BNY MELLON

iFlow

SHORT THOUGHTS

February 27, 2024

On Current US Repo Market Stability And QT

Ample Reserves, Slowing RRP Drainage & A Lull In The Basis Trade

- Repo stresses at end-2023 have not reappeared so far this year
- QT debate involves repo funding, the basis trade, RRP drainage, and the level of system-wide bank reserves
- A new iFlow data series shows a "grab for duration" in Treasuries

Last month we expressed a view that the Federal Reserve would slow the rolloff of its fixed income securities portfolio (QT) in H1 of this year; we foresaw an announcement at the conclusion of the April 30-May 1 FOMC meeting and a start in June (see here). This was partially in response to stresses in US funding markets at end-November and end-December last year, which to many indicated a potential shortage of liquidity in those markets.

Since then, however, funding markets have exhibited little – if any – signs of the strains seen late last year. Indeed, they've indicated sufficient liquidity. The DTCC's general collateral repo index (see chart below) shows that borrowing rates in repo have been quite steady so far this year – and rather low. We plot this rate as a spread versus the RRP award rate, the interest paid by the Fed on overnight reverse repos to institutions which park cash in this facility. Note the pronounced spread-widening at the end of November, and particularly in December, which gave rise to the QT discussion amongst market participants and the Fed.

RRP take-up has shown signs of change as well. From Jan. 2 through the end of the month, total take-up in the facility fell from over $700bn to just over $600bn, roughly the $100bn per month pace observed since the middle of last year. In February, however, RRP balances have stabilized, so far averaging over $541bn. We commented on this a few weeks ago (see here). The chart below plots the evolution of RRP balances along with total system-wide bank reserves. The former has plateaued for the moment, and the latter is well above $3trn. We

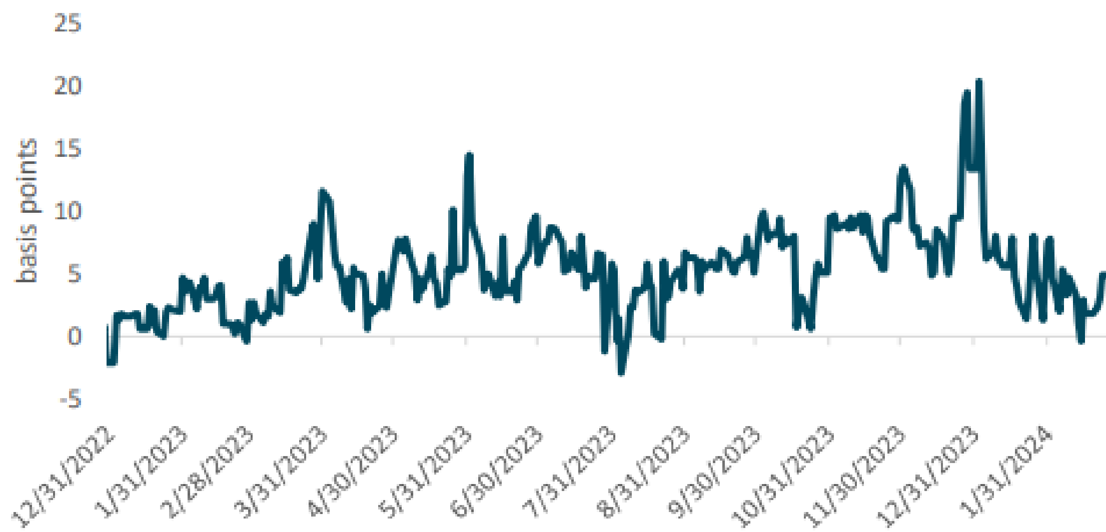
can see the near flat-lining of RRP balances in recent weeks, as well as the stability of – and even recent growth in – reserves, which are now comfortably above $3.5trn.

Nevertheless, we note a substantive discussion of the Fed’s balance-sheet reduction program in the minutes of the January FOMC meeting, released last week. “Many participants” thought the time to discuss slowing balance sheet runoff would appropriate at the March meeting. “The slowing of the pace of runoff could help smooth” the transition from an abundant reserves regime to an ample reserves one.

