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iFlow

SHORT THOUGHTS

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Balance Sheet Arithmetic & Reserve Shrinkage

Arithmetical Inference

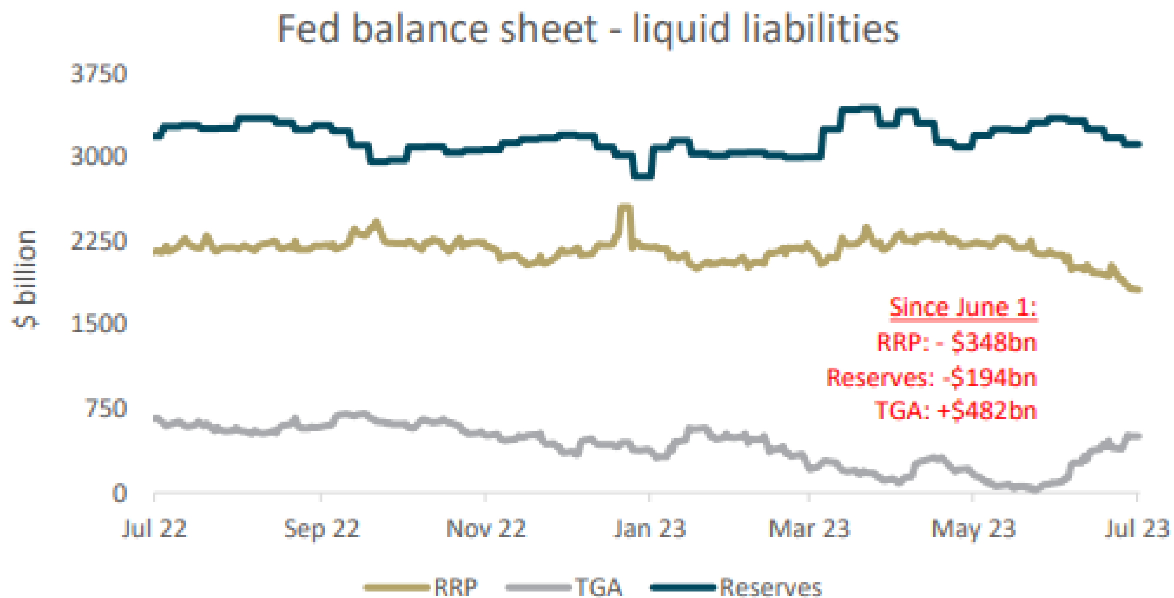
Since June 1, the US Treasury has issued just over $600bn in net bill supply. Much of that has gone to replenish the Treasury General Account (TGA), which has grown from just $22bn to over $500bn in that same period, a $478bn increase. Take-up of the Fed's overnight reverse repurchase facility (RRP) has fallen by nearly $350bn, while bank reserves have fallen by $194bn. Understanding the interplay of these sums is important.

Sticking, for now, with the liquid liabilities of the Fed's balance sheet (RRP, reserves, and the TGA), we can do some simple arithmetical inference. If we assume – admittedly, somewhat of an oversimplification – that the cash which left the RRP went dollar-for-dollar into the TGA (hence, not coming out of reserves), that leaves $134bn of the TGA rebuild that must have come from reserves. We presume the additional $60bn drop in reserves (the net of the $194bn drop noted above and the $134bn) came from quantitative tightening over the month. Indeed, the Fed's SOMA portfolio (holdings of Treasuries and MBS), fell by around $80bn over the period, not far from our $60bn.

The point of this exercise is to show that the T-bill issuance undertaken so far, as well as the substantial additional supply we expect for the rest of this year, will not come entirely out of RRP, but instead from a combination of RRP and reserves. To put it another way: $348bn in RRP drainage likely came from money market funds (MMFs). MMFs are by far the largest group of participants in RRP – to the tune of nearly 90% according to a recent

New York Fed post. The $348bn in RRP transformation into bills is just over 55% of the $600bn in net supply since the debt ceiling was resolved. If MMFs do not increase that percentage of additional upcoming supply, there will have to be a nontrivial decline in reserves.

