US Rates Watch

Fed considerations for slowing QT

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QT slowing sequence

At the January FOMC meeting we expect to learn more about Fed considerations around slowing the pace of QT (see: January FOMC preview). The Powell press conference will likely provide a high-level indication on the depth of this conversation but subsequent Fed official speeches & the FOMC minutes should provide more detail. We expect no decisions around slowing QT to be announced at this meeting but expect more direction on Fed preferences for when & how to manage this process in the Jan FOMC minutes. The Fed is expected to discuss slowing QT to engineer a more orderly transition from an abundant to ample reserve regime. The December FOMC meeting minutes set the stage to discuss conditions around slowing QT. The Fed likely needs to hold this discussion at the Jan '24 FOMC & make decisions sooner vs later as some measures of liquidity abundance have been rapidly declining, including the Fed ON RRP.

Indicators to watch for slowing QT

To determine the extent of liquidity abundance, we believe the Fed is examining: (1) level & change in ON RRP & reserve balances (2) level & change of money markets within Fed target range (3) reserve demand & distribution. See appendix for detail. Fed officials have suggested their indicators continue to show that liquidity is abundant, though that assessment is shifting. Dallas Fed President Logan said in early Jan that month-end jumps in repo rates imply "we're no longer in a regime where liquidity is super abundant and always in excess supply for everyone." We agree.

Fed ON RRP likely single best indicator of excess liquidity

To assess the degree of liquidity abundance, we believe the most simple and straightforward indicator is the balance of Fed ON RRP. Meaningfully positive use of Fed ON RRP implies there is excess liquidity in the financial system. If banks find themselves short on liquidity they can find ways to pull this cash out of Fed ON RRP via FHLB use, issuing directly to prime fund users of ON RRP, or competing more aggressively for deposits with MMF investors. Once ON RRP take-up reaches near zero it is no longer obvious that there is abundant excess liquidity in the system. Dallas Fed President Logan agrees with our assessment on the ON RRP balance. In early Jan Logan wrote: "we should slow the pace of runoff as ON RRP balances approach a low level." We are not sure of Logan's judgement around the ON RRP "low level" but believe it is likely $200-250b (see Logan and QT: QT taper now in March). At the recent ON RRP run rate, the low level of $200-250b could be reached in March. … *See page 2 for more detail…*

QT: Quantitative tightening

FOMC: Federal Open Market Committee

ON RRP: Overnight reverse repo facility

MMF: Money market fund

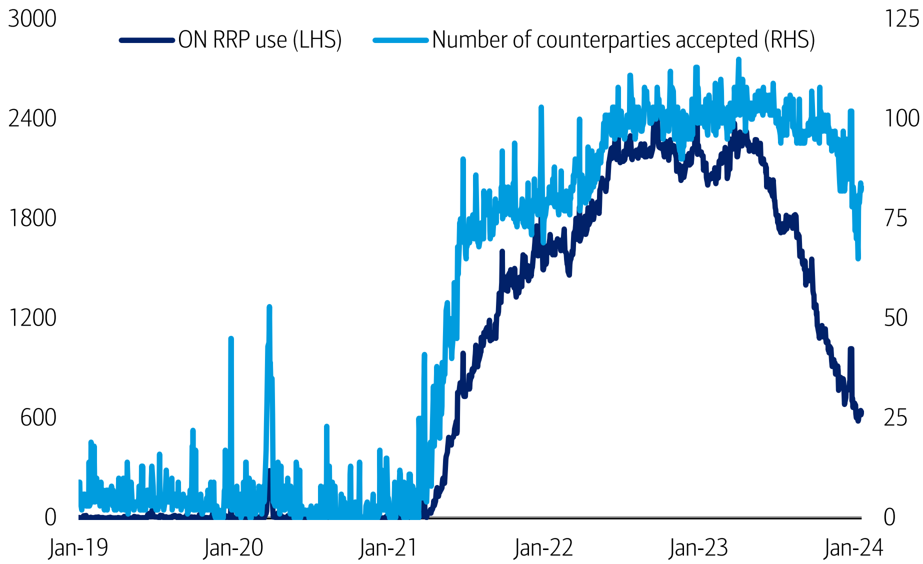
FHLB: Federal Home Loan Bank

SRF: Standing repo facility

Timestamp: 26 January 2024 07:00AM EST

The prior considerations drove us to revise our timing for QT slowdown announcement to the March FOMC. We acknowledge uncertainty around this estimate and will revise our expectation with Fed guidance. Not all Fed officials agree with Logan's assessment but we overweight her views given her familiarity & expertise on technical aspects of monetary policy implementation. Other Fed officials have argued for slowing QT once there is sustained SRF use, but we don't see the logic of adding liquidity via SRF & continuing draining liquidity via QT; if there is sustained SRF use, the Fed will likely cease QT shortly thereafter. We expect Logan's views on QT & policy implementation to sway others within the Fed.

