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iFlow

SHORT THOUGHTS

March 26, 2024

Fed On The Cusp Of Quantitative Tapering

- Fed plans to slow quantitative tightening "fairly soon"
- T-bill supply decelerating, helping to slow RRP drain
- iFlow shows ongoing switch out of cash and into short-duration debt

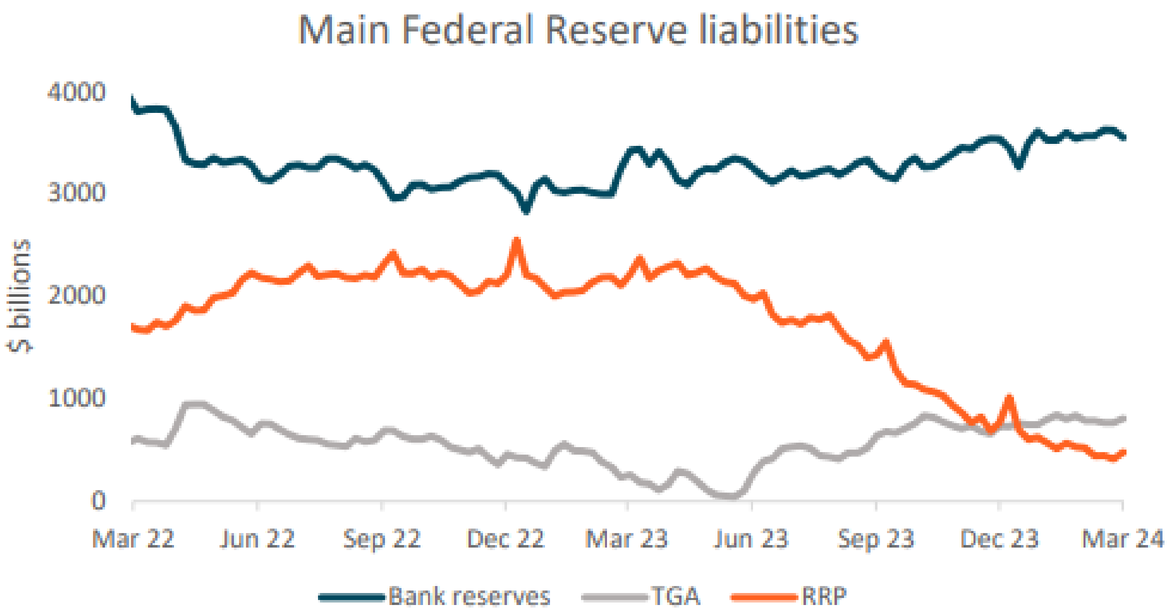
There has been sufficient time to analyze the Federal Reserve's monetary policy path since its meeting nearly a week ago, but we think it's worth revisiting the discussion around quantitative tightening (QT) during Chair Powell’s press conference. It’s clear to us that a slowdown in the pace of balance-sheet shrinkage – we've been calling for an early-2024 start – will happen “fairly soon” (Powell's words). We stick with our view for announcement at the conclusion of the April 30-May 1 FOMC meeting, with the actual slowing to start in June.

What is interesting to us is that the reasoning put forth by Powell pretty much aligned with our own arguments. First – and seemingly most importantly – is the belief within the Fed that although aggregate system-wide reserves are clearly abundant, the distribution of those reserves doesn’t seem to be uniform. In Powell's words: “Liquidity is not evenly distributed … and there can be times when in the aggregate, reserves are ample or even abundant. But not in every part, and those parts where they're not ample, there can be stress and that can cause you to prematurely stop the process.” We don’t have great visibility into the distributional question ourselves, but we had suspected this was on the Fed’s mind going back to Dallas Fed President (and former SOMA manager) Lorie Logan’s speech in mid-January, in which she mused about this very question.

