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iFlow

SHORT THOUGHTS

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Fed QT To Continue Well Into 2024

Reserves Amply Above Comfortable Levels

The total size of the Federal Reserve's Treasury and MBS holdings has fallen by just over $1 trillion since the central bank announced quantitative tightening (QT) in May of last year. Of that sum, Treasury securities are down $795bn and MBS holdings down $277bn. Yet, total assets held in the Fed’s Securities Open Market Account (or SOMA) is still an impressive $7.2 trillion. That's just over double the post-GFC low of $3.5 trillion that prevailed before the pandemic ushered in a new round of extraordinary asset purchases.

With the rate-hike cycle looking done – something we expected to be the case a while ago – there have been discussions around if and when the Fed will suspend this round of QT. We believe that QT will continue to shrink the SOMA portfolio well into next year. Furthermore, if and when the Fed starts to cut the federal-funds rate – something we don’t expect until at least June 2024 – we don’t think this would automatically spell the end of QT.

In principle, one could argue that if policy rates are now restrictive (according to Chair Powell they are) and the economy slows, bringing unemployment higher and inflation lower, then an initial rate cut sometime in mid-2024 would represent a removal of restrictive policy in response to a slowing macro picture, more so than it would be outright easing. Think of the initial rate cuts in this case as normalization, from tight policy to something closer to an equilibrium rate. In this vein, we think the Fed would still be willing to allow balance sheet shrinkage, as that would also represent a normalization of policy.

Of course, this scenario assumes that reserves on the Fed’s balance sheet don’t drift too low and remain above the so-called “lowest comfortable level of reserves” (LCLoR) necessary for the banking system and money markets to function smoothly. A reserves amount of $2.5

trillion has been bandied about as a consensus LCLoR. Current data suggests that reserves are still well above that level, at around $3.3 trillion. Moreover, this sum, reported weekly, hasn't dipped below $3 trillion since early March, at the outbreak of stresses among several regional banks this past spring.

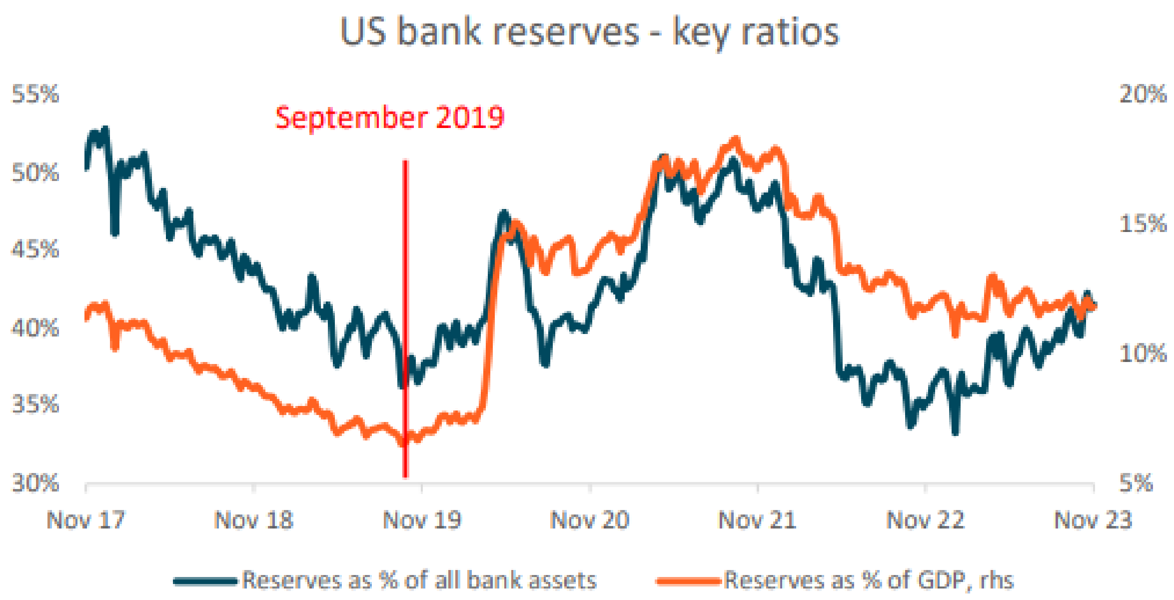
Beyond the outright quantity of reserves, the size of reserve holdings relative to either (or both) the ratio of reserves to the size of the US economy and/or the size of the banking sector is also encouraging. The chart below shows both ratios and indicates that at 12% of US nominal GDP, or 41% of total assets in the banking sector, the system is not near the lows in reserves observed over the past six years.

