BNY MELLON

iFlow

SHORT THOUGHTS

January 16, 2024

End Of Fed's BTFP To Have Only Minor Effects

Changes Coming From The Fed

- BTFP to end in March; will have limited liquidity impact
- QT to be tapered in May; basis trade could be reinvigorated
- Foreign flows into cash and short USTs have stabilized - could change with rate cuts

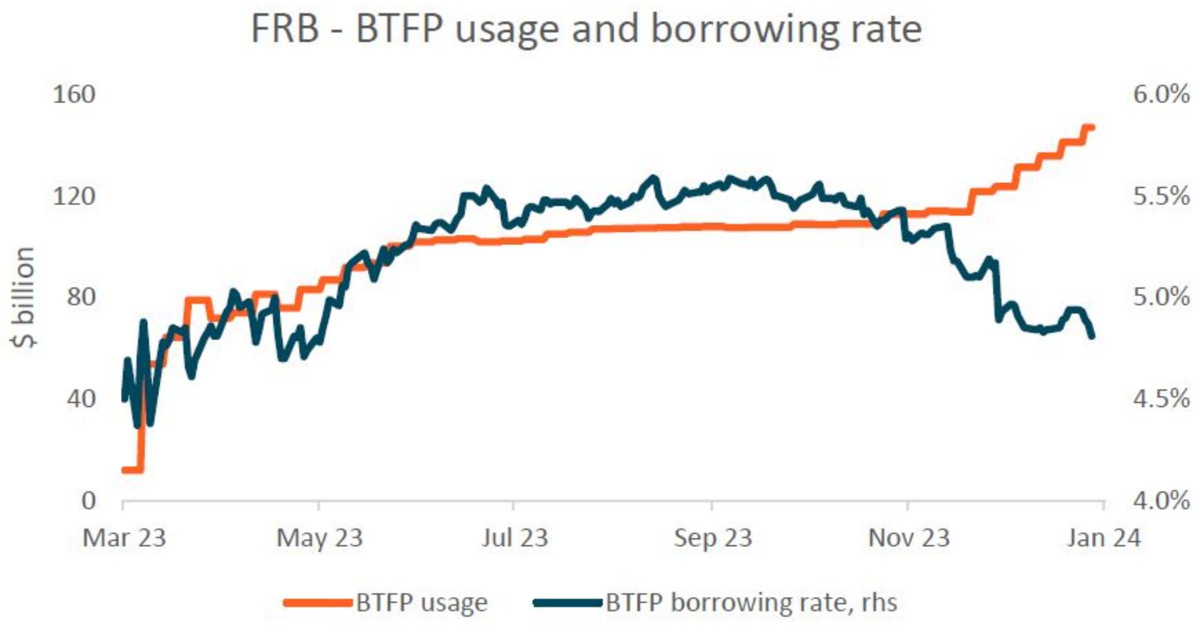
Last week, Federal Reserve Vice Governor for Supervision Barr signaled that the Bank Term Funding Program would likely not be renewed upon its initial expiry date of March 11 this year. The BTFP was set up last March in response to the regional banking turmoil last spring and provides emergency liquidity to banks. Its terms are quite generous: the Fed advances liquidity to banks who tap the facility at an attractive interest rate equal to one-year OIS swap rates plus 10 basis points. Furthermore, collateral posted to access the facility is accepted at par, meaning bank assets trading below that level would be valued more highly as collateral than at their mark-to-market values.

Usage of the BTFP quickly ramped up after its launch, rising to over $100bn by June and remaining above there for most of the year. Indeed, even after reaching that level, BTFP take-up continued to inch higher for most of the summer and autumn in 2023, reaching around $114bn by early December. Since then, enrollment has increased markedly, reaching a high of nearly $150bn at the beginning of January this year.

An attractive borrowing rate along with the generous collateral requirement made the BTFP attractive even to banks that weren't necessarily under stress. Given that the interest rate is calculated off OIS spreads (plus 10bp), as these spreads have fallen the rate to borrow as also fallen, corresponding to the increased take-up since late last year (see the chart below). In effect, banks could arbitrage the asset side of their balance sheets, borrowing from the facility and earning the IORB rate paid by the Fed on reserve balances, currently 5.40% (compared to 4.8% paid on BTFP borrowings).

