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# iFlow

**SHORT THOUGHTS**

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June 6, 2023

# Preparing For The Flood

## Who Will Buy All The Supply?

Last week we explained that following the resolution of the debt ceiling standoff, the US Treasury would be selling a large stock of debt – likely totaling well over $1 trillion by the end of the year. Such issuance is necessary both to replenish the Treasury's General Account (TGA), in which the balance had fallen to below $50bn last week as the X-date approached, as well as to pay back the "extraordinary measures" that Treasury was forced to tap in order to offset its inability to issue new net debt for the last five months.

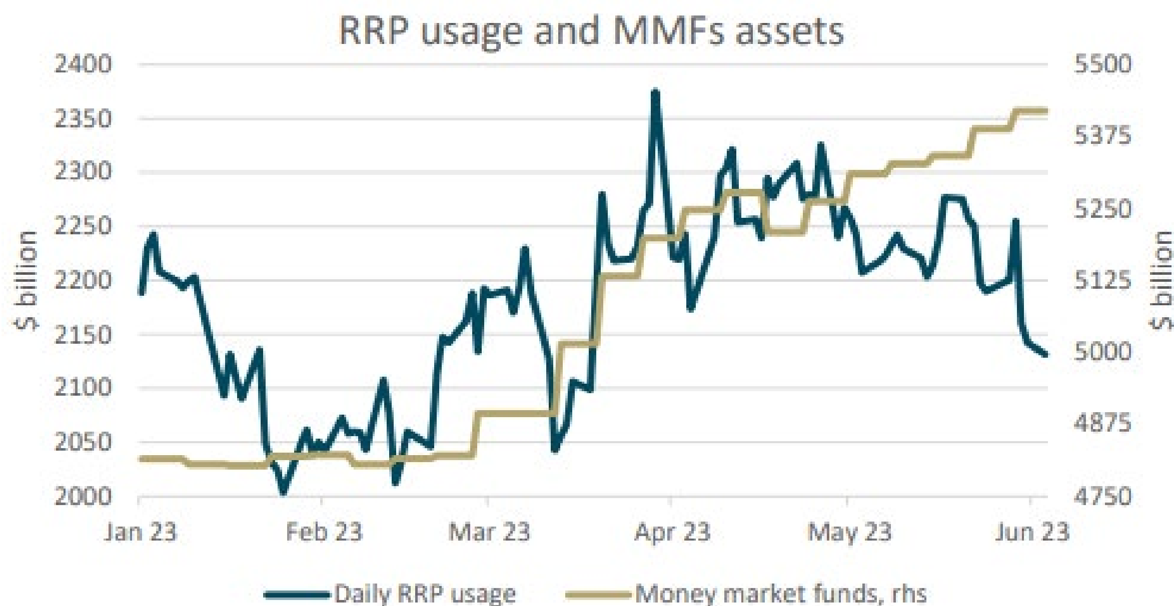
We had argued that this wave of issuance could be difficult for the market to absorb, and could simultaneously lead to an increase in T-bill yields and a decline in bank reserves. Both of those outcomes would be a liquidity shock to markets; we could see disruption in the bills market, and even more likely across the UST market as a whole.

The crucial unknown is the behavior of money market mutual funds (MMMFs) during the initial phases of the deluge. MMMFs in the main have steered clear of bills, especially those issues due to mature in June. MMMFs avoidance of this sector, along with many other types of investors, resulted in June bills, especially those due early in month, cheapening significantly. MMMFs have likely re-entered the market and snapped up attractively priced securities. Relatedly, MMMFs placed a lot of their excess and rapidly increasing quantities of cash into the Fed's overnight reverse repo facility (RRP) to earn a competitive risk-free yield, 5.05% currently. While negotiations between the White House and Congressional Republicans were in the most acute phase, a week or so ago, RRP

uptake got as high as $2.25trn on May 31. RRP usage has declined significantly since that level was reached, presumably because of the move by MMMFs to return to the bills market.

