US Rates Watch

Front end notes: times of stress

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Funding observations from a stressful week

What happened? US bank failures raised questions about systemic risk and contagion to other banks. This led to deposit outflows, demand for USD, and liquidity bolstering, all of which have impacted front-end rates. We discuss the impacts in more detail below.

What are we seeing? As a result of bank failures, other banks are facing deposit outflows. These deposit outflows are leading banks to find other sources of funding. We believe banks are primarily tapping the FHLBs for advances given large debt issuance levels this week. We discussed FHLBs in more detail: FHLB lender of 2nd-to-last resort.

MMF inflows were large at $121b w/w, according to ICI. Crane data suggest outflow pace moderated over the week. Deposits likely moving amongst banks vs leaving system.

Secured funding

GC repo cheapened & SOFR rose (Exhibit 1, Exhibit 2). Higher GC repo has likely been driven by: (1) $59bn in UST settlements, (2) banks bolstering cash raising in repo or outright sales, (3) FHLB debt issuance, (4) corporate tax-day requiring corps to pull cash. Risk-off deleveraging may have contributed to less funding available / more collateral.

SOFR volumes have also been trending upward (Exhibit 3). Higher repo volumes imply there is demand to fund more collateral, potentially due to bank funding needs.

The Fed's ON RRP facility, which is fixed at 4.55% saw take-up decline $122bn this week (Exhibit 4), despite $97bn in inflows into MMFs WTD. This has likely been driven by MMFs shifting their holdings from RRP into FHLB debt. O/N FHLB debt cheapened by as much as 14bps, as measured by FHLB Chicago, due to the increase in issuance.

Unsecured funding

Banking system stress was more clearly reflected in unsecured markets. Clearest sign of pressure is in 3m LIBOR-OIS widening out. FRA-OIS reflects an expectation for conditions to worsen (Exhibit 5). XCCY basis spreads widened for USD vs most currencies implying strong demand for USD in the risk off move (Exhibit 8).

In overnights, the FF rate returned to 4.58% after printing at 4.57% for most of March (Exhibit 6). The 25th percentile has also moved up since last week, from 4.56 to 4.58% This is likely indicative of FHLB's lending to less foreign banks who use the FF market to arbitrage IORB and instead extending to domestic banks willing to bid up for funding.

FF volumes have also dropped at the same time (Exhibit 7). This is likely driven by the FHLBs, the largest lender in FF, using up their excess cash to fund advances.

Bottom line: funding shows bank stress. FHLB issuance = banks shoring up liquidity. Secured funding = increased modestly. LIBOR & XCCY = USD funding pressure.

We discuss front end FAQs in the pages below.

USD: US dollar

FHLBs: Federal Home Loan Banks

GC: General Collateral

SOFR: Secured Overnight Financing Rate

ON RRP: Overnight reverse repo facility

WTD: week to date

MMF: money market fund

BTFP: Bank Term Funding Program

UST: US Treasuries

XCCY: Cross currency

IORB: Interest on reserve balances

GSE: Government sponsored enterprises

EFFR: Effective Fed funds rate

OBFR: overnight bank funding rate

FOMC: Federal Open Market Committee

QT: Quantitative Tightening

QE: Quantitative Easing

ESF: Exchange Stabilization Fund

TGA: Treasury General Account

FF: Fed funds

What to watch going forward in funding markets?

Unsecured: LIBOR is still produced & can evidence stress. Our preferred metric is 3m LIBOR-OIS (LIBOR: US0003M Index - OIS: USSOC Index). Short dated cross currency basis is also a proxy for USD demand (EUXOQQC BGN Curncy, JYBSS3M BGN Curncy).

Fed funds (FEDL01 Index) and overnight bank funding rate (OBFR01 Index): We expect to see an increase in FF and OBFR rates and volumes if there is increased bank stress.

Secured: SOFR rates and volumes are likely to rise if institutions are searching to raise liquidity. SOFR rate = SOFRRATE Index, SOFR volume = SOFRVOLU Index.

Bank data: Fed H.8 bank balance sheet data for this week won't be released until March 24. It will show deposit flows out of banking system and / or from small to large banks.

