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SHORT THOUGHTS

May 7, 2024

Drainage Of New York Fed's RRP Pauses

- RRP usage has plateaued around $450bn in the last few months
- Slowing T-bill supply and flat bills curve among the culprits
- As long as RRP stays steady, funding markets should be calm
- Bank lending officers tightened credit standards marginally in the past quarter

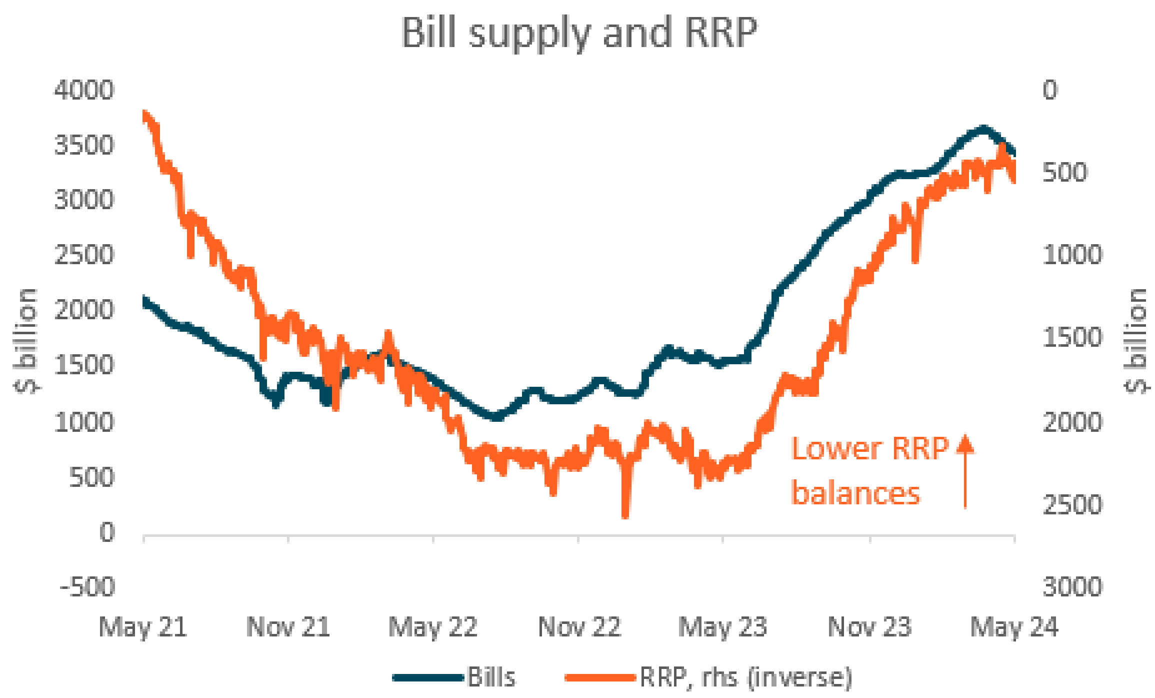
Fewer Bills, Flat Curve Conspire To Keep RRP Balances Steady

Usage of the New York Federal Reserve's Overnight Reverse Repurchase Facility (RRP) has held relatively steady for the last couple of months. This is in contrast to the period between April 2023 and the end of February 2024, during which balances fell steadily – from a peak of nearly $2.4trn to just around $500bn. Daily balances have since fluctuated around $450bn, with occasional forays above $500bn around month-ends. We think there are several – related – causes for this plateauing of daily balances, which we discuss below. In addition, this slowing of RRP drainage has implications for the Fed's balance sheet and quantitative tightening policy – the latter of which was changed at the recent FOMC meeting.

T-bill supply has dwindled since the end of March, with net issuance down $233bn since March 22. This marginal scarcity of T-bills has made it harder for money market mutual funds (MMFs) to deploy cash into short-term US sovereign debt, as supply is dwindling – and we don't expect it to pick up in the short term, given a relatively modest funding estimate from the Treasury and the ongoing – and almost inexorable – increase in MMF Assets Under Management. As of Wednesday last week, MMFs held $6trn in assets, just below the April 3 high of $6.1trn. This is even more impressive when we consider that US tax season just concluded, and it doesn't appear there were massive withdrawals over the past month.

The chart below shows the evolution of RRP balances (orange line, inverted) versus bill supply back to the spring of 2021. There is a clear relationship: the blue line (bill supply) peaked right around the time RRP usage started to stabilize in the mid $400 billions. Given the level of the Treasury General Account (currently $872bn – above the $750bn Treasury identified as its desired level) and fiscal receipts in April, bill issuance is likely to be spare in coming weeks. Furthermore, with the proportion of bills in the outstanding Treasury debt stockpile currently above 20%, a level the Treasury Borrowing Advisory Committee (TBAC) has identified as the highest recommended, more bills would worsen that proportion.

