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SHORT THOUGHTS

September 10, 2024

Money Funds and Fed Liabilities

Will MMF Assets Keep Growing? When Will Reserves Fall to $3trn?

- Money fund assets keep growing; we don't expect them to fall when rates do
- Rate uncertainty pushes MMF WAMs lower
- Total system reserves falling toward $3trn
- This could mark the transition from abundant to ample reserves

Money Fund Assets Typically Rise as Policy Rates Fall

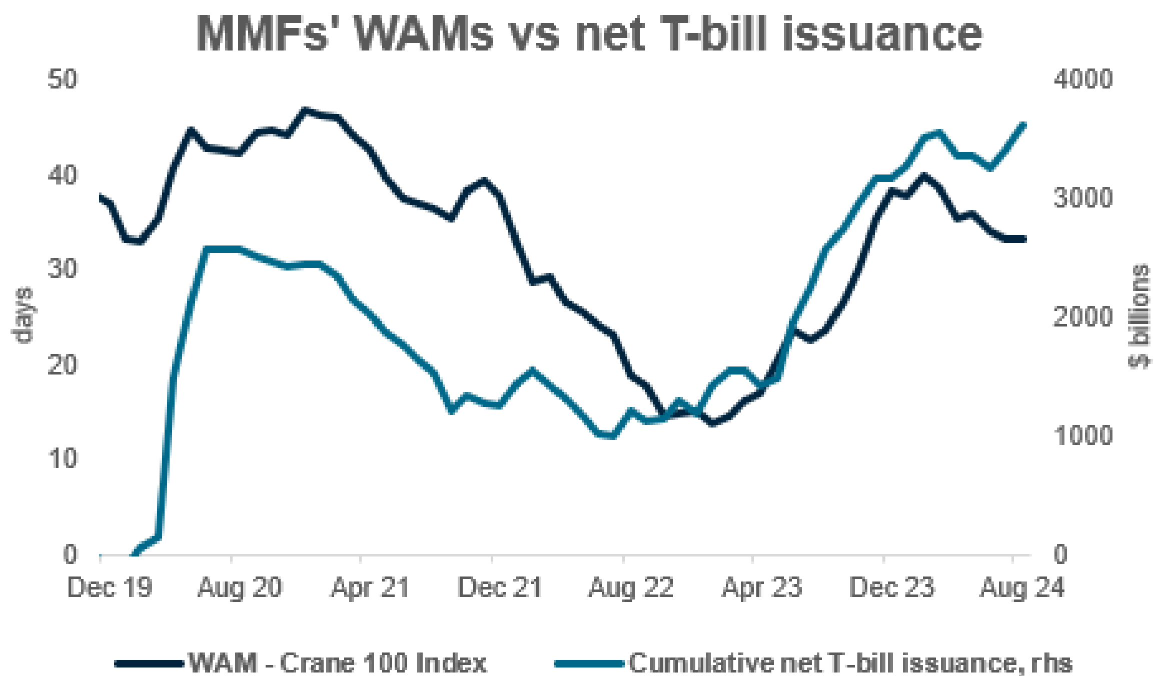
As money market mutual funds (MMFs) continue to absorb assets, it's reasonable to question whether or not the upcoming change in the interest rate environment will foster a decline in the asset class's inexorable growth. In short, will lower front-end rates – and as a result lower yields on MMFs – decrease their attractiveness, leading to lower total balances?

We don't necessarily think so. Typically, the Fed lowers policy rates when the economy (and, of course, inflation) cools. In the past when rate cuts commenced, MMF assets actually jumped – this despite yields on these funds falling due to lower rates. This seemingly counterintuitive result is due to the desire of MMF investors to hold cash during times of uncertainty for the economy and financial markets – characteristic of periods when policy rates are declining.

The one-day liquidity, relative safety, and higher yields relative to deposits are attractive features of the asset class. Cash and cash-like holdings typically swell during such periods, benefiting the MMF community. We don't think this cycle will be any different. Indeed, according to Investment Company Institute data, the total AUM of MMFs achieved another record last week, up to $6,3trn. All told, over the past 12 months, assets grew by around $700bn, $400bn of which were accumulated since the start of 2024.

Since the beginning of the year, MMFs' weight average maturity (WAM) in aggregate have fallen, however, from around 40 days at the end of 2023 down to 33 days last week. Exhibit #1 shows that MMF WAMs tend to follow bill issuance – larger bill supply leads to longer WAMs. In periods of interest rate uncertainty such as the present, money funds will shorten up maturities as longer-dated bill rates fall in line with policy expectations. Given the current debate over how fast policy rates will fall, we aren't surprised MMFs aren't taking big positions further out the T-bill curve.

