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SHORT THOUGHTS

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Don't Expect Fireworks At Jackson Hole

Not Time For A New Prescription

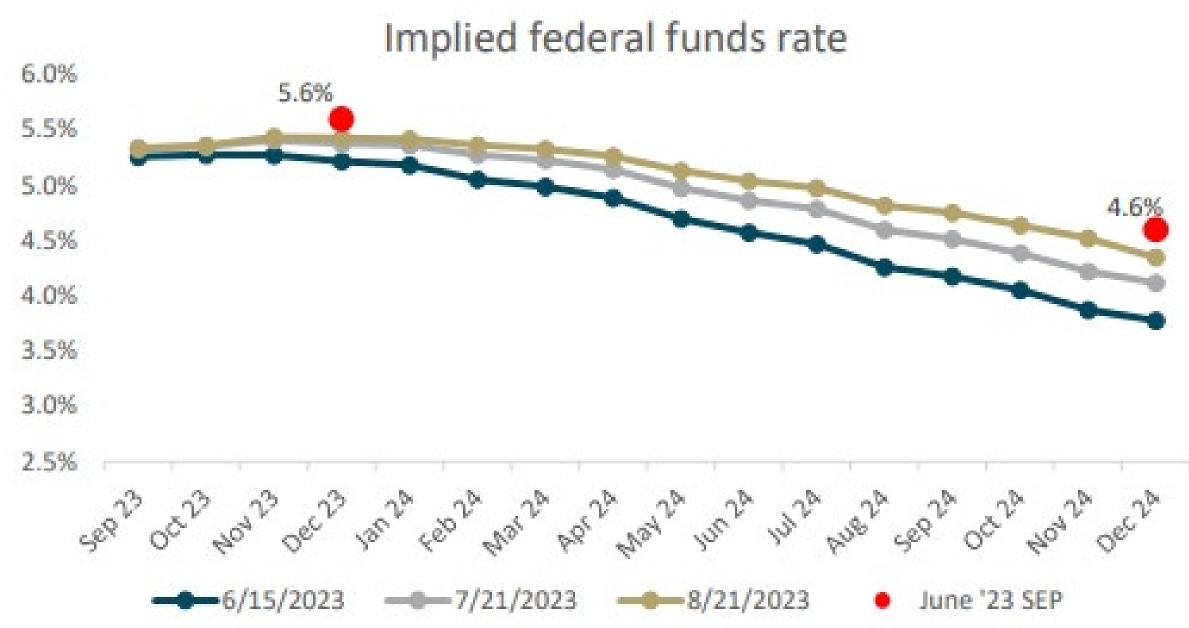
It’s that time of year again. The last full week of August has us and the market looking to Friday’s appearance of Fed Chair Powell at the annual Jackson Hole Economic Symposium, hosted by the Federal Reserve Bank of Kansas City. Will the Chair play it safe, essentially reiterating the message he delivered in his most recent post-FOMC press conference on July 26? Or will he be more prescriptive and provide hints on how much higher, if at all, rates will go, and on how quickly the FOMC is prepared to move, if they do at all.

We don’t expect fireworks on Friday. Very little in the economic picture for the US has changed. Inflation, while slowly relenting, is still too high for the FOMC’s comfort, even as growth remains robust. We think it's entirely too early for the Fed to declare victory and indicate an explicit end to the tightening cycle. Instead, as indicated above, we think it’s more likely that the remarks in Wyoming will resemble those at the July 26 press conference, as well as the minutes from that meeting nearly one month ago. We have had very little in the way of Fedspeak this month, and nothing from the Chair. Given a similar economic situation as that which prevailed a month ago at the last FOMC, and no overt progress on inflation, the Fed remains data dependent and the September meeting is, as Powell declared in his July remarks, “live”, meaning a rate hike is not ruled out, nor is a hold in policy.

The meeting minutes told us that “a couple of participants indicated that they favored leaving the target range for the federal funds rate unchanged", indicating some divergence of opinion. Yet we remind readers that the vote to raise the federal-funds rate by 25bp in July was unanimous. That "couple of participants" were just that, participants – or members of the Committee who do not vote on policy this year. It's entirely likely that had those participants been voters, they would have toed the line with the rest of the Committee. We don't think diverging views at this point – so close to the end of the cycle and with future economic and inflation developments highly uncertain – are terribly concerning. The decision to raise rates one more time or to leave them be is clearly going to be a close one. Not everyone on the Committee will have the same conviction on the rates view at this juncture, of course.

