BNY

iFlow

SHORT THOUGHTS

June 18, 2024

Sea Change In Cross-Border US Treasury Flows

- iFlow shows foreign demand returning to US Treasury market
- Small bank lending is now negative – monetary policy is biting
- RRP drainage meets flat T-bill supply

Coming Back Into The Market

We have been making a good deal of noise about foreign demand for US Treasuries, as captured by our iFlow data, for some time. Our data had been showing tepid – at best – buying of Treasuries by cross-border investors (see here, for example). This had been a concern for us because of our view that a lack of overseas real money participation in the bond market could be a problem in the overall market's ability to take down what we anticipate will be ever-increasing coupon supply in coming quarters.

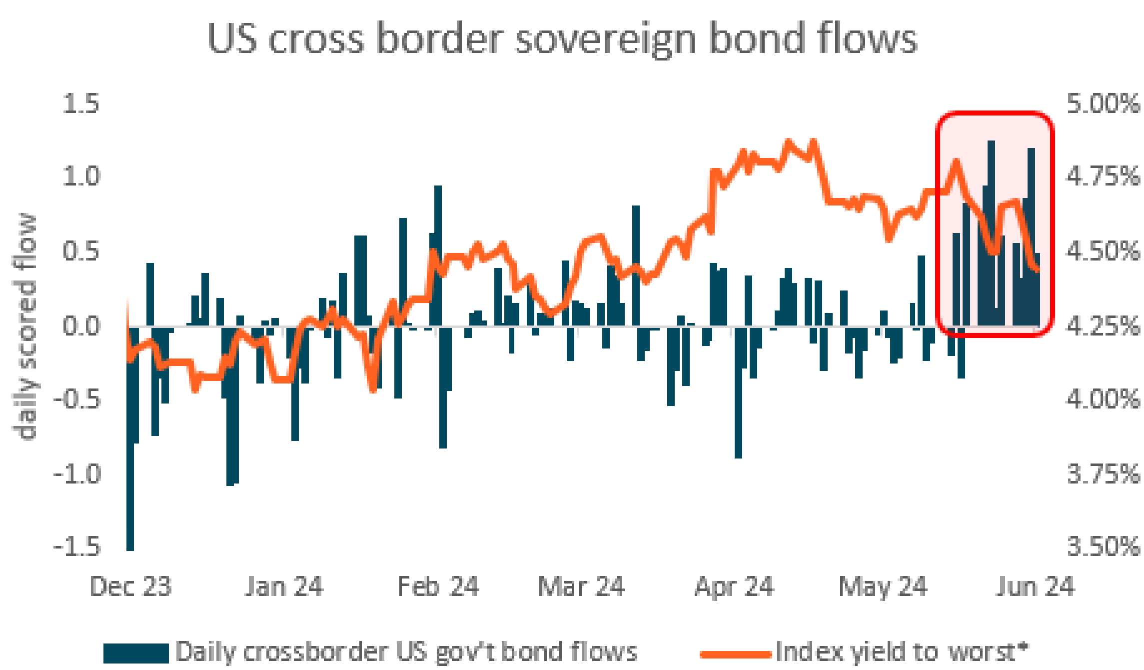
Fast forward to the end of May this year, and we are encouraged to see a reversal of these lackluster flows. The chart below shows daily (scored) flows by cross-border investors since the beginning of this year. The first half of June has seen a significant return to the market by the overseas real money investors that iFlow tracks.

Furthermore, from a visual examination of foreign flows against the Bloomberg US Treasury total return index (unhedged) yield-to-worst, we see that over the sample period displayed in the chart, yield movements tend to track inversely with these foreign flows. Note, for example, that the rally in bond yields since the beginning of this month corresponded to a nearly two-week period of cross-border inflows. The same pattern – only this time in the other direction – can be observed when flows are negative or close to zero.

