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iFlow

SHORT THOUGHTS

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FOMC & Treasury Refunding Previews

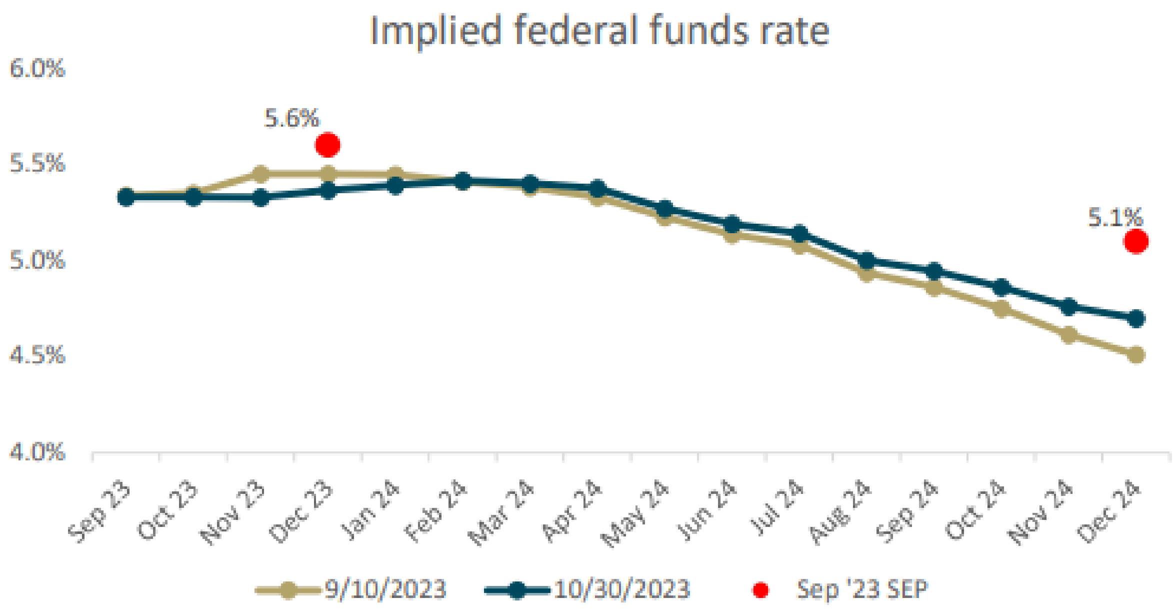
An Uncontroversial FOMC

There is almost no expectation of the FOMC announcing a rate move at the conclusion of its policy meeting Wednesday. Nearly every Fedspeaker over the last few weeks (pre-blackout) telegraphed a hold or, if you prefer, a “wait and see”. Our view that the Fed was done after the July 2 hike doesn’t seem at risk. Yet, we expect the Fed to again err on the hawkish side rhetorically. The statement, as well as Chair Powell’s remarks after the meeting, should make reference to potential future policy firming, depending on the evolution of price pressures, domestic demand, and the labor market. We see no chance of the Fed signaling that it’s done, instead keeping the optionality of a potential hike further down the line. We don’t think the Fed will actually be able to pull another hike off in this cycle, however, setting up a long period during which policy rates will stay where they are.

Despite strong economic data, including blowout September nonfarm payrolls reported in early October and an equally impressive 4.9% increase in real GDP last week, we think that the strongest period of economic growth is just behind and expect the numbers will begin to trend weaker into end-2023 and early 2024. But not enough, we caution, to hasten rate cuts any time soon. Rather, just enough so that the Fed will let the already high funds rate – nearly 2% in real terms now – continue to work on slowing the economy, along with the nearly 125bp rise in yields at the long end of the curve. We see higher yields and tighter financial conditions slowing corporate investment demand – see yesterday’s dissection of the GDP and PCE inflation numbers here. Furthermore, inflation is beginning to ebb. Again, not so quickly as to bring rate cuts forward into early 2024, but by enough such that barring a resurgence in inflationary activity, rates won’t move until mid-2024, in our view.

In summary, this meeting is unlikely to be a significant market event. As we will discuss below, we think the real policy event on Wednesday will likely be the release of the Treasury's quarterly refunding announcement.