Given steady repo rates this year, a lull in RRP drainage this month, and still-quite-abundant reserves, one might wonder why this discussion on reducing the pace of QT is taking place. We would add to that some signs that the (in)famous basis trade – where hedge funds short UST futures, go long in cash Treasuries and finance the trade via repo, aiming to exploit arbitrage opportunities between these two positions – is also taking a bit of a break. Short CFTC futures positioning by leveraged money has abated somewhat, and even come off in recent weeks. These developments are all part of the same ball of wax. Less borrowing in Treasuries has lessened their demand in repo, helping to stabilize cash positions in RRP, helping keep reserves elevated. Much of this lull has been attributed to policy uncertainty, with expectations of upcoming rate cuts having been pushed deeper into the year.

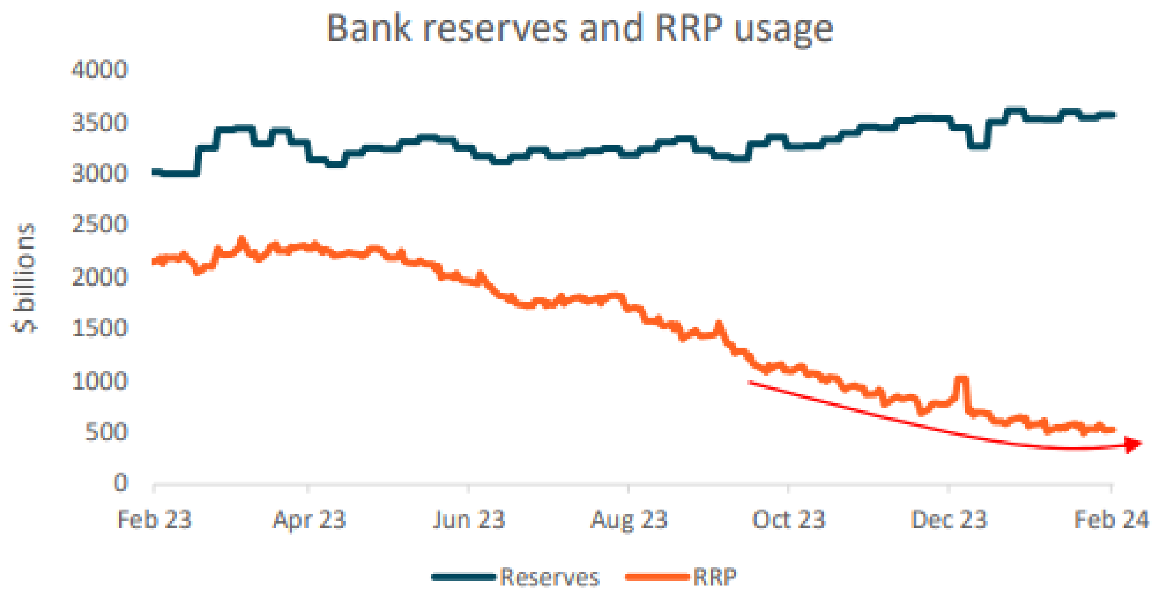
We don’t know if this relatively stable situation will persist, or if rate-cut expectations will begin to increase again in coming months. Like the Fed’s interest-rate policy, the equilibrium in cash markets – and thus reserves on the Fed's balance sheet – is very much data-dependent. We believe that currently strong economic data and recent backsliding in progress on inflation will eventually turn around, although when is uncertain. Should this happen, we expect the cycle to pick up again, re-focusing the debate around QT being slowed. It’s clearly on the Fed’s mind, and we still expect some announcement on the balance sheet on May 1, with implementation beginning in June.

Repo Settles In 2024



Source: BNY Mellon Markets, Bloomberg

RRP Drainage Stalls, Reserves Grow



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

iFlow Shows Duration Grab in USTs

We are pleased to introduce a new indicator derived from our iFlow for fixed income data suite, one we call “directional maturity”. It summarizes the weighted average maturity of flows into US Treasuries into one statistic, which can be thought of as akin to a duration indicator.

We exclude purchases/sales of USTs with less than 1y in maturity, as those are primarily T-bills or longer-dated bonds with very little time left to maturity.