The chart below captures this drawdown in RRP deposits over the last few days, against money fund assets. The former are daily through yesterday, while the later are weekly through May 31, just before the debt-ceiling agreement was passed by Congress. MMMFs very likely have already started buying bills they had been avoiding.

## *RRP Drain Starting?*




*Source: BNY Mellon Markets, ICI, Board of Governors of the Federal Reserves*

As this wave of new supply hits, the interplay of money funds and other investors in the bills market will be determinative of how much liquidity gets drained away from the money market. If the funding for this new issuance comes from the MMMFs, we might not see a substantial disruption in the Treasury market, as they will just be transforming excess cash balances into Treasury bills and that cash will be used to pump the TGA back up.

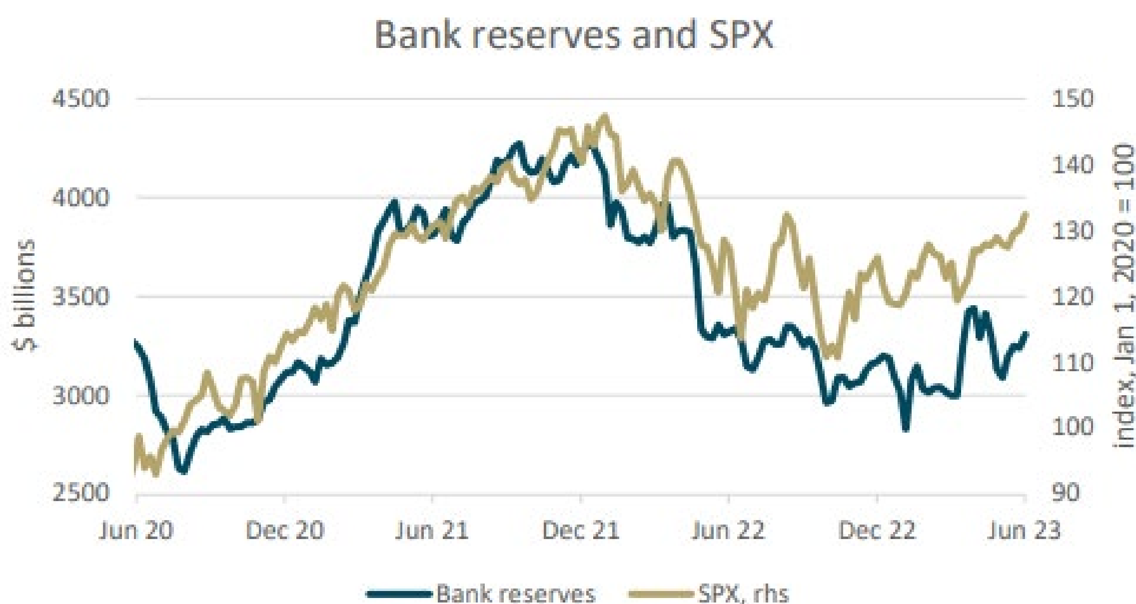
However, if demand from money funds is insufficient, and real money investors, banks, and other agents enter the bills market, the increasing TGA will deplete bank reserves. In this case we could see strains in the Treasury market as reserves fall to a level (reckoned to be just under $2.5trn) that is too low for comfort and liquidity will become scarce.

At the limit, if reserves do fall too low – past whatever the lowest comfortable level actually is – we could see a repeat of the September 2019 episode during which the repo market

seized up and the Fed had to initiate a series special overnight repo operations to absorb excess collateral in the banking system and provide cash against that collateral. QT then, ongoing from the GFC, effectively ended and reserves increased again.

Such a drain of liquidity from the banking system and the money markets, if it occurs, could impact risk assets. Since the pandemic, periods of significant reserve shrinkage have coincided with weak markets, as the chart below shows. If the process of Treasury re-issuing well over $1trn in six months leads to a liquidity drain like the one we warn about, we could see recently buoyant markets begin to experience a bout of underperformance.