Almost No Movement In FF Futures Since Last FOMC



Source: BNY Mellon, Bloomberg

Treasury Announcement To Overshadow FOMC

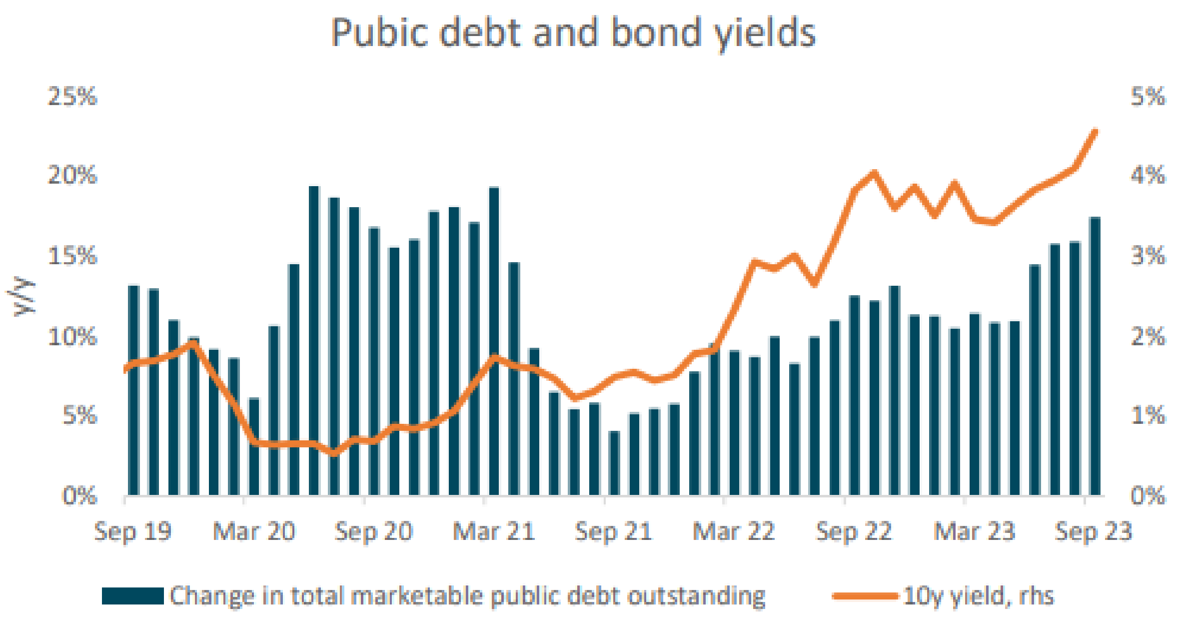
On Monday afternoon, the US Treasury published its borrowing estimates for the remainder of Q4 this year, and for Q1 next year. Both numbers represent records for the respective quarters, although the revised Q4 estimate, which came in at $776bn, was lower than the initial estimate of $852bn published in August. For Q1 next year, Treasury expects to borrow a net $816bn. The combined $1.592 trillion for Q4 2023 and Q1 2024 is a touch under the combined $1.67 trillion issued during Q2 and Q3 earlier this year, but still represents the second largest two-quarter borrowing schedule since the early months of the COVID lockdowns. The US fiscal trajectory is still a concern.

Wednesday morning will bring publication of the quarterly refunding statement, detailing issuance plans at various points along the Treasury curve. Depending on the split between bills and coupons (and among coupons across the curve), we could see some notable moves in yields. Current bill issuance is right at the top of the range recommended by the Treasury Borrowers Advisory Committee (TBAC), which prefers total bill issuance to be between 15% and 20% of total borrowing. If Treasury – with TBAC’s tacit acceptance – needs to increase the amount of coupon supply, yields could rise across most of the curve.