Will the Fed adjust administered rates?

Clients have asked if we believe the recent market stress will prompt the Fed to either reduce the ON RRP's counterparty cap from $160bn or lower the ON RRP rate 5bps to the bottom of the target range. We do not believe the Fed will make any adjustments to ON RRP. The question stems from the idea that by making the ON RRP less attractive, MMFs will not be as attractive vs bank deposits, slowing or reversing deposit outflows.

Dropping the ON RRP rate also risks dragging EFFR lower, which prior to the recent episode was printing lower in the range. Lowering ON RRP could risk EFFR printing uncomfortably close to the bottom of the target range. At the same time, raising IORB could risk EFFR printing too close to the top of the range if funding pressures continue.

We expect the Fed to judge it unnecessary to adjust administered rates now. Assuming that this bank stress is contained, the Fed would still want to encourage banks to compete for deposits by bidding up for funding. Additionally, the Fed would not want to be seen as hurting one market participant to support another.

Will the Fed adjust balance sheet policy?

Clients have asked us if the outflows from bank reserves will force the Fed to end QT early, especially given the large increase in Fed balance sheet this week. While reserve scarcity and market turbulence could certainly end QT, our economics team doesn't believe the Fed is there yet. We agree.

We have long argued the Fed would stop QT if: (1) recession & rate cuts, (2) market functioning issue, (3) reserve scarcity. Recent bank stress raises the risks around 1& 2. We still believe there is ample liquidity in the system ($2tn+ in ON RRP) and the Fed has a bias to keep reducing its security holdings. They will likely proceed with QT.

We acknowledge market functioning issues have increased. If conditions continue to deteriorate, this could force the Fed's hand, leading them to end QT.

Does recent bank stress impact debt limit?

We believe there has only been a marginal impact on the debt limit from the policy response so far, our base case remains mid-August. There are two things clients have asked most about: (1) the FDIC drawing $40bn from the TGA over the weekend, and (2) $25bn from the ESF being used to backstop the BTFP.

The FDIC withdrew $40bn from the TGA over the weekend, likely to have cash on hand to ensure depositor outflows. However, the FDIC returned that $40bn on Tuesday, therefore leaving no impact on the X-date.

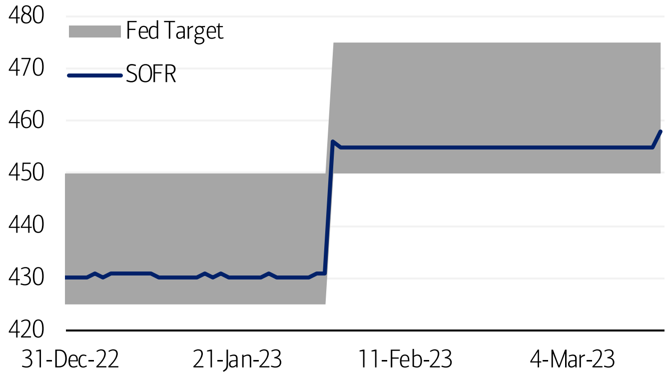
The ESF has a non-marketable US Treasury portfolio that they reinvest daily. At the debt limit, the Treasury can temporarily stop reinvestments of these Treasuries to increase headroom under the limit. For the BTFP, the Treasury lends $25bn from the ESF to the Fed which they can fund by either using those non-marketable USTs or borrowing from the Fiscal Service.

Whether Treasury uses holdings of non-marketable debt to cover the $25bn to the Fed or if they stop the reinvestment to increase headroom, it should have little to no impact on the X-date. Both lead to less intragovernmental holdings that count towards the debt limit, making room for more marketable public debt the Treasury can use to raise cash.

The more significant risk is a potential negative growth shock due to an economic slowdown triggered by this week's events. This likely means less income for Treasury and a higher deficit. Our base case remains a mid-August X-date but a significant increase in the deficit could pull forward the X-date to early June.

