nicely. On Feb. 22, small bank deposits were $5.35bn before falling to a low $5.15bn at end-March. They currently sit at $5.28bn. Large banks have not fared as well, with their deposits down by around $200bn since the onset of the mini crisis. Nevertheless, the performance of deposits overall has been a salubrious development.

Between the regional bank stress and the enormity of T-bill issuance, we initially feared that the post-debt ceiling deluge of bills would reduce bank reserves, drawing money out of deposits and into short-end paper. However, as described above, the overwhelming majority of bill issuance has been absorbed by MMFs and has left deposits relatively unscathed. By extension, bank reserves have remained abundant. Indeed, reserves have grown from just over $3trn at end-February to $3.3trn on Nov. 8, the last date for which we have data.

Doubtless, much of large banks' deposit reduction has been achieved by institutions shifting out of bank deposits and into MMFs. Again, we point to the arithmetic: the former have fallen by $200bn, while the latter have increased by $300bn. We can surmise that around two thirds of the MMFs' increase in AUM have come at the expense of bank deposits.

The upshot: the government's short-term funding policy since the conclusion of the current round of debt ceiling uncertainty has not led to a material decline in overall banking system liquidity. Furthermore, with RRP usage – admittedly much smaller – at around $950bn, there is nearly an additional $500bn or so from this facility that can be thought of as excess liquidity. As we discussed in the past, with reserves still healthily above $3trn, we think that QT can carry on well into next year (see here).

RRP Drain Leaves Deposits Steady



Source: BNY Mellon Markets, Federal Reserve Board of Governors

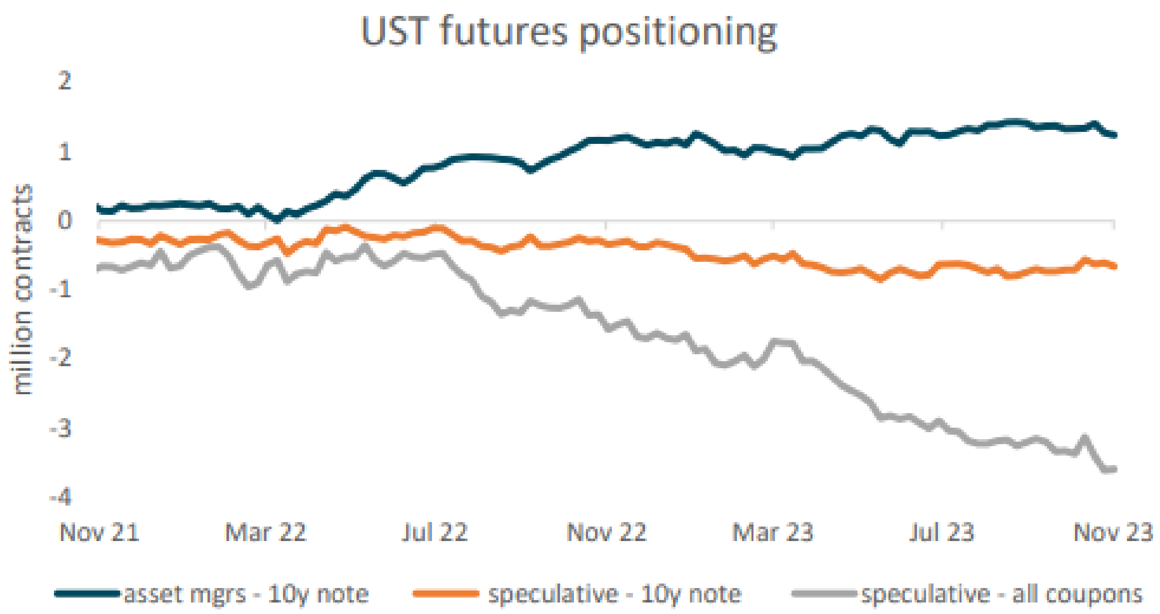
A Quick Look At Bond Positioning

Turning to the long end of the curve, we have been struck by the sizeable and quick decline in 10y yields over the last month. After touching an intraday high just over 5% on Oct. 23, the yield on the 10y note as of this writing is down to 4.42% – nearly 60bp lower. Much of this includes two large daily drops in the yield, the first on Nov. 3 after a downside miss for the October jobs report, and the second after a small downside miss on the CPI report on Nov. 14. The perception that the FOMC is done raising rates and the shift of market pricing to incorporate potential rate cuts has doubtlessly helped bond prices rally, as has a less-bad-than-feared (but still eye-watering) quarterly refunding statement in early November.