Fewer Bills, Slower RRP Drain

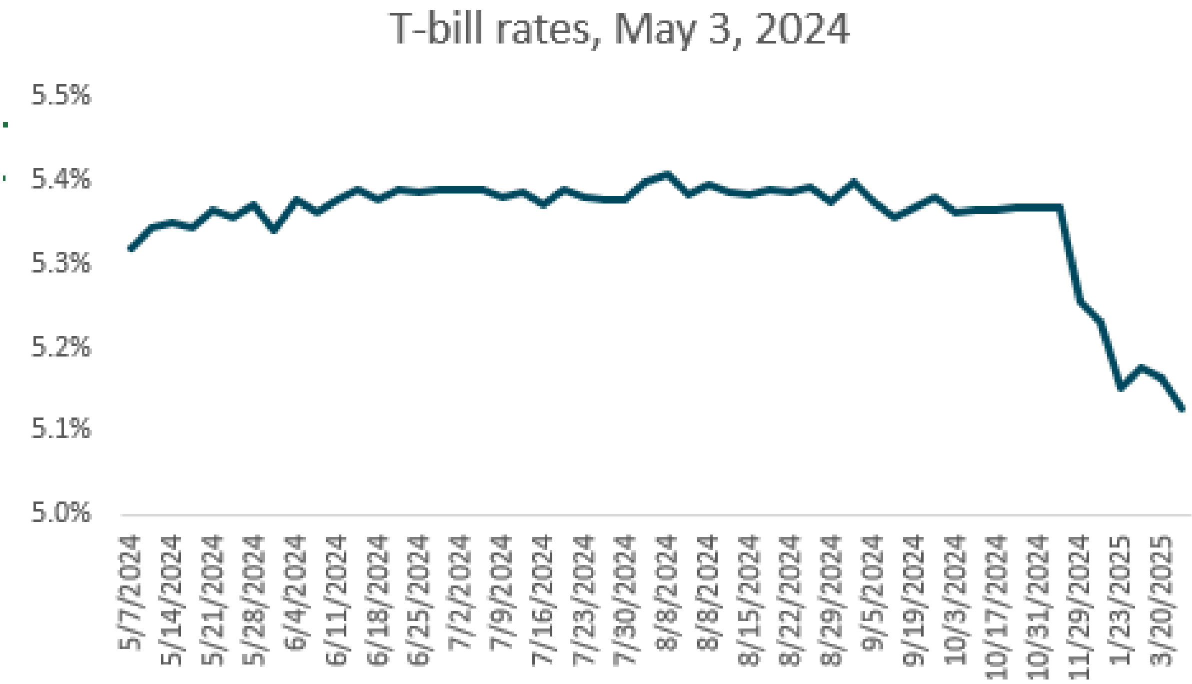


Source: BNY Mellon Markets, Federal Reserve Bank of New York, US treasury

In addition, the T-bill curve is as flat as a proverbial pancake near 5.37%, just a hair over the RRP award rate of 5.3%. Given the uncertainty about the path for the federal-funds rate into the autumn along with the paltry supply of and lowish returns on bills, it doesn't seem as if MMFs are interested in hoovering up many more bills. Lastly, looming MMF reform will likely impose liquidity requirements across the industry, meaning more cash holdings on the margin (i.e., more RRP usage). It's not clear to us that these factors will weaken in the short to medium term, meaning higher RRP balances for a while.

For the Fed's balance sheet, steady RRP holdings mean more excess liquidity in the system, as well as less downward pressure on reserves than if the RRP rundown were to continue at the pace that prevailed in the period we noted in the first paragraph. Combined with the recently announced cutback in Treasuries rolloff by the Fed, this suggests that an environment of abundant reserves (i.e., over $3trn) will endure. As a result, this eases our fears of liquidity scarcity and potential funding market shenanigans.

Flat as a Pancake



Source: BNY Mellon Markets, Bloomberg

The Fed's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices (the "SLOOS") was released on Monday. It showed a modest contraction in lending availability and almost no change in demand for loans. Credit remains tight, but over the past three months, not by very much.

For commercial and industrial loans, the SLOOS reported that 15.6% of respondents tightened their lending standards for large- and medium-size borrowers, and 19.7% did so for small borrowers. These are each up about one percentage point from the January data. Similar results hold for other lending categories.