Exhibit 1: SOFR in the Fed funds target range

SOFR jumped 3bps on Thursday



Source: BofA Global Research, Bloomberg

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Exhibit 2: Components of SOFR vs ON RRP (bps)

GC has jumped higher, contributing to the higher SOFR print

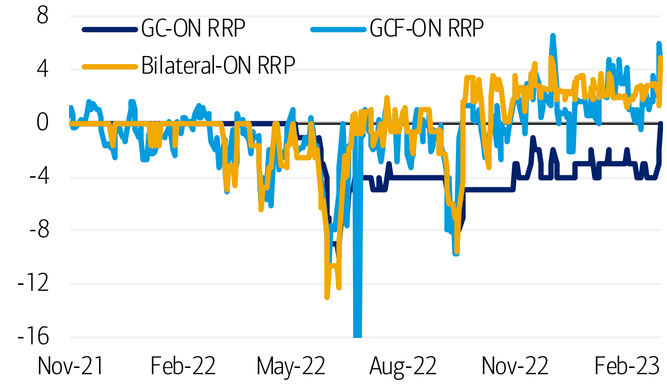

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Exhibit 3: Breakdown of SOFR volumes ($bn)

Bilateral repo volumes make up a majority of SOFR

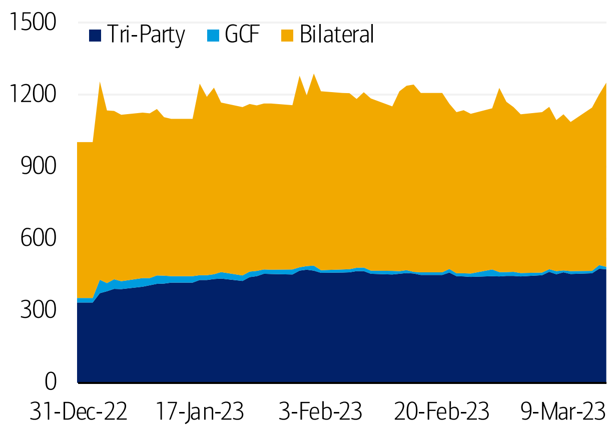

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Exhibit 4: ON RRP take-up ($bn)

ON RRP is down $163bn since the high on March 9

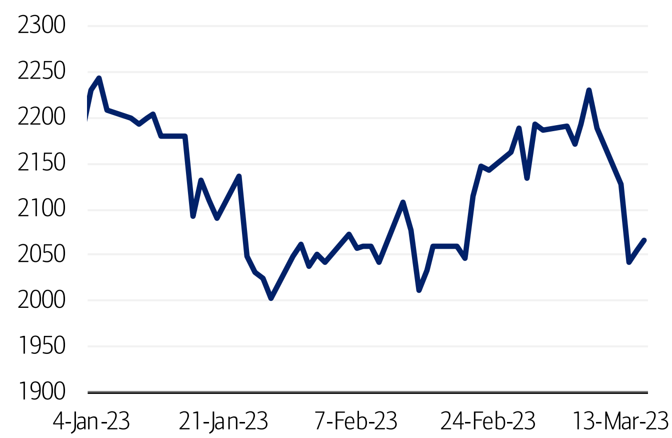

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Exhibit 5: 3m LOIS vs 3m FRA-OIS (bps)