Where along the curve is this new buying taking place? The chart below compares average daily scored flows across the five maturity buckets into which we can disaggregate US Treasury flows. We look at two periods, from the beginning of the year through the end of April, and from the beginning of May through the most recent available observation (June 14). We take average daily scored flow for the two periods and can see large jumps in demand across the longer maturity buckets. This suggests that higher yields at the longer end of the curve have been sufficiently attractive to induce foreign buying.

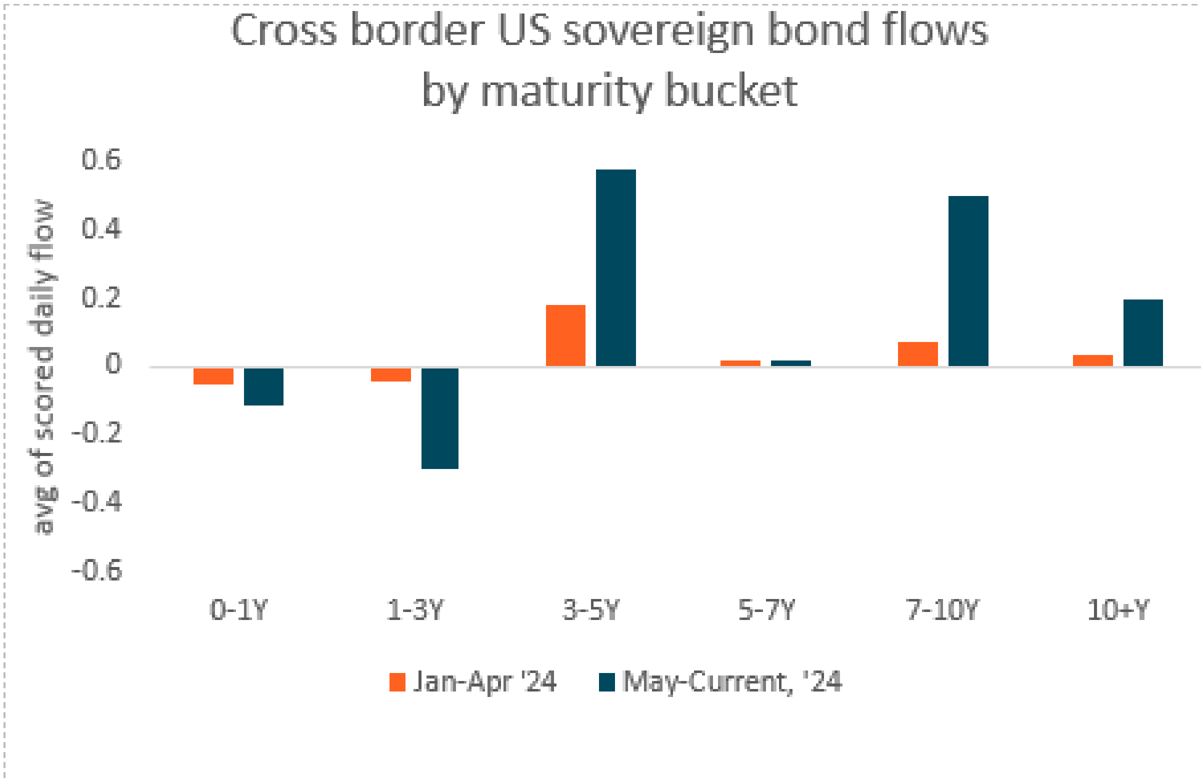
This is a new development, and one that allays – for the moment, at least – our fears of a demand-driven (or lack thereof) hiccup in yields.