Exhibit 1: Fed ON RRP use ($bn) vs number of counterparties accepted
Both Fed ON RRP use and the number of counterparties using the facility have seen a continued decline



Source: BofA Global Research, Bloomberg

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Appendix

The Fed is likely examining 3 key indicators to assess the extent of excess liquidity: (1) level & change in ON RRP & reserve balances (2) level & change of money markets within Fed target range (3) reserve demand & distribution. Detail on each below.

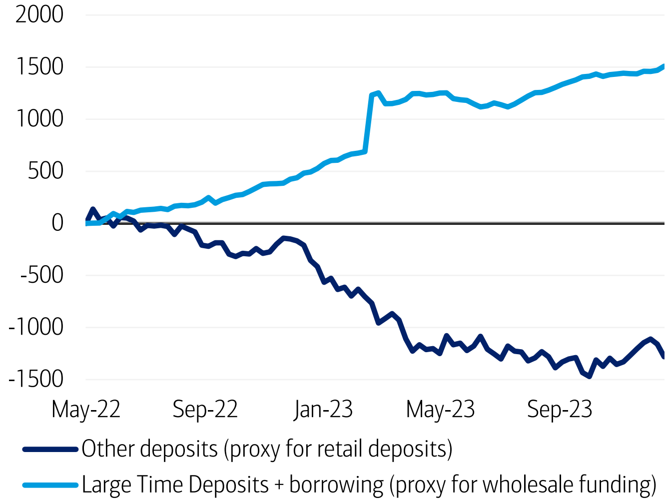
Level & change in ON RRP & reserve balances: since early summer '23, ON RRP take-up has fallen sharply while reserve balances have increased. We expected a fast decline in ON RRP due to the post debt limit TGA rebuild & ongoing QT, but ON RRP balances have been falling even faster than we thought. The decline in ON RRP balances reflects not only MMF preferences to extend their weighted average maturities & capture higher money market rates, but it also likely reflects increased bank competition to retain deposits & hold more liquidity.

Commercial banks have been paying up via large time deposits & other borrowings to offset retail deposit outflows, stabilize the size of their balance sheets, & hold higher liquidity buffers (Exhibit 2, Exhibit 3). These factors have supported increased growth in reserve balances.

The Fed likely appreciates that the sharp reduction in ON RRP & increased reserve balances reflects shifts in preference for MMF yield enhancement & commercial bank liquidity management. As ON RRP declines & reserve balances remain stable or trend higher, the Fed will likely want to proceed more carefully in its balance sheet reduction & liquidity drain.

Exhibit 2: Cumulative change in large TDs + borrowing vs other deposits ($bn)

Large time deposits and other borrowing have largely offset other deposit outflows



Source: BofA Global Research, Bloomberg

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Exhibit 3: Fed reserve balances ($bn

Fed reserve balances have been trending higher despite QT

Source: Bloomberg

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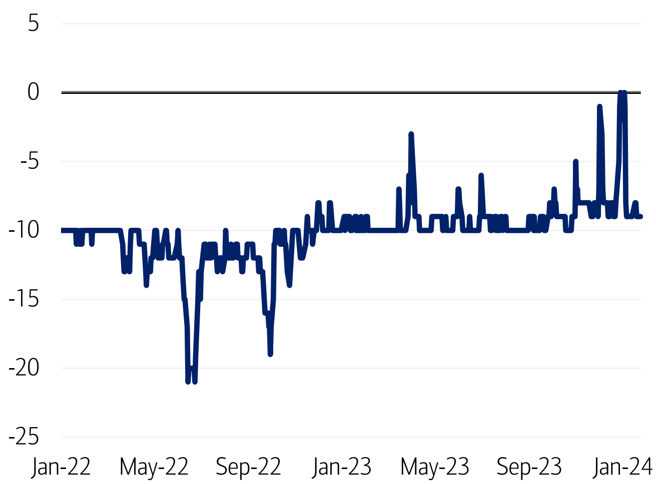
__**Level & change of money markets within Fed target range**__: to assess the relative abundance of liquidity in the system the Fed also monitors the level & change of money markets within their target range. If money markets are trading low vs Fed administered rates within their target range, it implies liquidity is abundant. If money market rates shift higher in the target range, it implies liquidity less abundant.

