

iFlow

SHORT THOUGHTS

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Watching RRP Drain

The Fed Was Right - Higher Rates Mean Lower RRP

Since June 1, following resolution of the debt-ceiling impasse, the US Treasury has issued approximately \$1.3 trillion (net) in T-bills. Over the same period, the overnight reverse repurchase program (RRP) at the NY Fed has declined over \$1 trillion, in line with what had been promised by Fed officials for months prior to June 1. The Treasury General Account (TGA) has been topped up close to Treasury's projected Q3 level and is just shy of \$700bn.

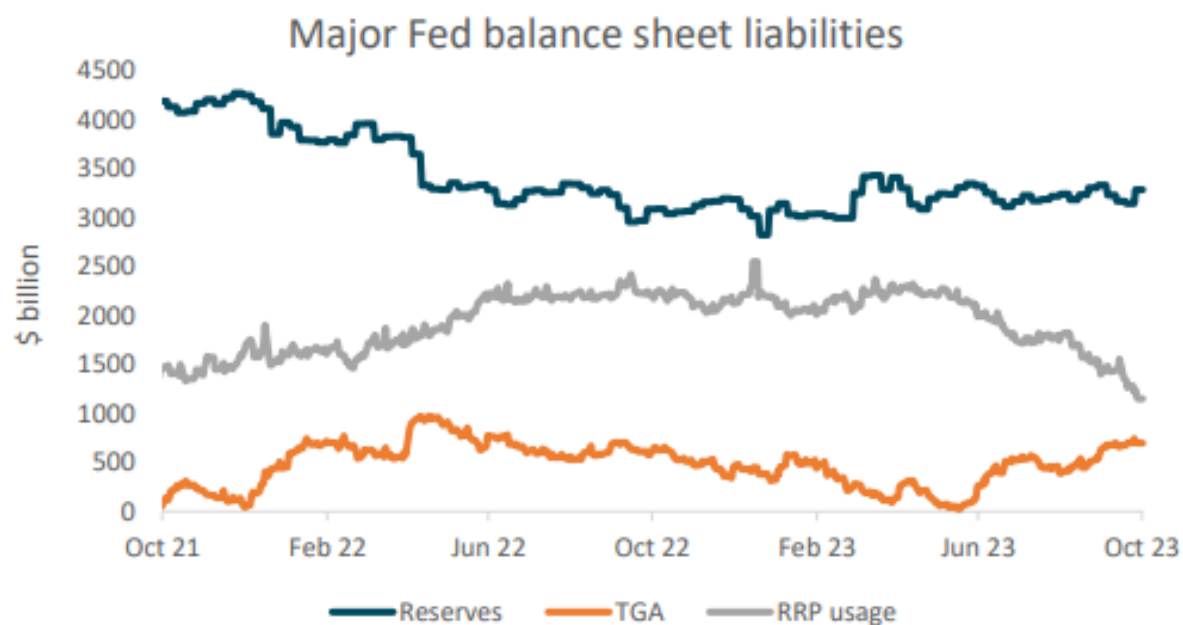
This happy set of circumstances suggests that despite the eye-watering quantity of supply from Treasury that has been issued in that period, the process has gone smoothly, and that markets are achieving what we thought might have been more difficult. Higher T-bill supply, at higher yields (thanks to Fed policy) has allowed money market mutual funds (MMFs) to switch out of the – then relatively attractive – RRP and into bills.

Don't forget that over this entire period, there has been an almost weekly progression higher in MMF assets. On May 31, MMFs managed \$5.4 trillion in assets. By Oct. 11, the last day for which we have observations, the Investment Company Institute reports this sum to be up to \$5.7 trillion. There seems to be little doubt that these monies are flowing into T-bills as well, given the cheapness of these securities.

What happens if RRP continues to drain at this pace? At some point, the money from RRP will run out, and we question who will be able to absorb the additional supply of T-bills we expect to keep coming. The proverbial "man on the street" will be one source, and again, we can understand why holding a perceived very safe asset of short duration (either via MMFs or directly from Treasury) with such an attractive return would be appealing, especially in a world where volatility in equities and long-end Treasuries could rise.