That arbitrage is set to disappear in a few months, removing liquidity from the system at the same time that balances at the Fed's reverse repo facility (RRP) are declining quickly. While we don't think this change will put regional banks back into the breach of the mini-crisis last spring, we do think the withdrawal of liquidity could push spreads slightly higher and make funding marginally more expensive. However, given our current Fed rate view – a federal-funds rate cut on March 20 – we don't think this development will be especially challenging. It could potentially affect the profitability of those banks which took advantage of this arbitrage, but shouldn't impact funding market rates materially.

BTFP Usage Rises As Borrowing Rates Fall



Source: BNY Mellon Markets, Federal Reserve Board of Governors

BTFP To Wind Down In March

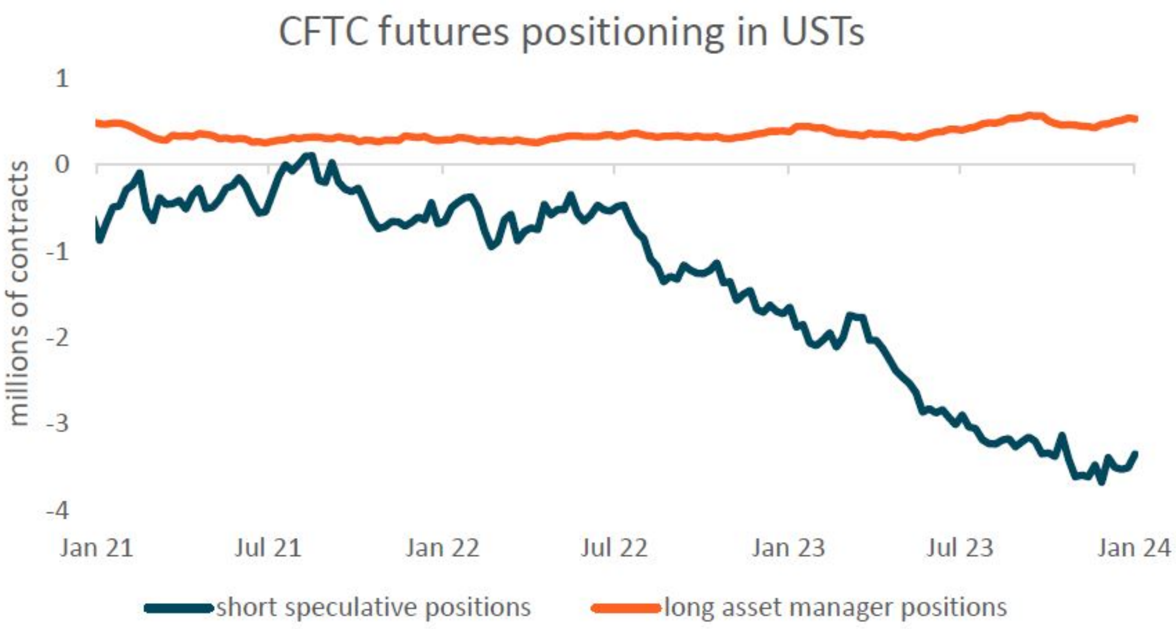
As argued last week (see here), we expect the Fed to start reducing the pace of quantitative tightening (QT) this spring; we peg May 1, the conclusion of the April 30-May 1 FOMC meeting, as the likely announcement date. Currently, of the $100bn per month in balance sheet roll off, $65bn is comprised of Treasury securities and the remaining $35bn MBS. Since QT started in June 2022, the Fed's System Open Market Account (SOMA) portfolio has fallen from a peak of around $8.4trn to just over $7trn now. Of that $1.4trn reduction, only $300bn or so has been in mortgages. The bulk (over $1trn) has been in Treasuries. That translates into an average of only $16.7bn per month for MBS and around $55bn in Treasuries, well below the limits set by the Fed back in 2022.

With the formal pace of QT set to slow, we believe that the pace of MBS runoff will be untouched, remaining at $35bn per month – still well above actually realized rolloffs – and that the UST proportion will be cut to around $35-40bn per month. We think this means that the actual liquidity drain due to QT will fall from a total of $100bn per month to around $50bn – not a massive marginal increase in liquidity.

One corner of the market that could see a material effect from this additional ~$50bn is the basis trade, which we've discussed before (see here, for example). The basis trade is employed as an arbitrage strategy by hedge funds and involves shorting Treasury futures and taking a long position in cash bonds and notes. This long-short trade is financed through private repo, essentially with money market funds lending to speculative players involved.

