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SHORT THOUGHTS

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Drainage From Fed's RRP Resumes

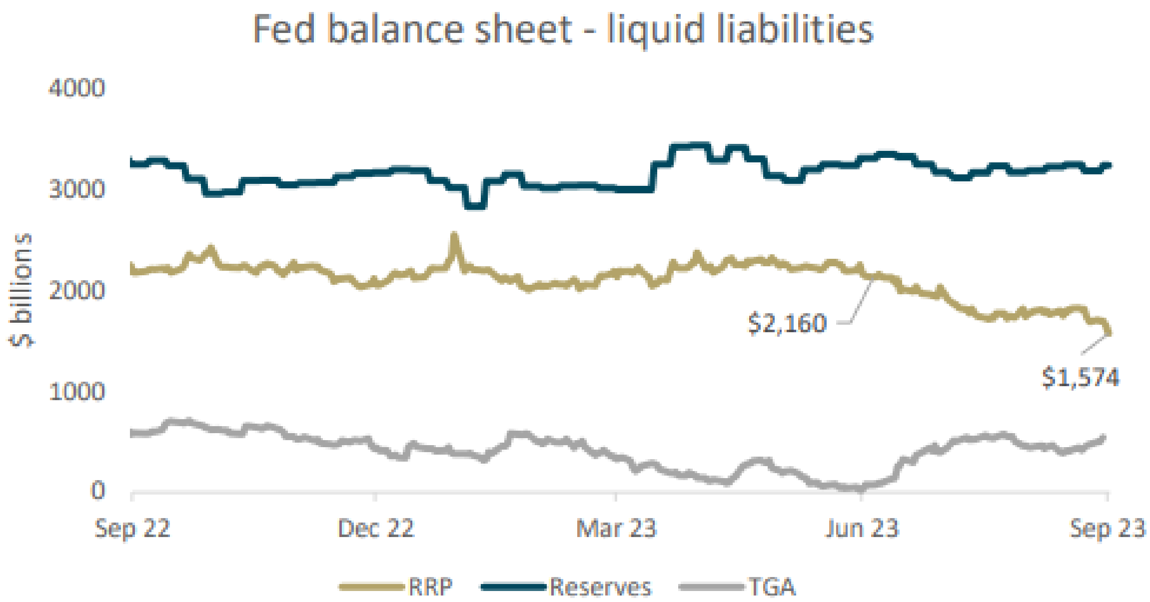
RRP Down, Reserves Stable

Daily balances in the Federal Reserve's overnight reverse repurchase facility (RRP) have taken another sharp leg lower, bringing the total drain since the June 1 debt ceiling resolution to over $600 billion. On that date, take-up was $2.16 trillion but would go on to fall rapidly between June 1 and July 18 – by a total of nearly a half-trillion dollars. Usage then stabilized at around $1.7-$1.8 trillion for several weeks. In the last eight days however, another $240 billion drained to a recent low of $1.574 trillion last Friday.

During the mid-July to mid-August period, when RRP take-up was not continuing to decline after the debt ceiling resolution, there had been concerns that if RRP usage were not to drain further, the high rate of T-bill issuance by Treasury would force monies out of reserves and threaten reserve scarcity. We had chalked it up to T-bill yields that were still not attractive enough at the time to induce money market funds (MMFs) to park cash in bills rather than in the RRP. That has clearly resolved itself in recent days, and RRP has resumed its decline. This is good news insofar as it has allowed a further rebuild of the Treasury General Account (TGA) – primarily via RRP shrinkage and not reserve shrinkage – from $416bn to $541bn in just eight business days. Recall that Treasury envisions a TGA of around $700bn by year-end. So despite the Fed’s ongoing (i.e., in the “background”) QT, total bank reserves have remained relatively steady in the $3.1-3.2trn range for most of this summer. This suggests that other players in the bills market have returned to take advantage of materially higher bill rates. For example, according to Bloomberg, the Dec. 15 bill now yields a compelling (compared to the RRP rate) 5.43%.

Given falling expectations of additional rate hikes from the Fed – at least until the Nov. 1 FOMC meeting and possibly for the remainder of this cycle – receding uncertainty over the rate path has made it attractive to MMFs to extend weighted-average maturities in their portfolios and snap up additional bills. We should continue to see RRP usage trend lower without a major decline in reserves. The interplay between reserves, the TGA and RRP usage will continue to be a concern of ours, but recent trends are encouraging.

Going In The Right Direction



Source: BNY Mellon Markets, Federal Reserve Board of Governors, Federal Reserve Bank of New York