### *Liquidity Drain And Risk Assets*




*Source: BNY Mellon Markets, Bloomberg, Federal Reserve Board of Governors*

## Corporate Buyers Strike

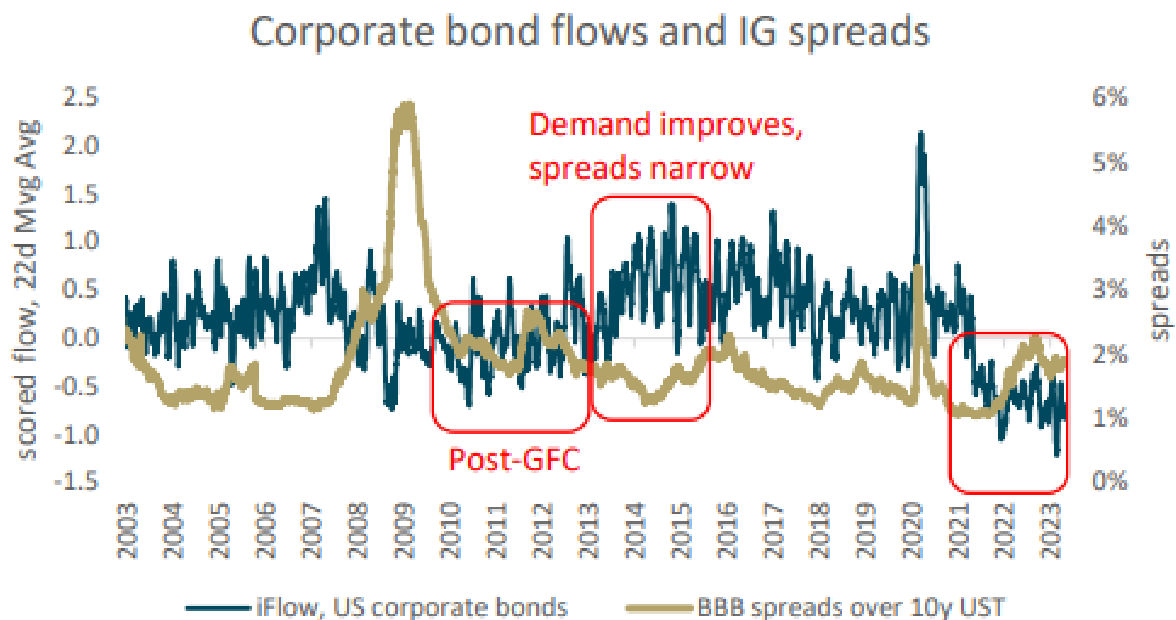
Back in late March we wrote about the dynamics of US corporate bond demand (see here). At the time, markets were in the midst of the acute phase of banking sector stress, and we noted that by the end of that month, US corporate bond demand had recovered. However, that was merely a short-term phenomenon. Since then – and really since the middle of 2021 – US corporate bond flows have been relentless and pervasively negative.

The chart below shows US corporate bond flows per iFlow for the entire period for which we have data. The last two years have seen the longest sustained period of outflows over the last 20-odd years; even during the worst days of the GFC, when flows were also quite

negative, demand hasn't been as weak for as long as it is currently. Yet, spreads continue to be well-behaved, at odds with the broad selling we observe in iFlow. In the several years after the GFC, when corporate bond flows were negative (although not nearly as weak as they have been recently), corporate spreads remained elevated above their pre-GFC levels. This corporate bond market disruption was a long-lived affair; corporate spreads didn't really narrow until 2014, which corresponds to a reversal of the negative iFlow trend of that time.

During this recent period of outflows, spreads have widened somewhat and are – with the exception of immediately after the lockdowns occurred – nearly as high (~190bp for BBB debt over Treasuries) as they were for any pre-pandemic period since 2013. We expect that as demand continues to be negative for corporate bonds, spreads will inch wider still.

## *Corporate Bond Outflows Persist*




Source: BNY Mellon Markets, iFlow

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