An “extra” ~50bn in liquidity would likely lead to the basis trade enduring through the summer; it could be further encouraged by what we expect to be the first of four rate cuts this year starting in March. The chart below shows the combined short speculative positions in USTs versus longs in the real money space (asset managers). Unless bond yields fall dramatically in coming months (making those shorts less profitable), we don’t expect the basis trade to ebb. It could actually increase instead with a slower pace of QT.

Basis Trade Still Active



Source: BNY Mellon Markets, CFTC, Bloomberg

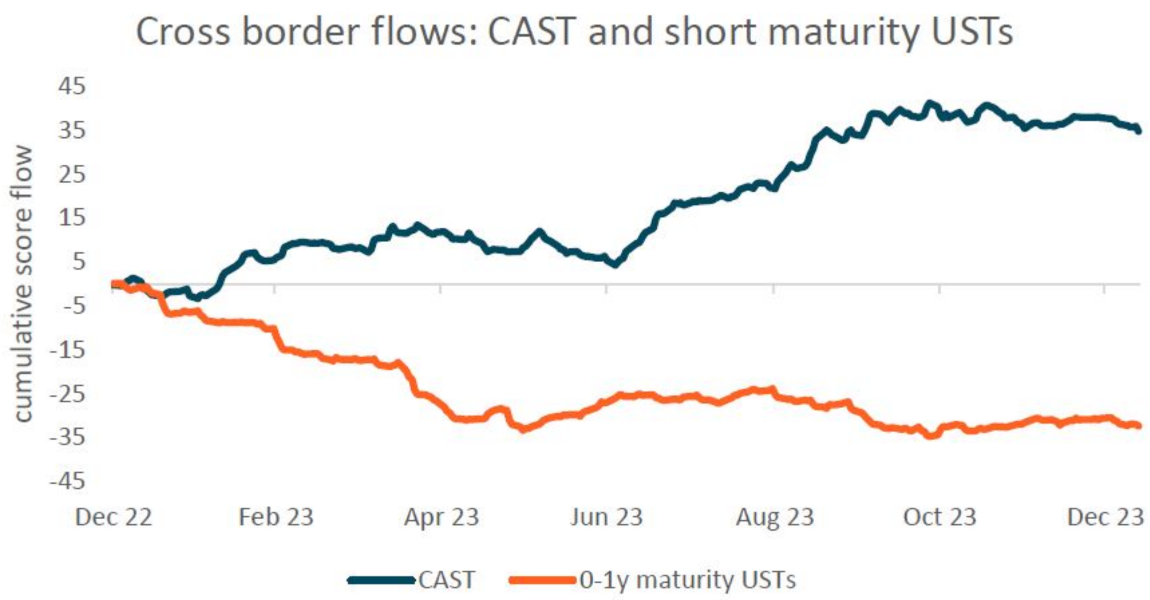
Foreign Investor Flows Into Short Duration Hold Steady

Foreign investor behavior in short maturities is bifurcated. iFlow shows that cross-border investors are staying in cash and short-term assets (CAST), while generally staying out of the front end. However, those long positions in cash and cash-like securities are being pared back. The chart below shows cumulative scored flows from foreign investors since the end of 2022 into the two short-duration markets.

Note that flows into CAST picked up significantly in July 2023. After that they went on stabilize somewhat with cross-border investors remaining in these very short-duration instruments. However, they were selling USTs in the 0-1y maturity bucket for the first few months of last year, and since the end of May have been reticent to add bills (and other USTs with less than 1y maturity) to their portfolios, even though selling has ceased. They appear to have been content with current short UST positions since May.

We don't think that steady foreign real-money positioning in USTs since June is surprising. The US debt ceiling was temporarily resolved at the very end of May, and investors – both foreign and domestic – went from selling bills in the runup to the deadline to either remaining steady (in the case of cross-border investors) to pilling into bills (local investors). As for the cash positions, we see foreign asset managers' strong and steady appetite as a reflection of attractive cash yields and liquidity preference. Once rate cuts begin this spring, as we expect, we anticipate some movements in both of the short-duration asset classes, with foreigners exiting from lower-yielding bills.

Steady Positions



Source: BNY Mellon Markets, iFlow

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