We don't think that rates will go higher in autumn. Instead of fine-tuning the level of rates, we think the Fed will focus on the length of time that rates stay at the current 5.5% target. The economy will likely slow as credit constraints in the financial system bite, and as the labor market loosens slowly. Inflation will likely remain high, but slowly – painstakingly so, in our view – come down, leaving the Fed to keep rates where they are until, in our view, the May 2024 meeting. This is roughly in line with market expectations (see chart below), which have become ever so slightly more hawkish over the summer. We still think there is a cut or two too many priced into 2024, but the market is coming around to the FOMC's June dot plot.

Moving Up Through The Summer



Source: BNY Mellon, Bloomberg

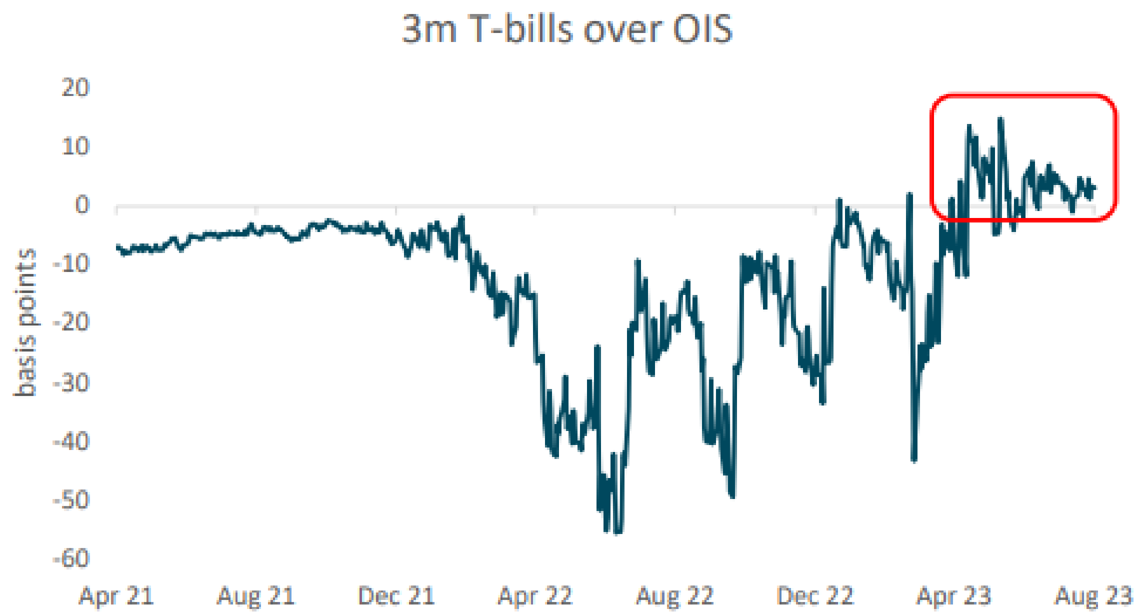
Bills Need To Get Cheaper - We Think They Will

The post-debt ceiling low in take-up at the Fed's overnight reverse repurchase facility (RRP) was $1.72trn on July 18 – down from approximately $2.25trn on May 31, right before the debt ceiling impasse was settled. Since then, RRP balances have inched up and stood at $1.825trn on Monday Aug. 21. Clearly something is preventing those balances from declining further, even as T-bill supply continues to ratchet up and Money Market Mutual Funds (MMFs) attract cash at an inexorable rate. Last week MMFs posted another record in AUM, as cash continues to flood the system.