New Cross-Border Buying In June



Source: BNY Markets, iFlow

Longer End Of The Curve Attracting Demand



Source: BNY Markets, iFlow

Small Lenders And Negative Loan Growth

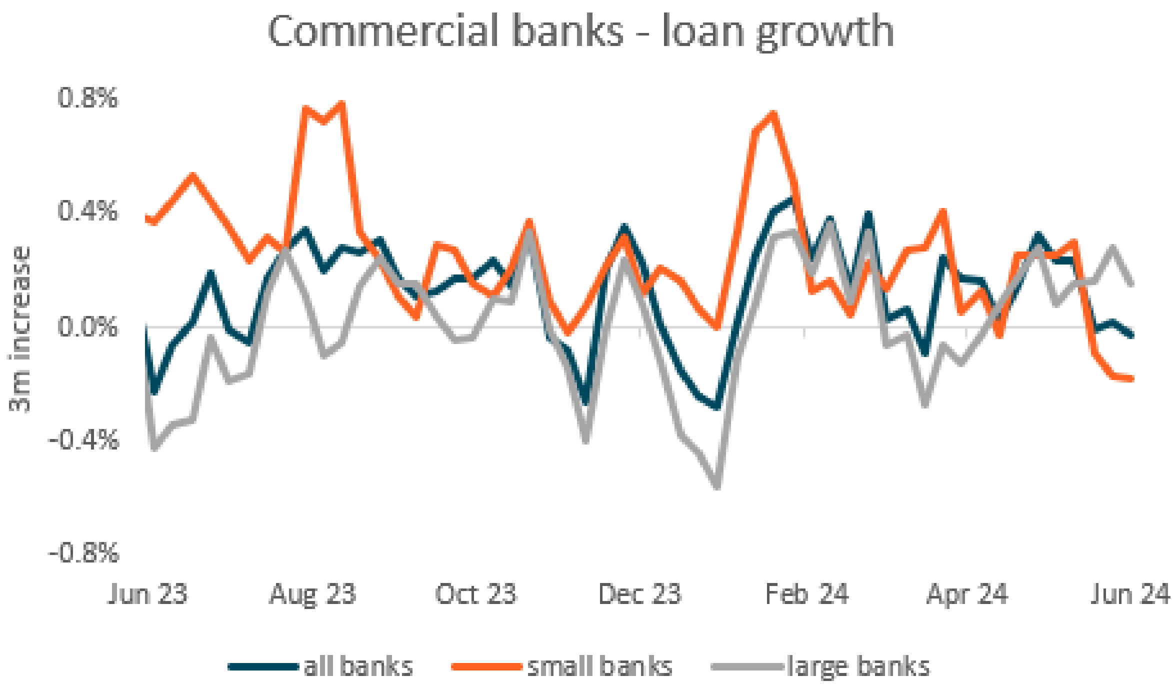
We have been closely tracking aggregate bank lending in the US, our interest deriving from a belief that monetary policy is working. Recent data show that lending by smaller banks (defined by the Federal Reserve to be any bank not one of the 25 largest) has fallen to cyclical lows and is now negative over a three-month period. Interestingly, small bank balance sheets, defined by total assets, are not shrinking overall, indicating that these banks' portfolio choices are shifting out of loans and into other assets. See the chart below.

Our view is that small banks are restricting credit growth in the economy. Considering that most small- and medium-sized businesses bank with these "small" lenders, falling credit growth in this sector should translate into weaker investment growth, slower hiring and, ultimately, lower inflation as aggregate demand slows. We believe this is occurring now.

That's why we maintain our Fed rate call – cuts to commence in September. The depth and pace of the cutting cycle is still to be determined, but we see two cuts this calendar year, matching the plurality of the individual submissions to the FOMC's June Summary of Economic Projections (see here for our post-FOMC thoughts).

Better inflation data for May is an encouraging sign, and we believe also confirmation of the process we laid out above: higher rates lead to constrained credit growth, which leads to lower investment demand, lower employment demand, and ultimately lower prices. We expect data over the course of summer to follow that pattern and validate the rates view.