We plot the directional maturity indicator in the chart below. It can be interpreted as follows: when the blue line is above zero, we are seeing net buying of (inflows into) USTs. Negative values indicate selling (outflows). When it's positive, higher values along the vertical axis indicate longer maturities are being relatively more sold – i.e., the directional maturity is positive and long. The same principle applies to negative values. Below zero readings indicate selling, and the lower the line goes, the longer in maturity the average weighted maturity outflows are.

The chart's timeline begins around the advent of the pandemic and shows an initial reaction of selling bonds in March and April. Once the Fed's bond buying program (QE) was in place, we saw a generally, steadily rising trend towards buying higher duration USTs, reaching its peak in early 2022. By the end of February of that year, when it became clear that the Fed was about to initiate its tightening cycle in March, duration flows collapsed. The previous long-maturity buying was replaced with selling, and investor flows wound up close to neutral in duration, remaining slightly positive for the duration of the FOMC's tightening cycle.

Two things occurred last summer: at the end of May, Congress agreed to suspend the debt ceiling; and in July, the FOMC raised its policy rate for the last time in the cycle. From that point on, we have seen an ever-increasing long duration grab, from nearly neutral in maturity-weight flows in June 2022 to slowly increasing until the beginning of 2024. We presume that expectations of rate cuts in early 2024 led to demand for duration last autumn, especially given the attractive yields then. Now that the rate-cut path (when will the Fed start, by how much will it cut, etc.?) is less certain, we may see a pause in demand for long-duration Treasuries until further clarity emerges.

---

iFlow Directional Maturity

Source: BNY Mellon Markets, iFlow

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

John Velis

AMERICAS MACRO STRATEGIST

CONTACT JOHN

bnymellon.com

BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may be used as a generic term to reference the corporation as a whole and/or its various subsidiaries generally. This material and any products and services may be issued or provided under various brand names in various countries by duly authorized and regulated subsidiaries, affiliates, and joint ventures of BNY Mellon, which may include any of the following. The Bank of New York Mellon, at 225 Liberty St, NY, NY USA, 10286, a banking corporation organized pursuant to the laws of the State of New York, and operating in England through its branch at One Canada Square, London E14 5AL, UK, registered in England and Wales with numbers FC005522 and BR000818. The Bank of New York Mellon is supervised and regulated by the New York State Department of Financial Services and the US Federal Reserve and authorized by the Prudential Regulation Authority. The Bank of New York Mellon, London Branch is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV, a Belgian public limited liability company, with company number 0806.743.159, whose registered office is at 46 Rue Montoyerstraat, B-1000 Brussels, Belgium, authorized and regulated as a significant credit institution by the European Central Bank (ECB), under the prudential supervision of the National Bank of Belgium (NBB) and under the supervision of the Belgian Financial Services and Markets Authority (FSMA) for conduct of business rules, and a subsidiary of The Bank of New York Mellon. The Bank of New York Mellon SA/NV operates in England through its branch at 160 Queen Victoria Street, London EC4V 4LA, UK, registered in England and Wales with numbers FC029379 and BR014361. The Bank of New York Mellon SA/NV (London Branch) is authorized by the ECB and subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Financial Conduct Authority and Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV operating in Ireland through its branch at 4th Floor Hanover Building, Windmill Lane, Dublin 2, Ireland trading as The Bank of New York Mellon SA/NV, Dublin Branch, is authorised by the ECB and is registered with the Companies Registration Office in Ireland No. 907126 & with VAT No. IE 9578054E. The Bank of New York Mellon, Singapore Branch, subject to regulation by the Monetary Authority of Singapore. The Bank of New York Mellon, Hong Kong Branch, subject to regulation by the Hong Kong Monetary Authority and the Securities & Futures Commission of Hong Kong. If this material is distributed in Japan, it is distributed by The Bank of New York Mellon Securities Company Japan Ltd, as intermediary for The Bank of New York Mellon. If this material is distributed in, or from, the Dubai International Financial Centre (“DIFC”), it is communicated by The Bank of New York Mellon, DIFC Branch, regulated by the DFSA and located at DIFC, The Exchange Building 5 North, Level 6, Room 601, P.O. Box 506723, Dubai, UAE, on behalf of The Bank of New York Mellon, which is a wholly-owned subsidiary of The Bank of New York Mellon Corporation. This material is intended for Professional Clients only and no other person should act upon it. Not all products and services are offered in all countries.