We were told that RRP usage would continue to decline with higher rates and additional T-bill supply, and the Fed's own insiders continue to expect as much. From the minutes of the July 26 FOMC meeting: *A further decline in ON RRP balances was deemed probable amid sustained projected Treasury bill issuance, further reductions in the size of the Federal Reserve's balance sheet in accordance with the previously announced Plans for Reducing the Size of the Federal Reserve's Balance Sheet, and a possible further reduction in policy uncertainty that could incentivize money funds to extend the duration of their portfolios.*

It's true that T-bill issuance has cheapened bills to the point where they should be attractive to MMFs, as we wrote last week. However, the spread between, for example, the 3m T-bill rate and 3m OIS, which recently went positive for the first time since 2020, doesn't seem high enough to attract additional MMF monies out of RRP – at least not enough to keep daily balances declining. Nevertheless, MMFs have extended WAMs out to around 25 days, suggesting there is some interest in going further out the bills curve. However, it appears that bills aren't still sufficiently cheap to incentivize a full-scale move out of RRP at present. We think that once it's recognized that the Fed won't be raising rates further and reducing policy uncertainty, combined with continuous and rising bill issuance into Q4 and year-end, there will be enough premium in the bills curve to reduce RRP further.

Bills-OIS Spread Just Barely Positive - Not Quite Enough

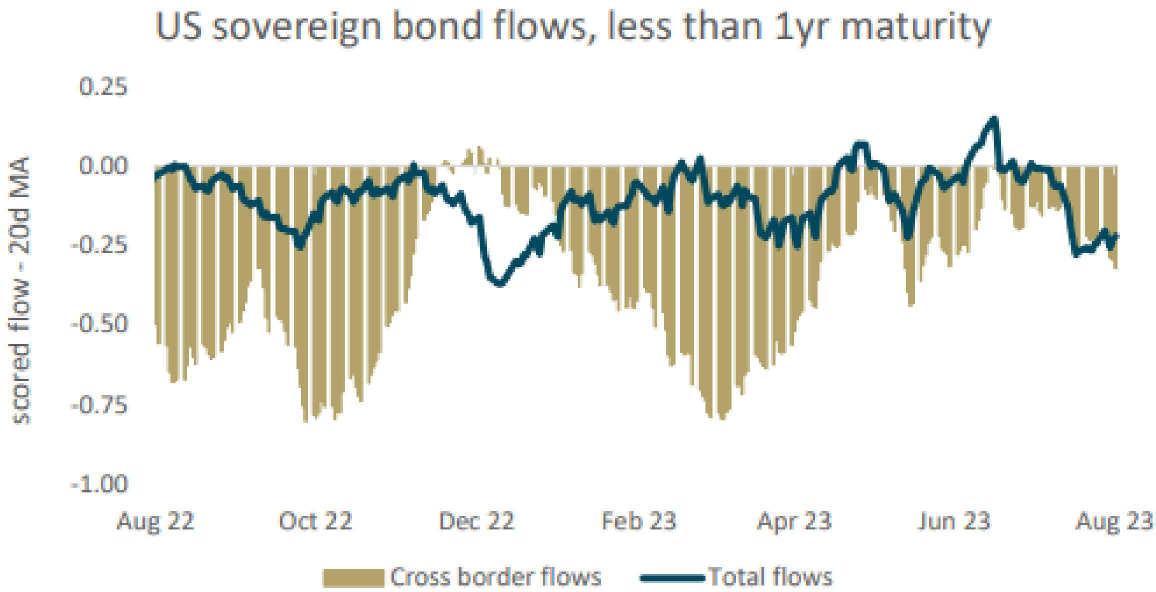


Source: BNY Mellon Markets, Bloomberg

Last week in this space we pointed out that for the first time in a while, foreign purchases of US Treasuries had turned positive, at least in the middle of the curve, i.e., the 1y–10y maturity bucket that we report via iFlow. We attribute this to the recent bear steepening which has sent yields significantly higher, especially around the 10y maturity. Yields now seem attractive enough to entice overseas money into the US market.

One place where we don't see increasing foreign demand, however, is in the very short part of the curve, the less-than-1y maturity bucket. The chart below depicts both total and cross-border flows into this segment of the Treasury curve, and we see renewed selling. Above we discussed that MMFs are beginning to tepidly extend out the bills curve and buy short-dated paper. But for all paper with a short duration, the cross-border component is sufficiently negative to make the total flow (cross-border plus domestic) negative as well. We think this means that the front end will cheapen further, as waning demand pressures prices.

Foreigners Shunning Front End



Source: BNY Mellon Markets, iFlow

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

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