Some money market rates have started shifting higher vs the Fed's administered rates & within the target range (Exhibit 4). This trend is clearest from repo rates, including the SOFR's tri-party and bi-lateral components (Exhibit 5). The federal funds rate has yet to shift higher but it tends to follow SOFR with a lag and will start moving higher in the target range as SOFR keeps rising. Recent increases in repo rates, especially on month-end dates, promoted Dallas Fed President Logan to say "we're no longer in a regime where liquidity is super abundant and always in excess supply for everyone." We agree.

Exhibit 4: SOFR spread to IORB (bps)

SOFR has been trending higher in the range relative to IORB



Source: BofA Global Research, Haver Analytics

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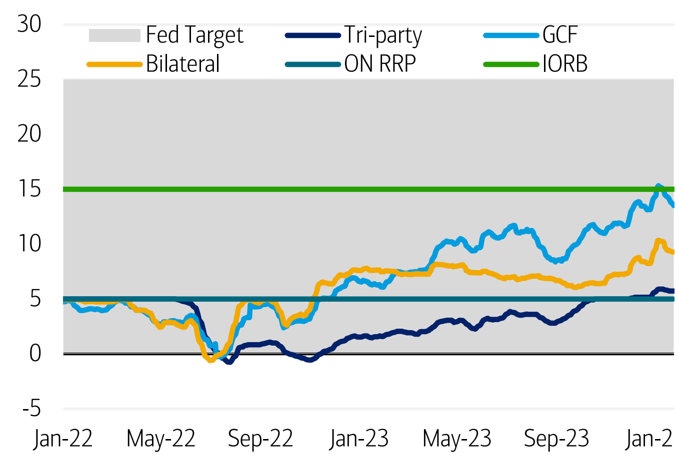
Exhibit 5: UST repo rates and Fed administered rates relative to the Fed's target range (bps)

UST overnight repo rates have been rising within the target range



Source: BofA Global Research, Haver Analytics

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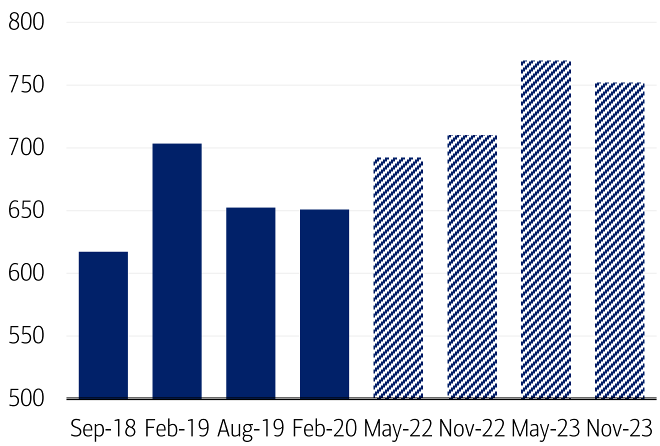
Reserve demand & distribution: to determine the extent of liquidity abundance the Fed will also consider reserve demand & distribution. Reserve demand has been evidenced not only via growth in large time deposits & other borrowings to offset retail deposit outflows, but also through survey responses to the Fed. The Fed's Senior Financial Officer Survey (SFOS) suggests bank LCLoR has generally been rising since 2019. The majority of respondents expect to maintain their reserve holding with more respondents leaning towards increasing their reserves in the future vs decreasing reserves (Exhibit 6, Exhibit 7). To us, this implies that commercial banks are not currently sitting on tremendously large abundant reserve quantities.