Leverage In The Hedge Fund Basis Trade

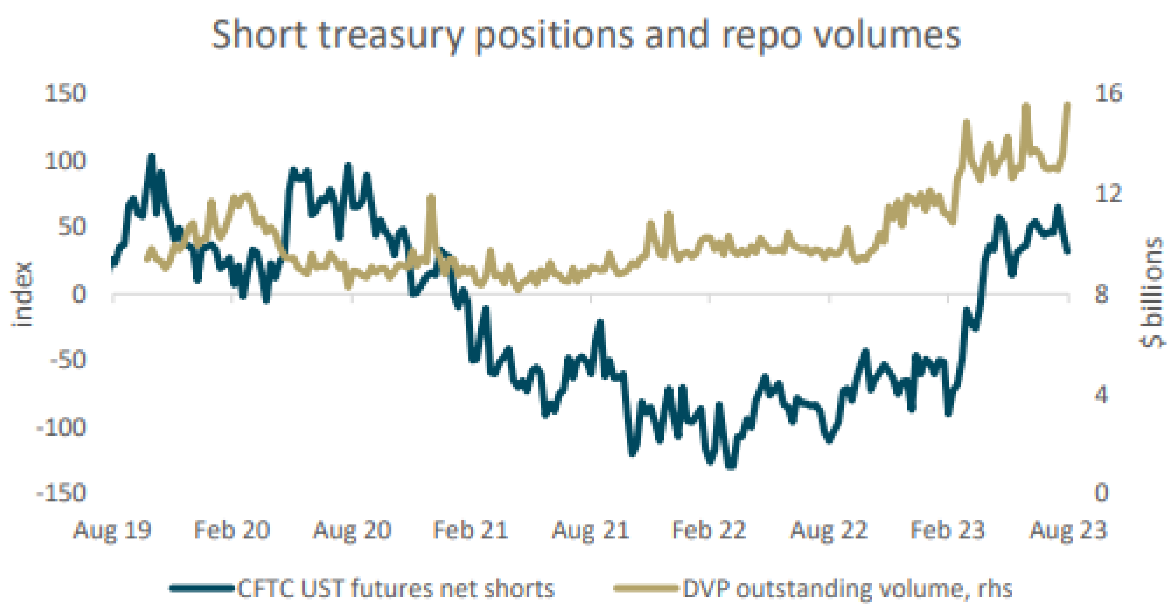
Last week a note published in the Federal Reserve Board of Governors FEDS Notes series drew a bit of attention. It argued that evidence from the futures and repo markets suggest that hedge funds and other leveraged players are re-entering the basis trade – shorting US bond futures alongside a long cash Treasury position, financed by borrowing in the repo markets. In this way, an investor can position for falling bond prices, levering up with repo borrowing. The note argues that this increasing leverage in the bond market could prove disruptive if for some reason these positions were forced to unwind.

In this section we'll try to replicate the logic of the Fed piece and show this trade in action. The graph below shows total short positions in US note and bond futures by leveraged money players (blue line), and hedge fund borrowing volumes in sponsored repo. The short futures positions are among the highest that have been observed in the CFTC data since before the pandemic. Borrowing is also at its highest. Again, it appears that these investors are financing a short futures position with repo borrowing.

Without quantifying it, the note concludes that “Should these positions represent basis trades, sustained large exposures by hedge funds present a financial stability vulnerability.” Implied in this is that should market shocks ensure, these leveraged positions would be highly exposed and a forced, rapid unwind could create significant liquidity strains.

Much depends on the future course of bond yields, which after rising significantly in early August, have stabilized. However, the volatility in yields of late has been notable. We estimate that the 1-month standard deviation of daily changes in 10y bond yields is higher now than at any point since the summer of 2008, an inauspicious comparison.

Financing Treasury Shorts

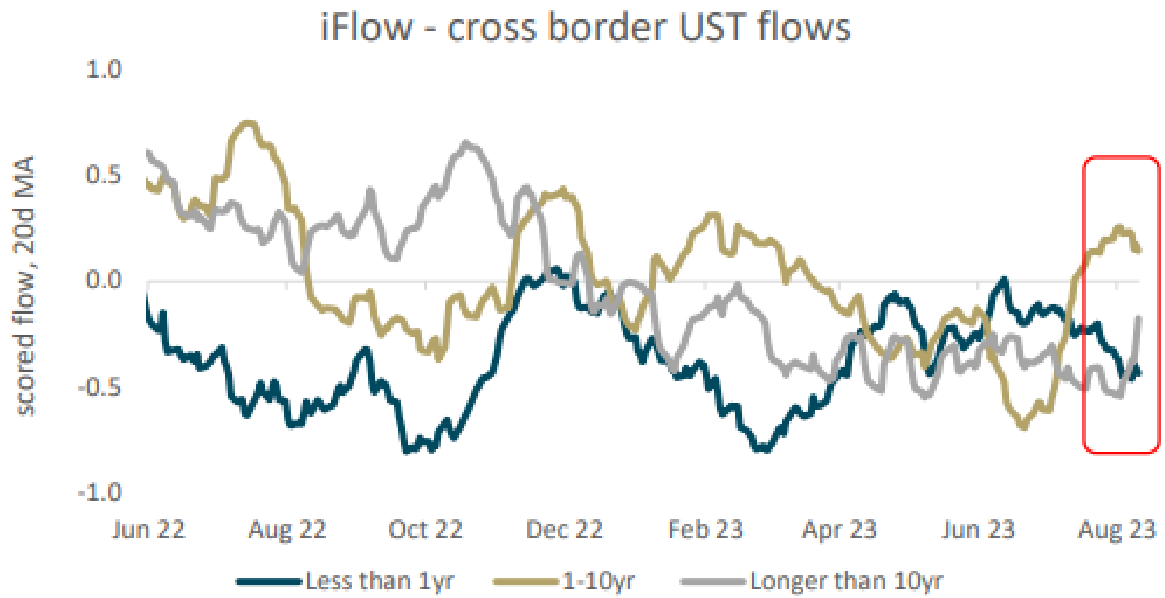


Source: BNY Mellon Markets, Bloomberg, DCC, CFTC

Foreign Money Returns To Treasuries

One factor that may be responsible for the recent stabilization in bond yields could be the return of foreign money into the market, presumably attracted by those higher yields. The chart below shows cross-border flows into US sovereign bonds for three maturity buckets – less than 1y, 1y-10y, and greater than 10y. Note increased buying from foreign investors in the latter two buckets. This is quite a turnaround, and quick as well. For nearly a year we have been lamenting the lack of foreign demand in the Treasury market, arguing that it could play havoc with Treasury pricing, especially in the face of significantly larger issuance plans from the Treasury. This worry seems to be less acute now than it was just a month ago, when foreign demand was close to rock bottom.

Coming Back To US Shores



Source: BNY Mellon Markets, Bloomberg, Federal Reserve Bank of New York

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

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