For contrast, the repo market-related stresses of September 2019 saw ratios of reserves to GDP and total banking assets of 6.5% and 36%, respectively, well below where we are now. Back then, the Fed suspended post-GFC QT (which had the SOMA portfolio decline from $4.24trn to $3.55trn between April 2017 and September 2019), and – through repurchases hastily initiated after the September 2019 funding stresses – reversed the decline in reserves by adding an additional $350bn.

To quote Chair Powell's remarks on the topic at the FOMC press conference last week: *So, the committee is not considering changing the pace of balance sheet run off. It's not something we're talking about or considering and I know there are many candidate explanations for why rates have been going up and QT is certainly on that list. It may be playing a relatively small effect, although I would say at $3.3 trillion in reserves, it's not, I think it's hard to make a case that reserves are even close to scarce at this point. So that's not something that we're looking at right now.*

Unless a new episode of funding stresses or Treasury market disfunction emerges in the next several months, we don't reason for the Fed to suspend reducing the size of its balance sheet or the SOMA portfolio well into 2024. These levels – and ratios – of reserves are key to watch; should they deteriorate next year, we might have a different story to tell. For now, though, we don't think conversations about when the Fed will suspend QT are relevant.

Still Ample Enough



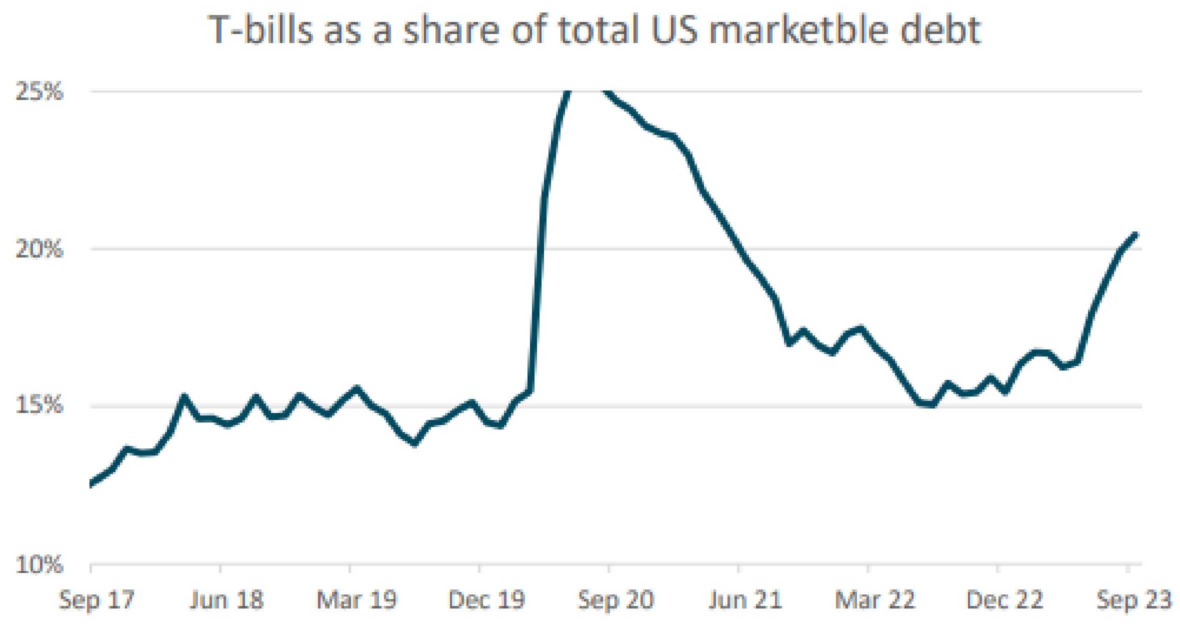
Source: BNY Mellon, Federal Reserve Board of Governors, Bureau of Economic Analysis

Appetite For Bills Still Strong

We also need to look at the ongoing and persistent drain of the Fed's overnight reverse repurchase facility (RRP). Falling some $1.1 trillion since the beginning of June, it's quite clear that money market mutual funds (MMFs) have been leaving the RRP to onboard Treasury bills. Indeed, net T-bill issuance since June 1, when the debt ceiling was temporarily resolved, has been north of $1.5 trillion, leading to higher T-bill yields. Combined with a receding likelihood of additional rate hikes, the shift out of RRP and into bills has taken place in concerted fashion. In other words, funds for the renewed (and very large) issuance of bills have come out of MMFs and other cash holdings, not out of reserves.