The information contained in this material is intended for use by wholesale/professional clients or the equivalent only and is not intended for use by retail clients. If distributed in the UK, this material is a financial promotion.

This material, which may be considered advertising, is for general information purposes only and is not intended to provide legal, tax, accounting, investment, financial or other professional advice on any matter. This material does not constitute a recommendation by BNY Mellon of any kind. Use of our products and services is subject to various regulations and regulatory oversight. You should discuss this material with appropriate advisors in the context of your circumstances before acting in any manner on this material or agreeing to use any of the referenced products or services and make your own independent assessment (based on such advice) as to whether the referenced products or services are appropriate or suitable for you. This material may not be comprehensive or up to date and there is no undertaking as to the accuracy, timeliness, completeness or fitness for a particular purpose of information given. BNY Mellon will not be responsible for updating any information contained within this material and opinions and information contained herein are subject to change without notice. BNY Mellon assumes no direct or consequential liability for any errors in or reliance upon this material.

This material may not be distributed or used for the purpose of providing any referenced products or services or making any offers or solicitations in any jurisdiction or in any circumstances in which such products, services, offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements.

The terms of any products or services provided by BNY Mellon to a client, including without limitation any administrative, valuation, trade execution or other services shall be solely determined by the definitive agreement relating to such products or services. Any products or services provided by BNY Mellon shall not be deemed to have been provided as fiduciary or adviser except as expressly provided in such definitive agreement. BNY Mellon may enter into a foreign exchange transaction, derivative transaction or collateral arrangement as a counterparty to a client, and its rights as counterparty or secured party under the applicable transactional agreement or collateral arrangement shall take precedence over any obligation it may have as fiduciary or adviser or as service provider under any other agreement.

Pursuant to Title VII of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the applicable rules thereunder, The Bank of New York Mellon is provisionally registered as a swap dealer with the Commodity Futures Trading Commission (“CFTC”) and is a swap dealer member of the National Futures Association (NFA ID 0420990).

BNY Mellon (including its broker-dealer affiliates) may have long or short positions in any currency, derivative or instrument discussed herein. BNY Mellon has included data in this material from information generally available to the public from sources believed to be reliable. Any price or other data used for illustrative purposes may not reflect actual current conditions. No representations or warranties are made, and BNY Mellon assumes no liability, as to the suitability of any products and services described herein for any particular purpose or the accuracy or completeness of any information or data contained in this material. Price and other data are subject to change at any time without notice.

Rates: neither BNY Mellon nor any other third party provider shall be liable for any errors in or delays in providing or making available the data (including rates, WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates) contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees’ negligence. The WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates are provided by The World Markets Company plc (“WM”) in conjunction with Reuters. WM shall not be liable for any errors in or delays in providing or making available the data contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees’ negligence.

The products and services described herein may contain or include certain “forecast” statements that may reflect possible future events based on current expectations. Forecast statements are neither historical facts nor assurances of future performance. Forecast statements typically include, and are not limited to, words such as “anticipate”, “believe”, “estimate”, “expect”, “future”, “intend”, “likely”, “may”, “plan”, “project”, “should”, “will”, or other similar terminology and should NOT be relied upon as accurate indications of future performance or events. Because forecast statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict. iFlow® is a registered trademark of The Bank of New York Mellon Corporation under the laws of the United States of America and other countries.

This document is intended for private circulation. Persons accessing, or reading, this material are required to inform themselves about and to observe any restrictions that apply to the distribution of this information in their jurisdiction.

Currency Administration is provided under and subject to the terms of a definitive agreement between BNY Mellon and the client. BNY Mellon exercises no investment discretion thereunder, but acts solely pursuant to the instructions in such agreement or otherwise provided by the client. Unless provided by definitive agreement, BNY Mellon is not an agent or fiduciary thereunder, and acts solely as principal in connection with related foreign exchange transactions.

All references to dollars are in US dollars unless specified otherwise.

This material may not be reproduced or disseminated in any form without the prior written permission of BNY Mellon. Trademarks, logos and other intellectual property marks belong to their respective owners.

The Bank of New York Mellon, member FDIC.

© 2020 The Bank of New York Mellon Corporation. All rights reserved.