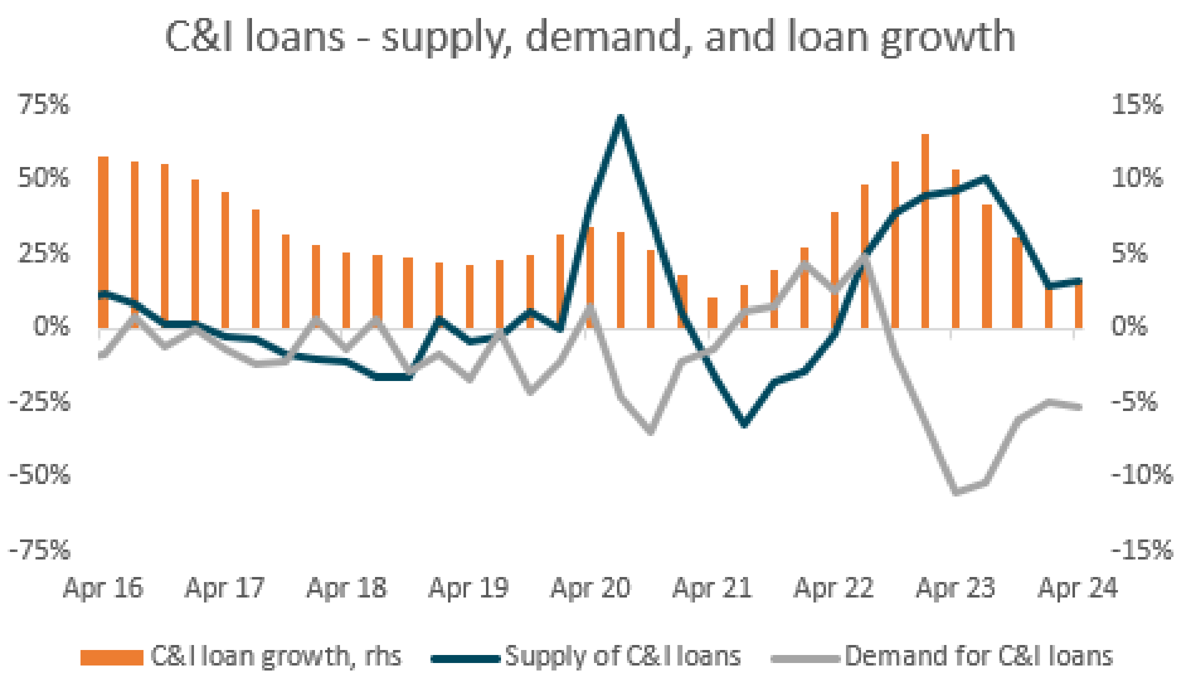
The chart below plots SLOOS data back to 2016. We show the percentage of banks that report having tightened standards for C&I loans (blue line), the percentage of banks reporting stronger demand for C&I loans (gray line), and realized annual growth in C&I lending by all commercial banks (orange bars). Note how the actual lending data correspond to lending standards, and how loan demand is an almost mirror image of lending standards.

Note also how the pre-pandemic data were relative steady before the lockdowns made banks very cautious to lend in H1 2020, but much more willing to lower standards during the period of near-zero rates and extensive quantitative easing in late 2020 and 2021. Once rate hikes began in early 2022, lending standards became much tighter, with nearly 51% of banks reporting tighter conditions in July 2023, the month of the Fed's last rate hike. Since then, standards haven't necessarily become looser. Instead, the post-July 2023 data imply that fewer additional banks have tightened standards further since then.

We have been monitoring credit growth for a while and have seen it falling from its late 2022 highs, as the chart demonstrates. This, as well as the lending standards data, are artifacts of the rate hiking cycle – a clear demonstration of the transmission of monetary policy through the credit channel. This is a sign that policy is indeed restrictive. However, it appears that this effect is beginning to fade, as the recent quarters reveal in the data.

Another quarter or two of data like Monday's and we could conclude that the credit markets are in a steady state – low demand, high lending standards, low credit growth. This would validate the Fed's decision to stand pat on the policy rate for over a year since the last hike (assuming there is no cut until at least September). This should cool domestic demand further, but without leading to an outright recession, in our view.

Credit Standards, Loan Growth Stall



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

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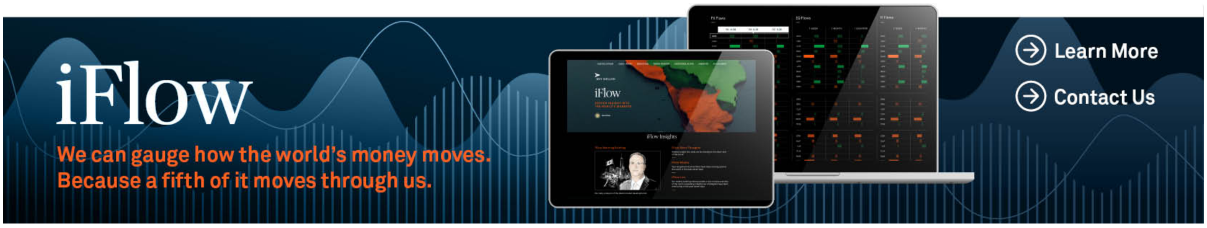

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