We think the market has gotten ahead of itself, however. Fiscal dynamics are not going to improve without serious work in Washington, DC over the next few months, a prospect we currently think is remote. While we concur with the market that the Fed is done raising rates, we think the rush to price in cuts is overdone. These are two factors that we believe will eventually put pressure on yields to go higher again.

How is positioning set up? Not much differently than it was before November. Hedge funds' short futures positions (thanks to the persistence of the basis trade – see here) remain significant, while real money (read: asset managers) remain long 10y note futures. The chart below illustrates this positioning: the gray line indicates speculative positioning across all coupons and the orange line just in the 10y note. The gray line continues to decline, while the orange line is holding steady. Asset manager positions in 10y note futures are also relatively unchanged over the last several weeks.

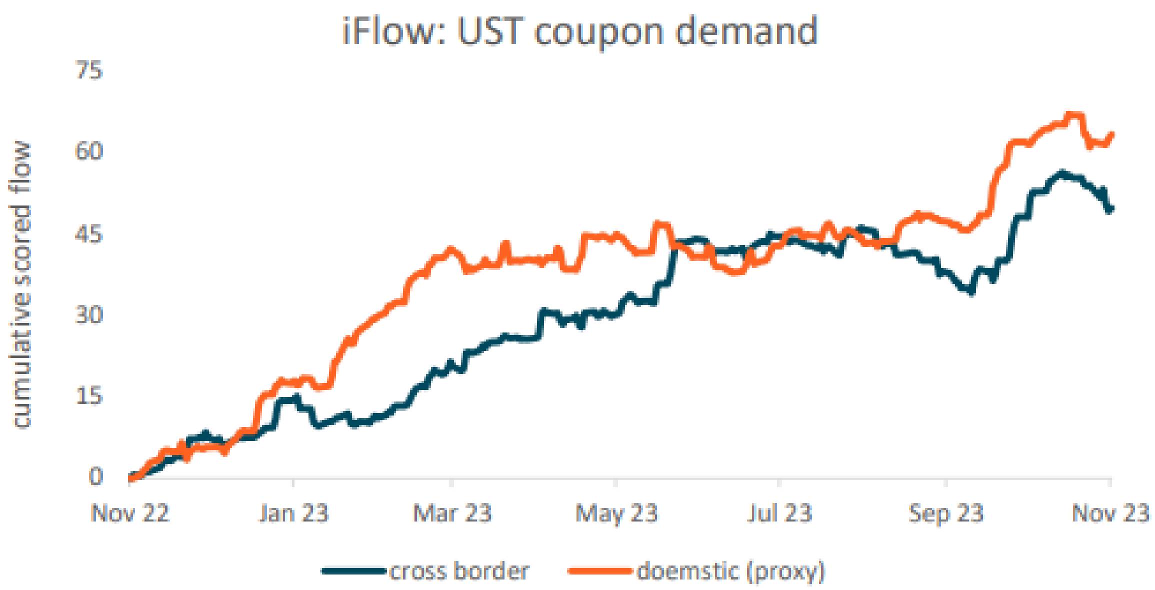
The Futures Are The Present



Source: BNY Mellon Markets, Bloomberg, Commodity Futures Trading Commission (CFTC)

Turning to our iFlow data – covers predominantly real money, long-only investors – we can see that demand for USTs (coupons only) remains robust as well. Real money continues to add to its Treasury position, and domestic investors have been relatively unrelenting since this summer. In short, they have been buying USTs all the while yields were rising and kept doing so as yields fell in the past month. There appears to be a small inflection point currently, but in the overall context of the accumulation of USTs we depict, it's too small and too recent to lead us to believe a big exit from bonds is coming. Nevertheless, it bears watching. While capitulation of real money's long Treasuries position doesn't look immediate, if it were to happen it could be a significant development.

Real Money Demand Still Holding Up



Source: BNY Mellon Markets, iFlow

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

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