3m LOIS widening out. FRA-OIS reflects an expectation for conditions to worsen

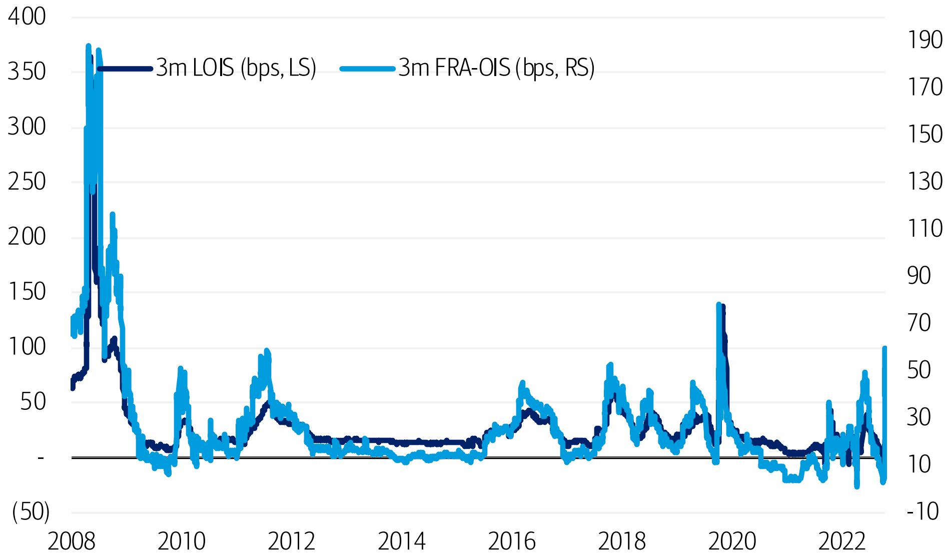

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Exhibit 6: Effective Fed funds rate and its percentiles

EFFR moved back up this week after a soft start to March

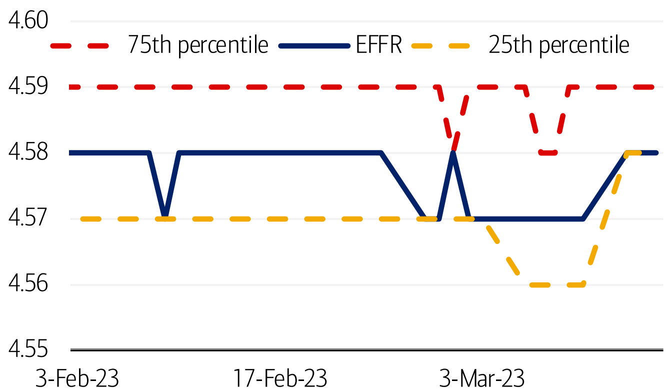

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Exhibit 7: Fed fund volumes ($bn)

Fed fund volumes dropped by as much as $74bn from March 9

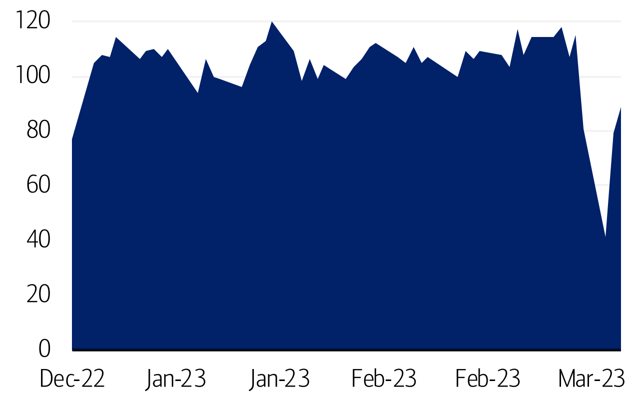

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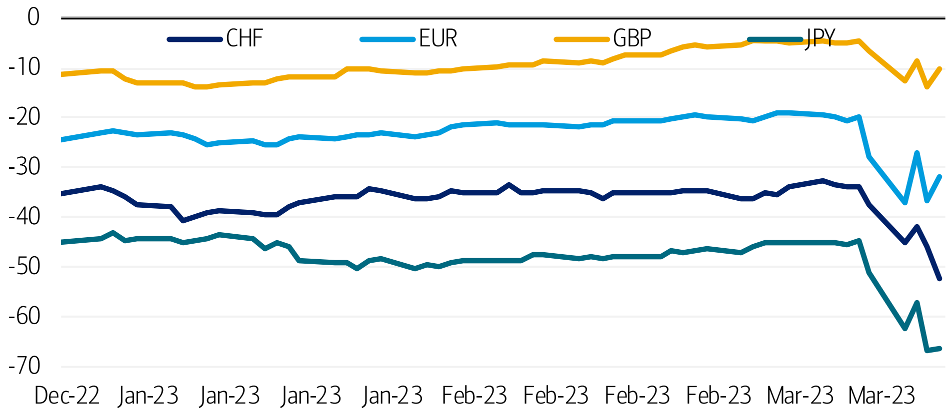
Exhibit 8: 1y basis in different currencies vs USD (bps)

1y basis spreads to USD have widened due to an increase in demand for USD



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