Big Drop In Small Bank Lending



Source: BNY Mellon Markets, Federal Reserve Board of Governors

T-bill Issuance Levels Off, Bringing RRP With It

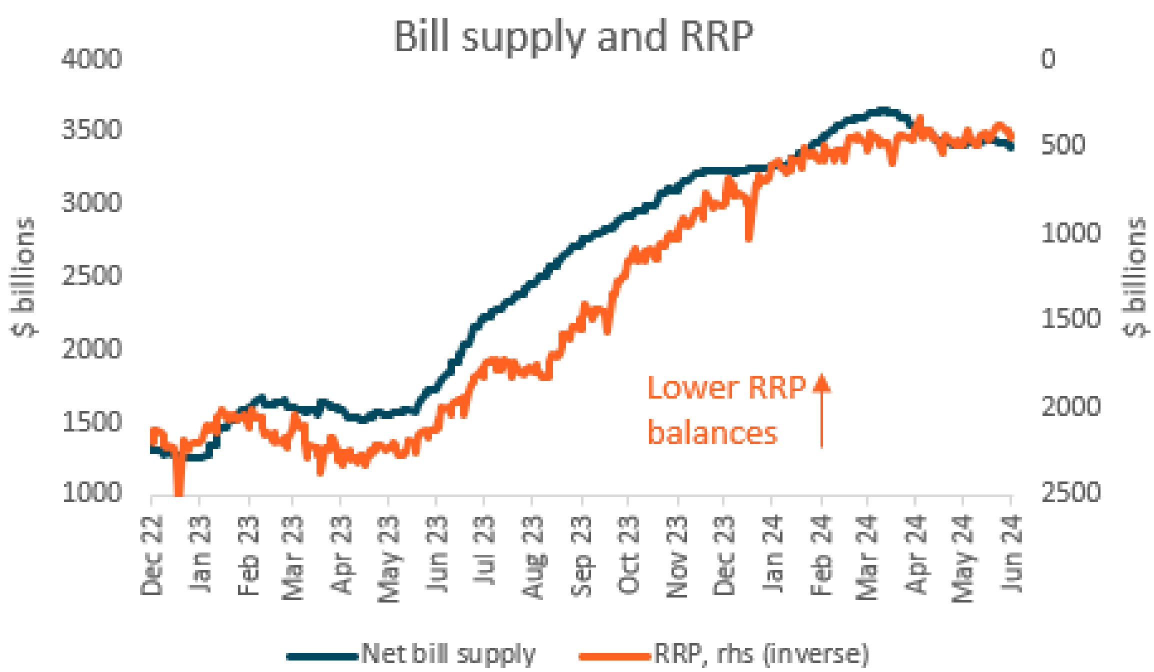
Some weeks ago (see here), we wrote about stabilization in daily reverse repurchase facility (RRP) usage at the New York Fed. After a massive and rapid drain of the RRP between the end of May 2023 and the end of this March, the shrinking of RRP has slowed, with the balance generally at or above $400bn per day over the last two-and-a-half months.

Granted, on some days usage has been somewhat below $400bn, e.g., this Monday. The 15th of the month brings tax payments and coupon auction settlements, which tend to dent RRP demand. Outside of these seasonal blips, we see RRP shrinkage running into the headwinds of paltry T-bill supply and uncertainty about when the rate-cut cycle begins.

Net bill issuance has been close to flat since the end of April, and the Treasury’s cash balance (TGA) has been falling since the April income tax collection period. The first chart below shows a close relationship between RRP balances and bill supply.

