BNY MELLON

iFlow

SHORT THOUGHTS

March 12, 2024

On The Fed's SOMA And T-bills

- Fed unlikely to move majority of SOMA holdings into T-bills, even over a long period
- T-bills only comprise 3% of SOMA holdings currently
- MMFs' WAMs have plateaued, even as RRP drainage picks back up

A Majority T-bill SOMA Portfolio Desirable But Unlikely

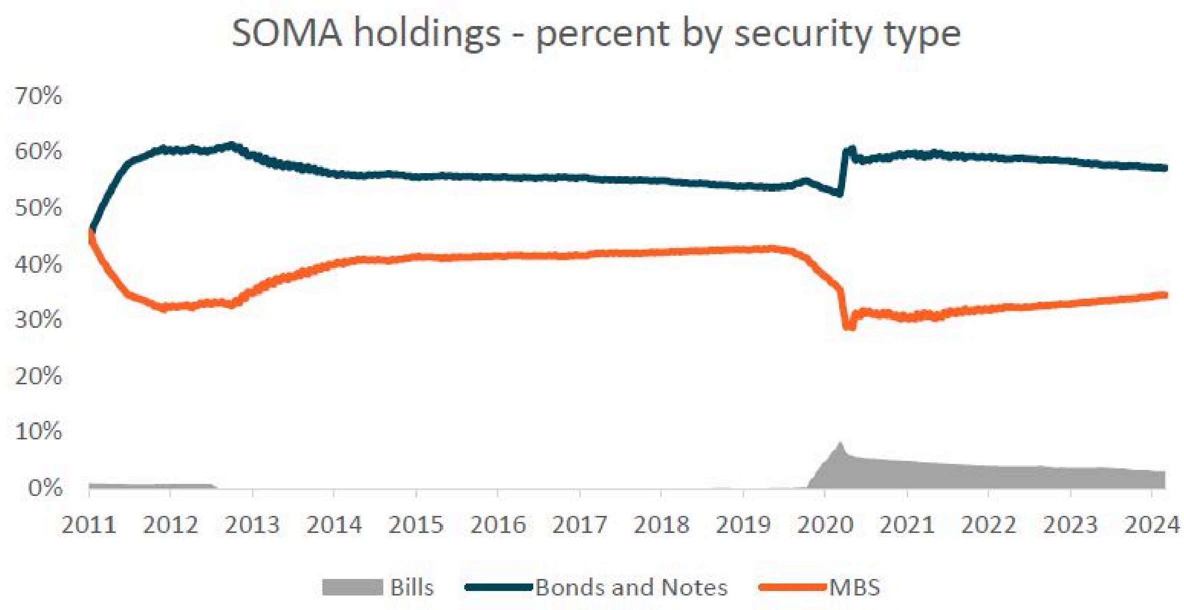
Last week we discussed recent remarks by Federal Reserve Governor Waller and Dallas Fed President Logan on quantitative tightening (QT), noting their views on how the transition from a regime of abundant reserves to one of ample reserves would have to be calibrated carefully, in some ways by “feel” as the crossover is impossible to know in advance.

Waller also offered some comments on how he’d like to see the Fed’s balance sheet evolve as its size declines. He would like to see the percentage of mortgage-backed securities (MBS) in the System Open Market Account (SOMA) portfolio run down to zero and would favor moving the portion of Treasuries in favor of much more T-bills. His argument for the latter in summary, “Moving toward more Treasury bills would shift the maturity structure more toward our policy rate—the overnight federal funds rate—and allow our income and expenses to rise and fall together as the FOMC increases and cuts the target range.”

This seems to us an unattainable goal, at least in the short run. Before the Global Financial Crisis, T-bills accounted for nearly one-third of the SOMA portfolio. However, as the chart below shows, the T-bill portion of the SOMA portfolio, even going all the way back to 2010, is rather small. At its peak, the T-bills portion was 8% of total SOMA holdings, right at the beginning of the quantitative easing program initiated in March 2020. It’s been declining ever since and is currently a mere 3%. The majority of the portfolio is held in Treasury bonds and notes, currently some 57% of total, followed by the MBS portion, which stands at 34%.

We think the laudable goals stated by Waller are almost completely out of reach, at least for the next several years. To replace maturing coupons with T-bills, even gradually, could distort the markets for both instruments, and in any case could take a decade or more. This is one of those occasions when optimal policy goals may simply be unattainable.

Bills A Paltry Portion Of SOMA



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

WAMs, MMFs, RRP and QT

Take up of the Fed's reverse repo facility (RRP) stalled in February, with daily balances steady around $550bn. We wrote about this a few weeks ago (see here). We had initially suspected that uncertainty about when the FOMC would start cutting rates and lower T-bills yields out the curve deterred money market funds (MMFs) from extending the maturity of the holdings, leading to slower drainage of the RRP in February. See the chart below.