Last week, we somewhat tongue-in-cheek remarked that our iFlow data showed that real money was happy with a “T-bill and chill” strategy. We reiterate that now. However, once the RRP drains to negligible levels, the T-bill buyers might have run out of appetite, and this could portend some liquidity concerns at the front end of the curve. That time may seem a long way off but recall that it was a mere 4 ½ months ago that we were concerned about RRP well north of \$2 trillion. Things can develop quickly in markets, and it’s not too early to start to ponder what could happen next.

Reserves Resilient While Reverse Repo Recedes



Source: BNY Mellon, Federal Reserve Board of Governors, US Treasury

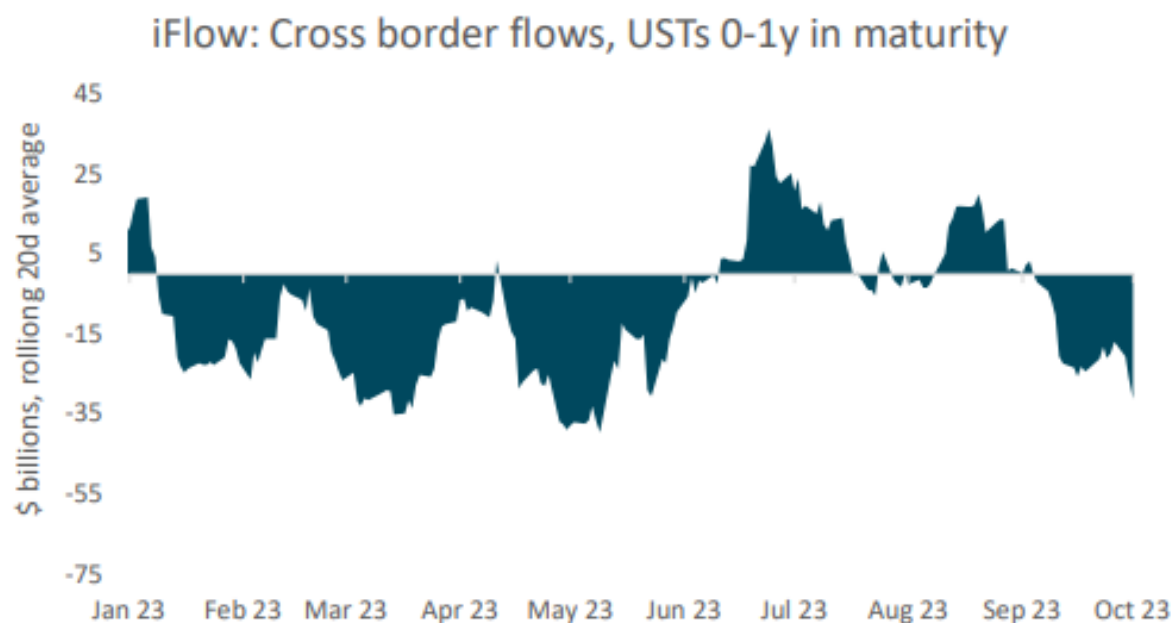
Don't Count On Foreigners To Buy The Bills

One source of T-bill demand absent now is the foreign channel. Our enhanced iFlow data separates out US government bond flows by maturity bucket, the shortest duration segment being the 0-1y part of the curve. We should caveat that this part of the curve is not just bills but also includes any bond with 1y or less left on its term, e.g., a 10y bond issued in 2014 could fall into this bucket. Nevertheless, we think it’s a good proxy for bill demand.

When we look at cross-border flows into the sub-1y bucket since the year began (chart below), we see three distinct regimes. From the turn of the year through the end of May there was a general trend toward selling short duration govovies, followed by a period of fairly solid demand for most of the summer, particularly pronounced in June on the resolution of the debt ceiling standoff, but generally lasting until the end of August. From that point on, we’ve seen another drop in appetite from the beginning of September, right through the latest date for which we have data.