The Fed's Liabilities



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

Who Will Fill The Gap?

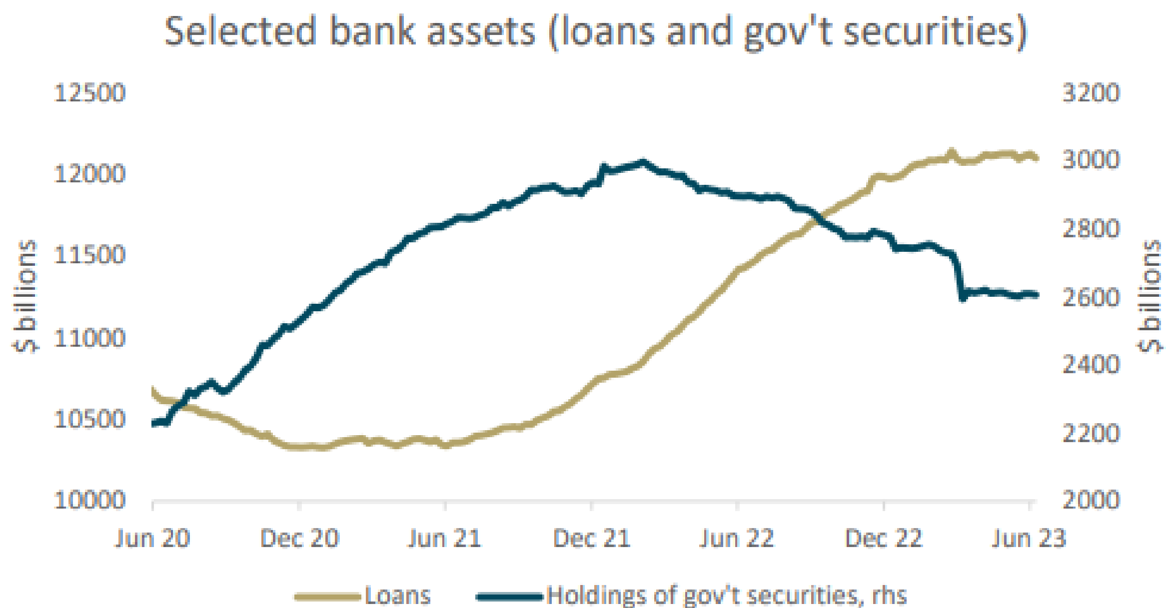
What about banks and broker-dealers? They are active participants in the Treasury market. However, there is little evidence that these actors are rushing to fill the gap between bill supply and MMF demand. The chart below shows that bank holdings of Treasuries have declined by around $400bn since the end of 2021. There would have to be a massive shift in banks' asset allocation for them to serve this function. In a rising rate environment, holding large additional sums of Treasuries is not attractive, and capital requirements – particularly the Supplementary Leverage Ratio (SLR) – don't leave much room for adding them.

Notice on the chart that loan growth in the banking system has plateaued since the beginning of the year, a trend that wasn't helped by the stresses of March and April. If banks don't step in to help soak up the increased issuance by Treasury and aren't in the business of making loans, what assets will they put on their balance sheet? Balance-sheet shrinkage is clearly a risk, meaning reserves could decline even further.

This becomes a potential issue later into the year. The Treasury's quarterly funding plans are set to be announced in early August. We expect a significant amount of both additional bill supply and coupon issuance. Who will buy all these securities? We have frequently pointed out that foreign participation in the UST market has been shrinking, with iFlow showing net sales of US sovereign debt across almost all maturities (see here).

The upshot is two-fold. First, we expect the market to have trouble digesting all this paper and so see yields rising, especially back-end. Market liquidity, touchy already, could deteriorate more. Second, banking system reserves – already declining anew after a short-lived jump as the Fed dealt with the banking stresses – could come under further pressure. This is probably our biggest concern into late summer, and especially early autumn.

Banks Out Of The Loop



Source: BNY Mellon Markets, Federal Reserve Board of Governors

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