Indeed, Wednesday morning is likely to be of more relevance to the market than the FOMC meeting later that day. We have written a great deal on supply and demand dynamics in the Treasury market, arguing that these eye-watering levels of coupon supply will struggle to meet sufficient buyers at current prices. Bill issuance, if it breaches the 20% threshold recommended by TBAC, still looks like it can be absorbed within reasonable quantities. We wrote about the TGA drain a few weeks ago, commenting that it has been proceeding relatively smoothly as money market mutual funds (MMFs) have been happy to turn the extremely high levels of RRP usage into bill holdings, ever since the debt ceiling was temporarily resolved in early June (see here).

While Monday's announcement of borrowing needs for the rest of this year and into next year was not as large as could have been feared, it still represents a lot of supply to take down. The details on the issuance schedule, i.e., which maturities will be increased, will be required reading for the market on Wednesday morning.

Borrowing Rising



Source: BNY Mellon Markets, SIFMA, Bloomberg

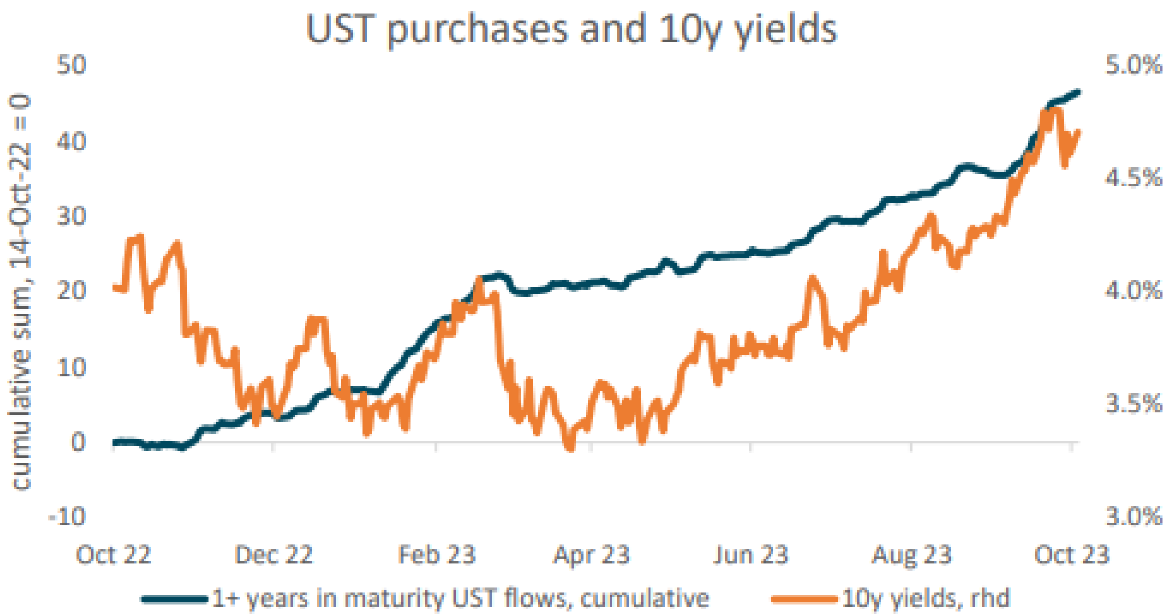
Buying USTs As Yields Rise

We have been concerned about the ability of the market to absorb all this looming, expected supply. We have pointed out that foreign demand for UST securities has been weakening – evidenced by both our iFlow data on real money, long-only institutional flows, as well as what can be gleaned from data on primary dealers and US commercial banks, both of which have not been materially increasing their exposure.

What we find interesting is that overall, iFlow shows that institutional buyers of Treasuries have been buying coupons all the while bond yields have been rising (bond prices falling). The chart below depicts cumulative flows into USTs of greater than 1y in maturity (i.e., ex bills). Note that from February this year until around the end of May, flows were fairly flat before picking up after June 1 when yields really started to move higher. There was also a period of consolidation during September, but a resumption of buying during October.

In short, real money has been long and wrong USTs for most of this year. This conforms to anecdotal evidence we have gathered from countless meeting with investors, including those same long-only real money accounts from whom the data in the chart is derived. We frequently hear that subsequent moves higher in yields and lower in bonds represent good buying opportunities, but also a lack of agreement on where yields go from here.

Long And Wrong



Source: BNY Mellon Markets, iFlow, Bloomberg

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

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