Again, as mentioned above, there is a lot of time between now and when we think RRP could dip so low that overall T-bill demand becomes potentially compromised. We cannot say with any certainty when this point would be reached, or what foreign appetite for bills will be at that time. However, if we get there without foreign demand for bills, we could see an exacerbation of any liquidity issues that could arise at that time.

Cross-Border Investors Check Out For Now



Source: BNY Mellon Markets, iFlow

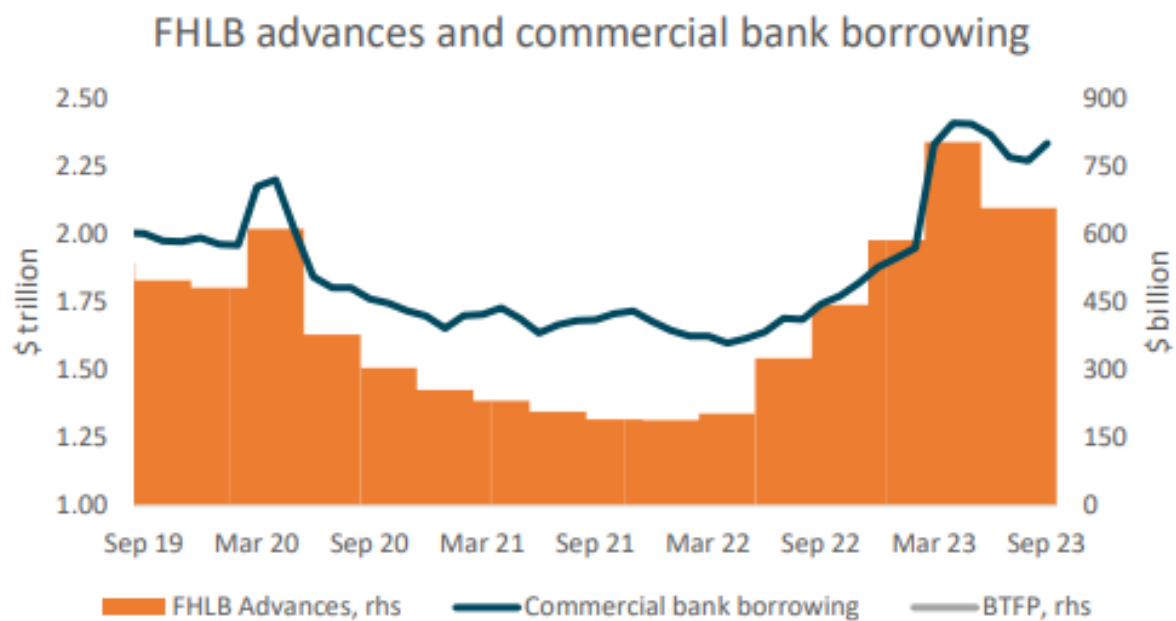
Bank Borrowings Boom

We have observed that commercial bank borrowing is on the rise. While usage of the Fed's Bank Term Funding Program (BTFP), put in place to ease the stresses of the regional banking turmoil earlier this year, has stabilized at about \$110bn, bank borrowings from all sources have grown from about \$1.5 trillion in March/April to over \$2.25 trillion presently.

Note in the chart below the correspondence (in direction and dynamics, if not in levels) between Federal Home Loan Bank (FHLB) advances and overall bank borrowing. This could indicate either funding or liquidity stresses in the overall banking sector. We don't think that this is a significant problem for banks, but it deserves keeping an eye on, especially as the BTFP nears the end of its one-year life span.

We know funding costs for banks have increased, either through higher deposit rates, necessary to attract deposits as rates rise, or through money markets – witnessed by rising commercial paper spreads, higher interbank funding rates – and higher borrowing needs as shown by the FHLB advances and the overall higher bank borrowing depicted below.

Advances Advance, Borrowings Rise



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

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