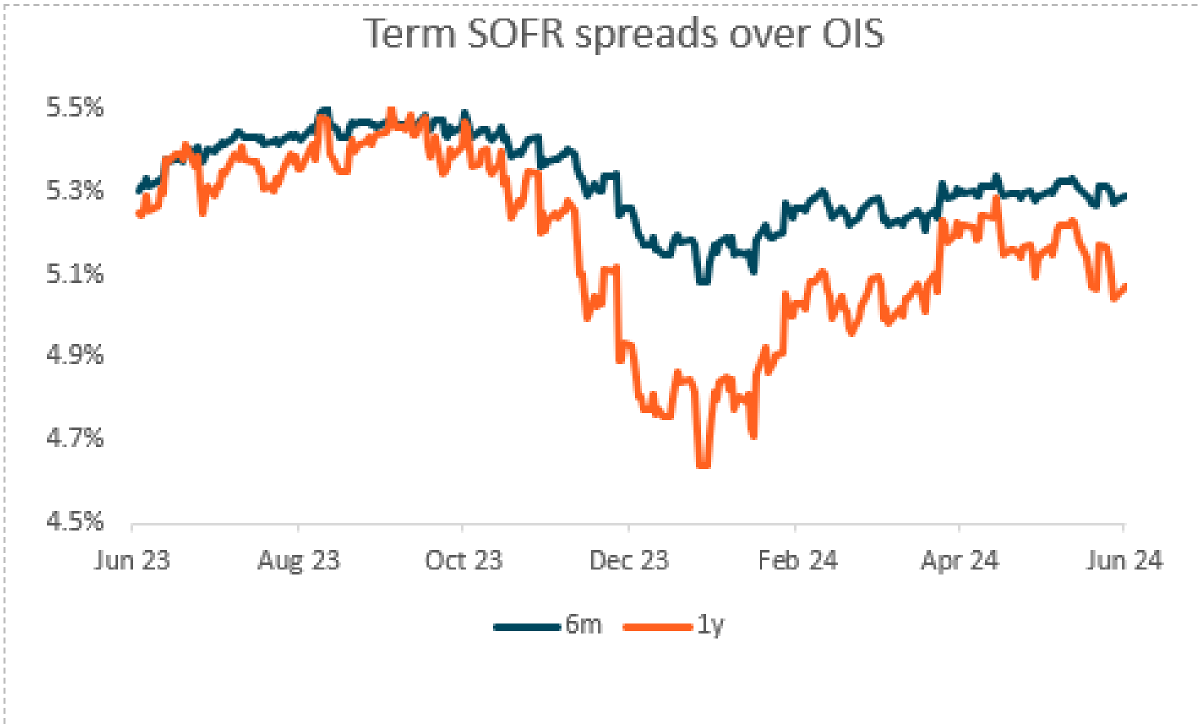
In the second chart below, we plot the 6-month and 1-year SOFR spreads over OIS, a proxy for monetary policy expectations. While the 6m spread has been generally flat since repricing a higher-for-longer federal funds rate back to February this year, the 1y spread has started to decline again. If our Fed policy call is correct and September becomes more and more priced in by markets over the summer, expect the 6m spread to tighten as well, and for RRP drainage to remain much slower than over the May 2023 through April 2024 period.

Bills And RRP Flat



Source: BNY Markets, US Department of the Treasury

SOFR Spreads To Fall?



Source: BNY Mellon Markets, Bloomberg

Disclaimer & Disclosures

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

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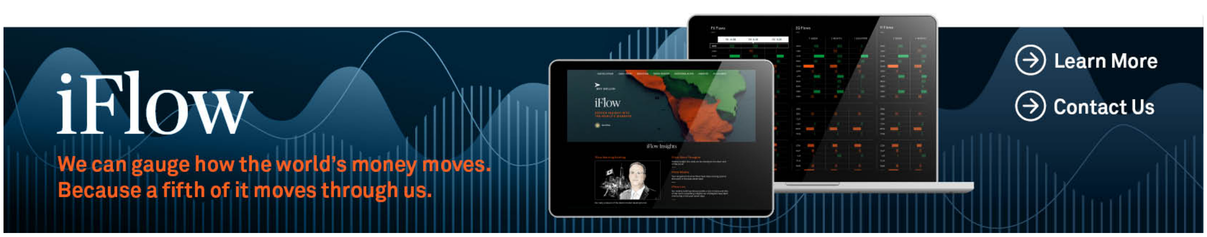

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