August 8, 2023

Fun At Both Ends Of The Treasury Curve

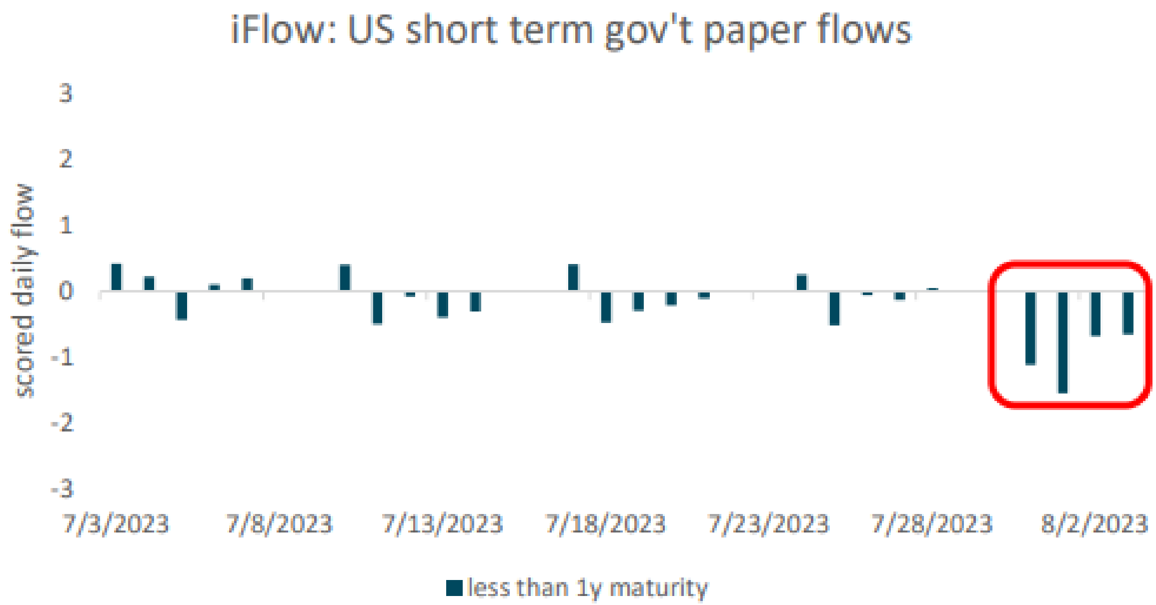
Cheapening And Steepening

Last week was noteworthy for the US Treasury market, in particular the long end as duration sold off heavily thanks to a confluence of events that we had been anticipating for some time now. This week is likely to be noteworthy as well – at both ends of the curve.

At the short end the market will be challenged to digest higher bill supply following the Treasury's refunding announcement last week. Since June 1, after the debt ceiling impasse ended, the bills market has managed to take down $830bn in net supply. Now, however, the Treasury is poised to increase supply sharply given the new quarterly funding plans (see here). Across four offerings, this week's auction size is $11bn more than last week.

iFlow shows increasing sales of short-term US government paper every day last week (see chart below). This suggests bills are not cheap enough to induce buying from real money. Interestingly, primary dealers, according to the NY Fed, have also reduced their bill holdings, by nearly $55bn over the two weeks ended July 26; we lack data for the past week but suspect they are still reducing holdings. Finally, after reaching a recent low of $1.71trn on July 18, usage of the RRP facility crept back up to $1.79trn as of this past Friday.