Second, the Fed is wary of repeating the September 2019 episode: reserve scarcity contributed to a severe funding squeeze which forced the Fed to not only end the post-GFC process of QT but also provide so much liquidity that balance-sheet shrinkage to that point became balance sheet expansion in Q4 2019. Again, to quote the Chair regarding 2019: “This is our second time in doing this, and I think we're going to be paying a lot of attention to the things that started to happen and that foreshadowed what eventually happened at the end of that tightening cycle where we wound up in a short reserves situation. We don't want to do that again." The Fed learned its lesson five years ago and seems to be of the opinion that the further it wants to reduce the size of the balance sheet, the slower it needs to go. As Powell said last week, "it's sort of ironic that by going slower you can get farther." We agree.

As the familiar chart below shows, even with a significant – and ongoing – drain in RRP balances, reserves have barely budged and sit at $3.49 trillion. Again, aggregate reserves appear abundant, but it seems the Fed has an inkling that they are not well distributed across the system. A common view on the street and, it appears, within the Fed is that once RRP balances are close to or indeed completely depleted, pressure will arise in funding markets, but this distributional question could materialize in "stress" or "frictions", in the Chair's words. We think we're on the cusp of a QT taper.

Fed Balance Sheet

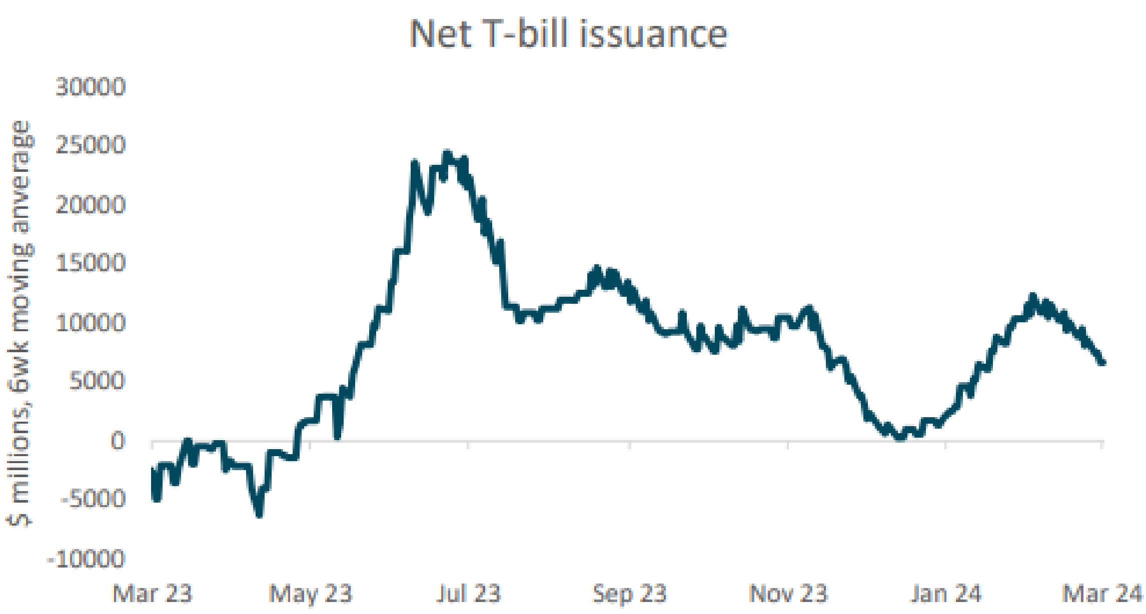


Source: BNY Mellon Markets, Board of Governors of the Federal Reserve System

Somewhat related to the above is a recent reduction in the pace of T-bill issuance. The chart below illustrates the slowdown using a rolling 6-week average of daily net issuance. Bill supply increased impresively in the second half of last year after the debt ceiling was suspended at the end of May. After that quick and heavy runup, things settled down by August and remained fairly steady until the end of the year, only to resume in early 2024. Most recently, Treasury slashed auction sizes across the bills curve, and the pace of net issuance has clearly decelerated since the end of February. The reduction is likely due to the size of the Treasury's General Account, which had been consistently targeted at $750bn but has been steady above that level, hovering around $800bn (TGA in chart above).