Exhibit #1: WAMs Follow Bill Supply



Source: BNY Markets, Crane Data, US Treasury

Reserves Have Fallen Toward $3trn as Corporate Tax Date Looms

The Fed's main balance sheet liabilities are bank reserves (currently $3.2trn), the Treasury's general account (TGA), which has been steadily between $700bn and $800bn since the summer, and reverse repurchase agreements, or RRP, currently hovering around $300bn, also since the middle of the summer. The stability of the balance sheet has been encouraging for those keeping an eye on overall system liquidity.

We have written much about the transition of banking system reserves from abundant (as they are now) to ample and the implication for liquidity and funding markets. We have argued (see here) that reserves remain abundant at present. If and when reserves transition to merely ample, we may not know it *ex-ante* but will instead have to infer it from repo rates and other short-term money market spreads.

Exhibit #2 shows the evolution of these main Fed liabilities. Note the steadiness of the TGA and the very slow – in fits and starts – reduction in RRP balances. We have noticed, especially in the past two weeks, that reserve levels are slowly falling. From a 2024 high of $3.6trn in early March, they are down nearly $400bn through last Wednesday to $3.2trn. The Fed's quantitative tightening (QT) is largely responsible for the drop. Nevertheless, reserves remain comfortably above $3trn, a round number which is commonly identified as potentially marking the transition from abundant to ample reserves. If RRP balances drain further, liquidity may become pressured.

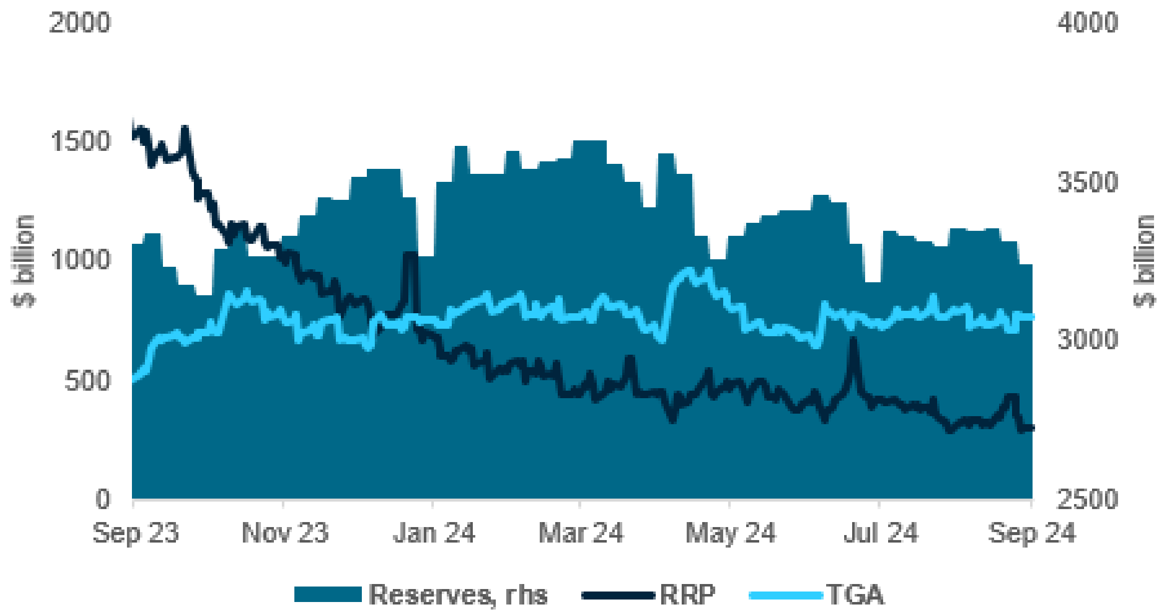
We haven't seen a significant rise in repo rates for a sustained period, although they have been elevated at times this summer and into the autumn months. Periods which include large treasury settlements as well as month- and quarter-end effects have at times seen repo rates inch up, but they are currently well-behaved. This is also helped by expected rate cuts priced in through to the end of the year and beyond.

Still, this decline in reserves, especially if it continues, has our eyes peeled for repo disruption. The upcoming tax date next week (September 16) represents one potential source of stress, although we're not overly worried, even though we all remember around the same time of the month in September 2019, there was a scarcity of system liquidity which caused a repo market storm, ultimately requiring the Fed to step in and create a special liquidity operation, effectively ending QT at the time.

While we think next week will pass relatively smoothly, the longevity of the current episode of QT is a question in our eyes. We don't think that the upcoming FOMC meeting will mark the end of QT, but we don't think it can last much longer, especially if reserves fall closer to the much watched $3trn level.

Exhibit #2: Fed Liabilities Relatively Steady, Although Reserves are Falling

Fed Balance Sheet - Main Liabilities



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

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

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