Exhibit 6: Sum of bank respondents' LCLoR estimates from SFOS ($bn)
Bank respondents LCLoR have generally been rising since 2018



Source: BofA Global Research, Federal Reserve. Note: The formatting of the question and responses has changed several times over the course of the survey. Patterned bars represent estimates of the sum of bank LCLoR based on bucket sizes or % change since prior survey

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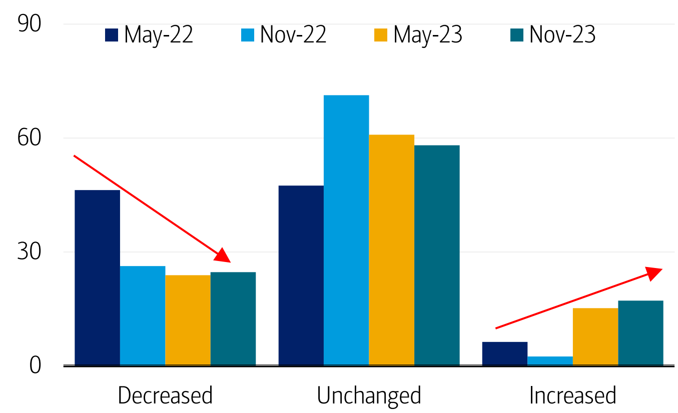
Exhibit 7: Bank respondents' expected change in reserves as a % of total respondents from the SFOS (%)
Most respondents expect reserves to remain unchanged but the downward bias has declined over time with more respondents seeing upside growth in reserves in the future



Source: : BofA Global Research, Federal Reserve

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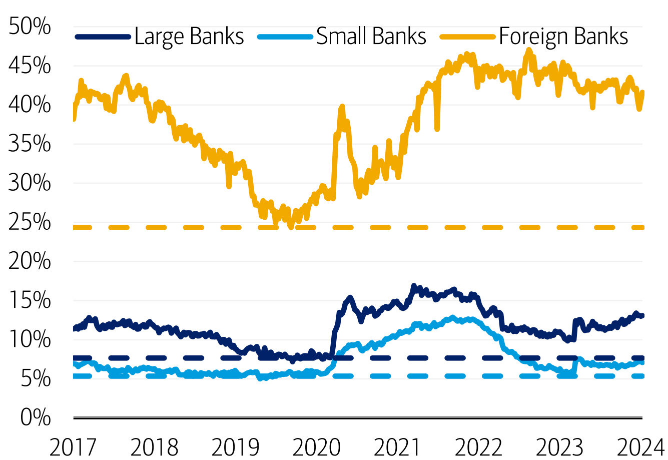
<u>The distribution of reserve holdings</u>: At present, foreign banks operating in the US currently hold the largest amount of cash versus their total assets (Exhibit 8). The higher cash / asset ratio at foreign banks likely reflects a higher degree of cash holdings for purely arbitrage purposes, given less stringent regulatory requirements from their home supervisors (i.e. borrow overnight in fed funds at 5.33% & lend to Fed at 5.4%). As money market rates increase we expect to see a lower concentration of reserve holdings at foreign banks and further signs of reserve competition from domestic banks (Exhibit 9: % of total borrowing in FF from domestic vs foreign banks).

Exhibit 8: Bank cash to asset ratios vs 2019 trough level
Bank cash as a % of assets are well above their 2019 trough



Source: BofA Global Research, Bloomberg

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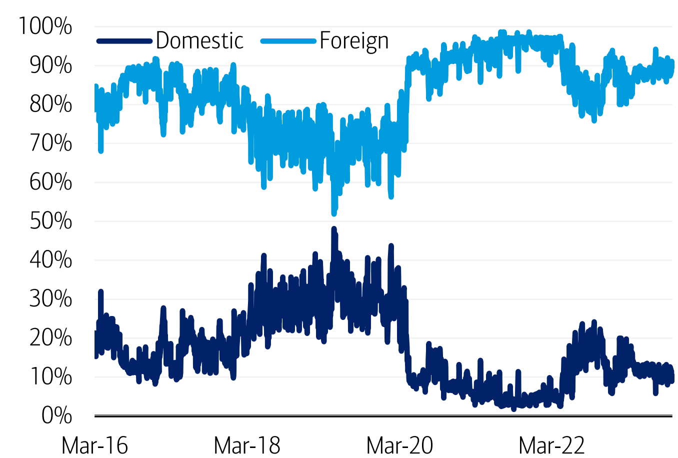
Exhibit 9: Fed funds activity by bank type (%)
Foreign banks are still the dominant borrower in FF



Source: Federal Reserve

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