Interestingly, at the same time, declining balances in the reverse repo facility (RRP) have slowed, although they are still ongoing. We see two likely reasons for this attenuation in the RRP drain. First, with policy uncertainty and richer T-bills out the curve past a few months, yields are less attractive for money market funds (MMFs) to extend maturity – something we wrote about two weeks ago. Secondly, bill supply is growing much more slowly as TGA balances remain above target. With 2023 income tax payments just a few weeks away, there will also be less funding pressure for the government, so the TGA should remain in fine fettle for the next six weeks at least. We have written about some concern we have regarding a potential drop in reserves around tax time, as well (see here).

Bill Supply Is Slowing

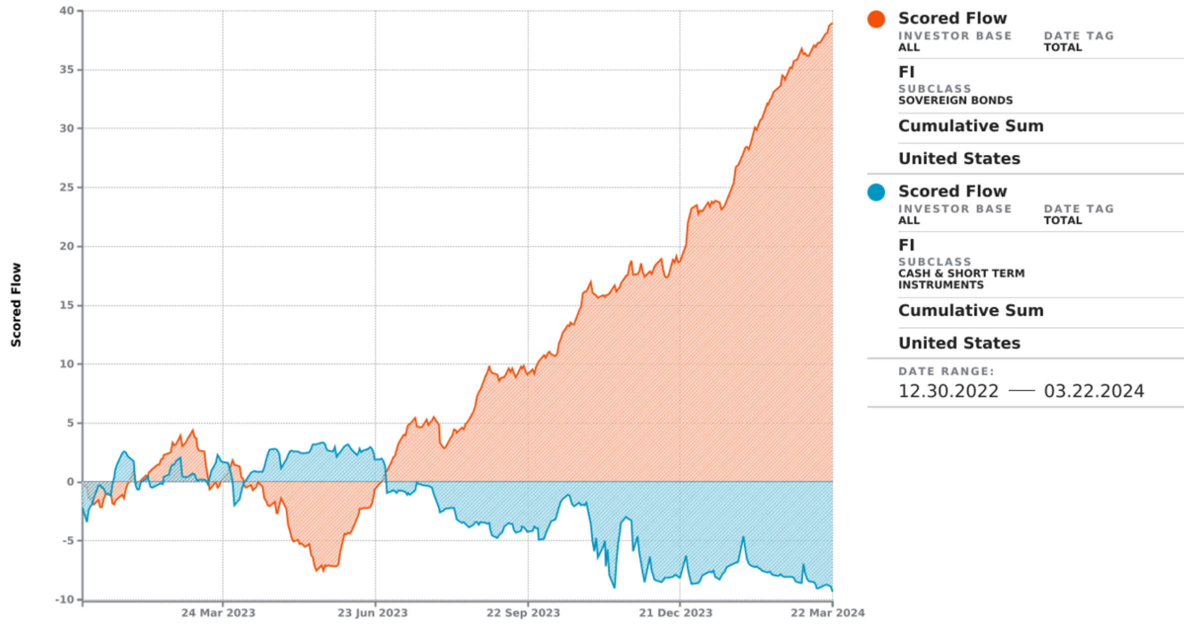


Source: BNY Mellon Markets, Bloomberg, US Treasury

Worth noting from our iFlow data is that the switch from cash and cash-like assets into short-maturity government paper continues apace. The chart below shows cumulative flows into short-duration Treasuries, i.e., all US sovereign debt maturing in less than 1y. Real money continues to accumulate such assets, seemingly at the expense of cash and short-term instruments. This mimics the general behavior of MMFs, which have been switching out of RRP and into bills and other short-maturity Treasuries.

iFlow Shows Asset Switch Ongoing

FI Scored Flow



Source: BNY Mellon Markets, iFlow

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