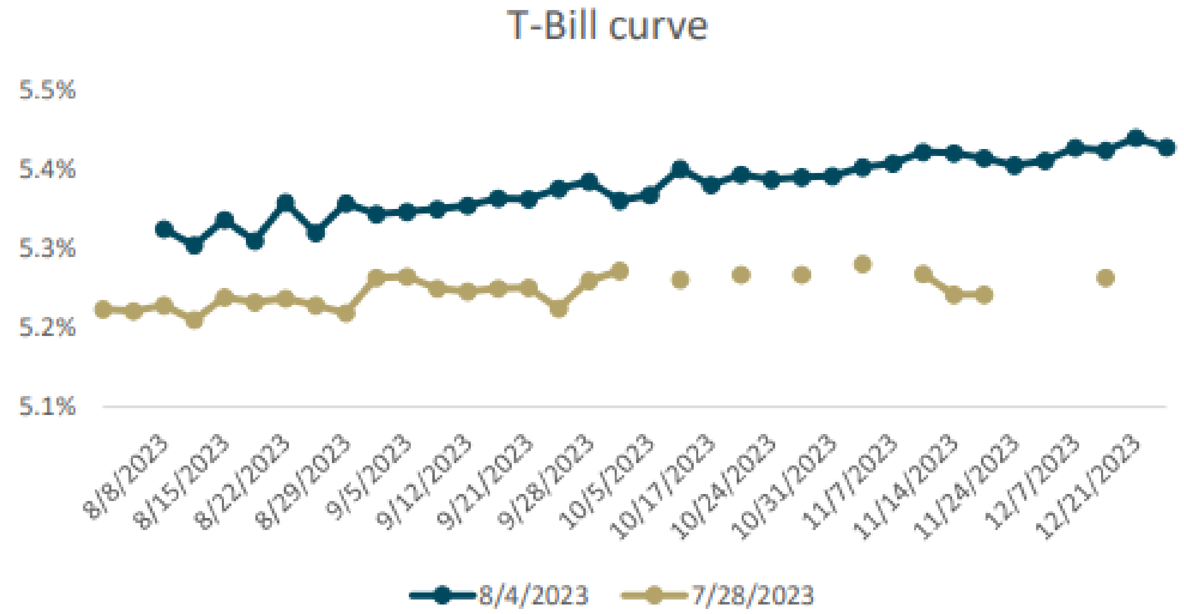
Selling Short-Term Paper Last Week



Source: BNY Mellon, iFlow

Bills have been cheapening – and offer yields above the 5.3% RRP rate across the curve – but apparently not by enough to induce another large wave out of RRP. The chart below plots the T-bill yield curve as of the end of last week versus one week prior – it's notably higher. Meanwhile, money fund assets have grown by another $41 billion (through Aug. 2 from the beginning of July). RRP remains attractive given its overnight duration. Even GC repo rates have sunk below the RRP rate in recent days thanks to long-end volatility. We will be watching to see if upcoming supply increases can continue to be digested.

Cheaper Across The Bills Curve



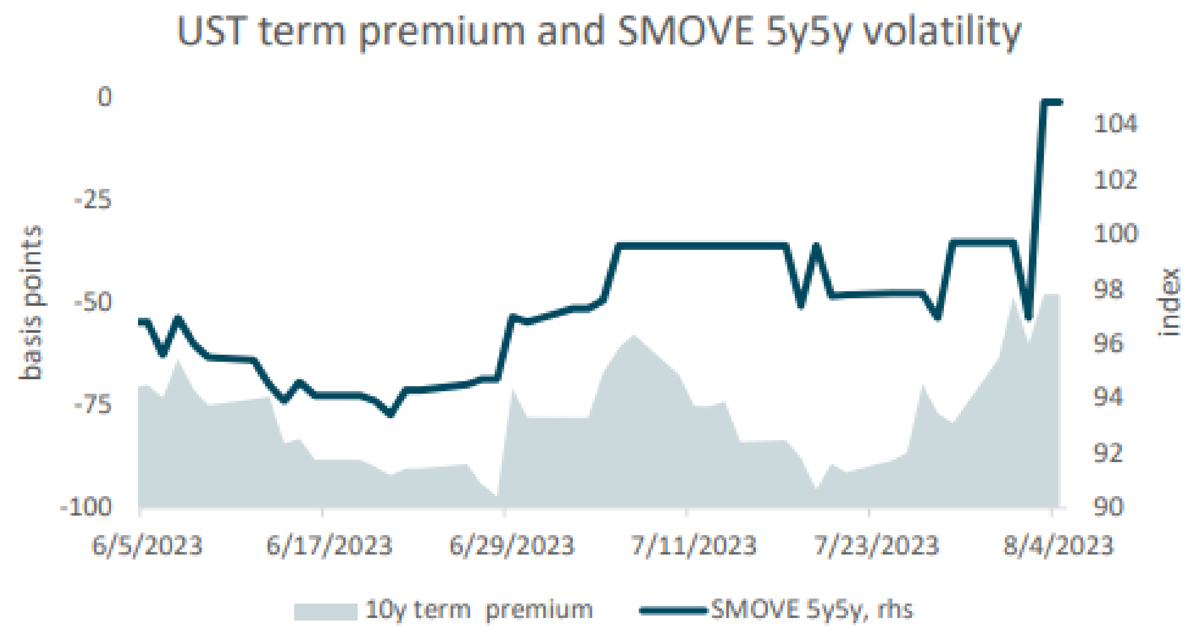
Source: BNY Mellon Markets, Bloomberg

The long end of the curve has suffered the above-mentioned volatility. For most of last week bear steepening was the state of affairs, although much of the move higher in 10y and 30y yields was reversed on Friday. We will look for the curve to re-steepen this week, especially if the CPI and PPI prints don't have good news in the form of further deceleration.

A combination of the Bank of Japan's yield curve control tweak, the massive supply numbers announced by Treasury both Monday and in the middle of last week, and another run of strong data have pushed long-end rates higher. At the same time – and the driver of the move higher in yields – the term premium rose significantly: nearly fifty points since July 19.

The increase in long-end yields has led to a significant rise in swaption volatility. The chart below shows the increase in the 10y term premium as well as in the SMOVE index of swaption volatility 5y5y forward. This week will be a fascinating one in the Treasury market. We see an overall higher move in the curve and expect steepening to continue.

Volatility Rises



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

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

John Velis

FX AND MACRO STRATEGIST FOR THE AMERICAS

CONTACT JOHN

bnymellon.com