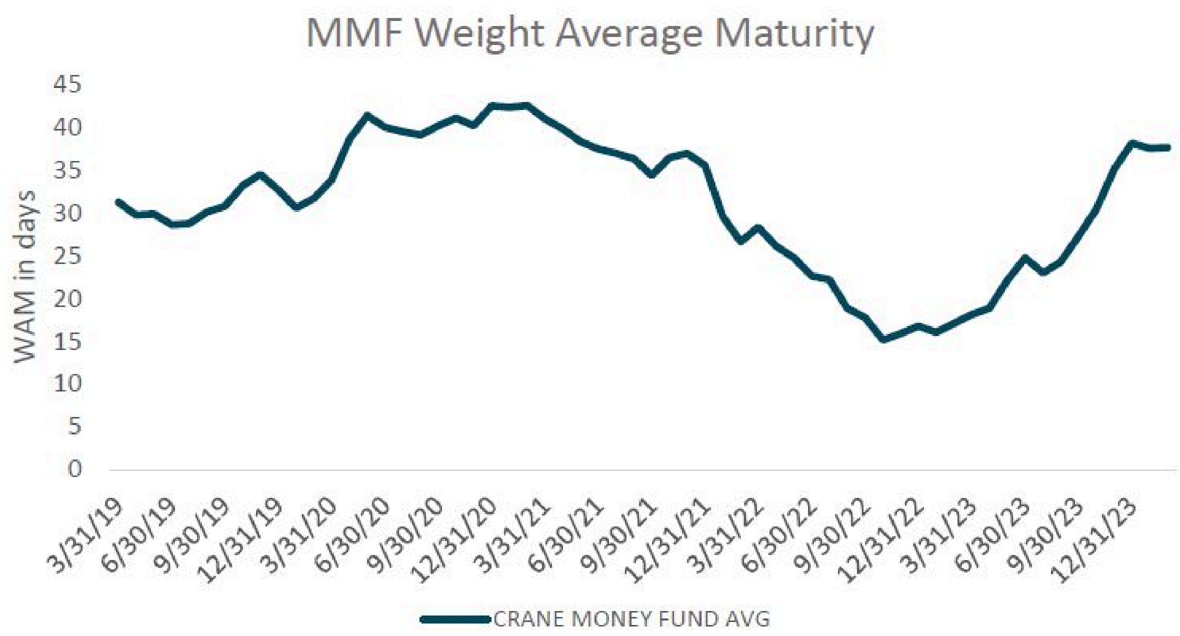
Entering March, however, we have seen a resumption RRP drainage – last Friday's total down to just $445bn, $100bn lower than the February average. Nevertheless, MMFs' Weighted Average Maturities (WAM) have leveled off at around 37-38 days. While that's high relative to the last four years, including before and during the pandemic, it is still lower than its peak of over 40 days observed in early 2020 – a time of heavy COVID-related T-bill issuance as well as the prospect of rates staying close to zero for the subsequent few years.

However, the reluctance of MMFs to increase WAMs might suggest that RRP drainage could slow, as the funds stop buying more expensive T-bills further out the curve. This implies more lending in the repo markets, which would keep the T-bill portion of MMF portfolios steady, at least for the moment. We think that once rate uncertainty recedes and the Fed gets ready to cut rates, MMFs will continue to limit WAM extension.

That doesn’t necessarily mean that the RRP drain will slow. As we said above, repo remains an attractive option, and this movement of cash into repo will keep that market well behaved, something we have worried about since the end-2023 repo rates spike, which ultimately gave rise to the Fed's QT discussion. However, once RRP does get quite low, reserves should start to decline, which is one of the fears raised by various Fedspeakers of late.

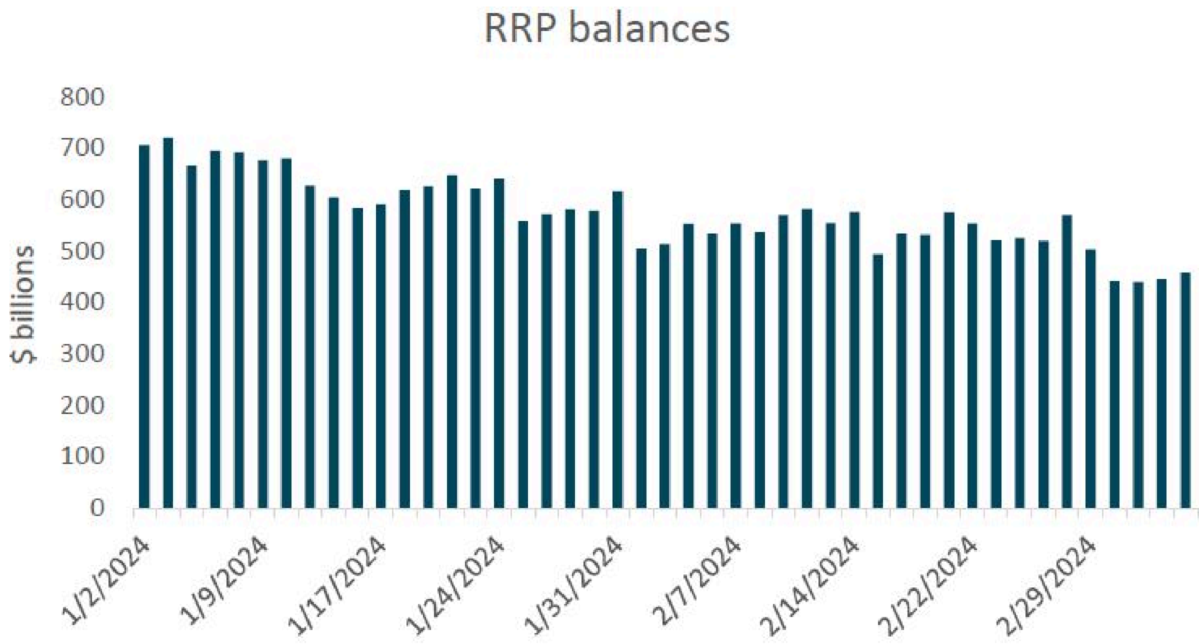
We see RRP close to zero by July – not far away. This is why we still expect a QT tapering announcement at the May FOMC, as we suspect the Fed has a similar trajectory in mind.

WAMs Flattening



Source: BNY Mellon Markets, Crane Data

RRP Drain Picks Up in March



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

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