The question now is if additional bill supply – at a likely equal or greater pace than in H2 – will continue to be absorbed as easily as it has been so far. This is especially relevant since the ratio of T-bills to all marketable public debt outstanding has just moved north of 20% limit (see chart below) recommended by the Treasury Borrowing Advisory Committee.

Breaking The Range

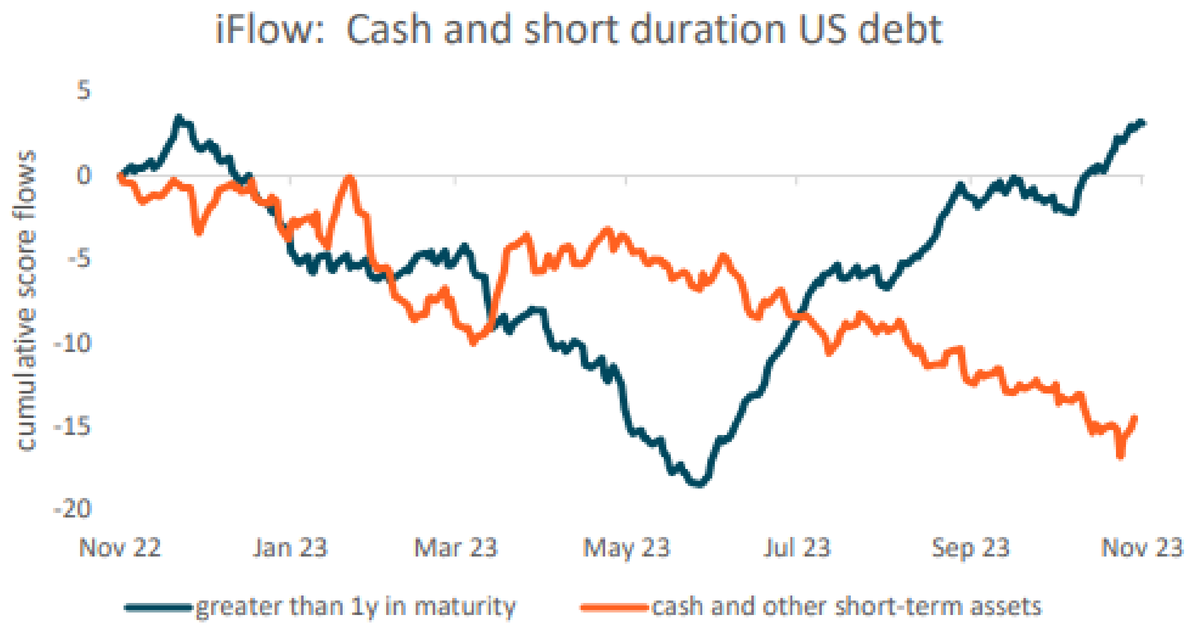


Source: BNY Mellon Markets, SIFMA

iFlow Confirms Bill Purchases Still Strong

Our iFlow data shows that this switch out of cash and into bills is ongoing, with no signs of relenting. We can break out sovereign flows across the yield curve and examine those flows into the sub-1y maturity bucket. Admittedly, this sector of the curve includes more than just T-bills; it would also include longer-dated bonds that are within one year of coming due, for example, a 10y note issued over nine years ago. Nevertheless, the chart is clear. The real money investors captured within iFlow illustrate this shift out of cash and into the very front of the curve, especially – again – since June 1. It appears that appetite for bills, even in the face of record issuance, remains unsated, and that between MMFs and real money institutional funds, bill demand is sustainably large enough to absorb it.

Switch Out Of Cash And Into Bills Goes On



Source: BNY Mellon Markets, iFlow

Please direct questions or comments to: iFlow@BNYMellon.com

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