Liquid Insight

Losing our liquidity

07 November 2023

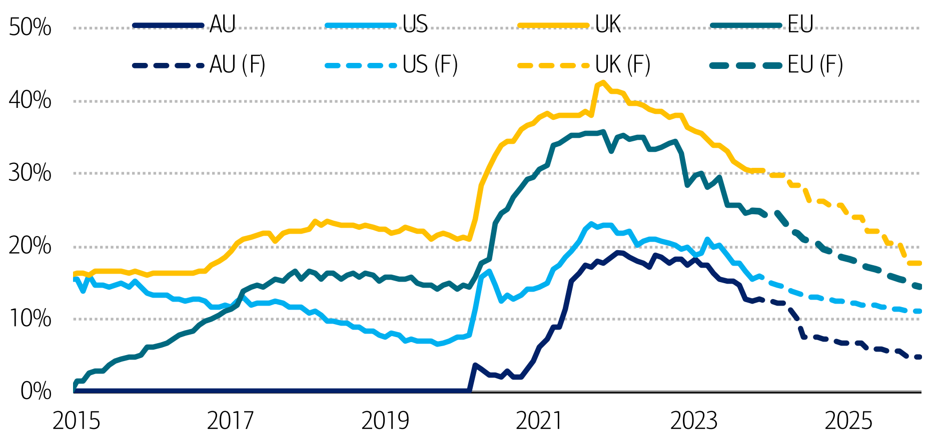
Rates and Currencies Research
Global

Key takeaways

- Australian funding markets have started to tighten as banks prepare to repay AUD 104bn in TFF loans to the RBA in 2024.
- Global excess liquidity is set to decline as Fed QT continues & TLTRO (Europe), TFSME (UK) and TFF (AU) repayments come due.
- In Australia, we recommend selling Jun24 bank bills vs OIS and we close our recommendation to pay Mar24 6m 6s3s.

By Oliver Levingston, Ronald Man, Agne Stengeryte, Katie Craig and Mark Cabana

Chart of the Day: Excess liquidity, % GDP
Liquidity drain to accelerate in 2024



Source: BofA Global Research, Bloomberg
*Excess liquidity defined as bank reserves less minimum requirements (if applicable) plus deposits at the central bank by domestic institutions via repurchase agreements (repo) (if applicable).

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Falling excess reserves = tighter AU funding markets

Over the past few weeks, Australian funding markets have started to tighten as Australian banks prepare to repay AUD 104bn in Term Funding Facility (TFF) loans to the Reserve Bank of Australia (RBA) in 2024. We forecast a drawdown in bank reserves in Australia will occur against the backdrop of declining excess liquidity worldwide. Central bank efforts to reduce the size of their balance sheets will likely accelerate the drawdown of excess liquidity in the US, UK and Euro Area in 2024 (Chart of the Day). In this note, we consider the timing of liquidity depletion in the US, Euro area and the UK, and discuss how we would trade this market in Australia.

Global Rates & Currencies Research
MLI (UK)

Oliver Levingston
Rates Strategist
Merrill Lynch (Australia)
+61 2 9226 5173
oliver.levingston@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Agne Stengeryte
Rates Strategist
MLI (UK)
+44 75 41694477
agne.stengeryte@bofa.com

Katie Craig
Rates Strategist
BofAS
+1 646 855 6625
katie.craig@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

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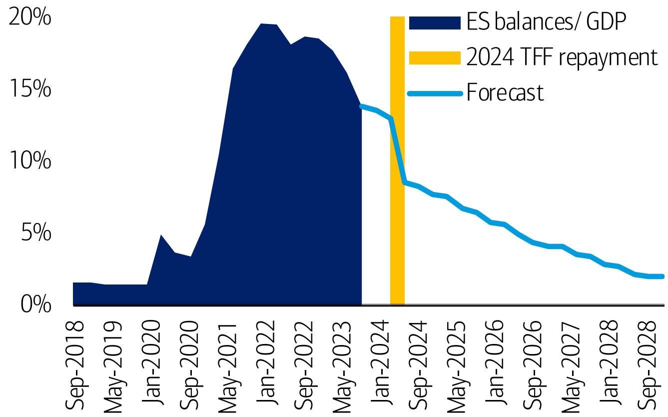
Australian funding markets to tighten further as TFF looms

Over the past few weeks, funding markets have started to show signs of tightness as Australia prepares for Term Funding Facility (TFF) repayments to the RBA by the major banks in 2024. The spread Australia's four major banks pay over cash to issue bank bills has widened from around 0bps to 7bps over the past three weeks (Exhibit 4).

Australian banks face a record funding task in 2024 as AUD 104bn of AUD 188bn TFF loans are set to mature (vs AUD 84bn repaid in 2023). The TFF maturity schedule is also highly concentrated in Q2 2024. More than 85% of TFF loans due to be repaid in 2024 will roll off in May and June. The pace of liquidity drain will be the fastest in Australian history and we see money market spreads as likely to normalize and even overshoot given the speed at which bank reserves will be depleted (Exhibit 2).

Exhibit 1: Reserve balances to drain fast in 2024
TFF repayment in 2024 to reduce surplus balances



Source: BofA Global Research, RBA

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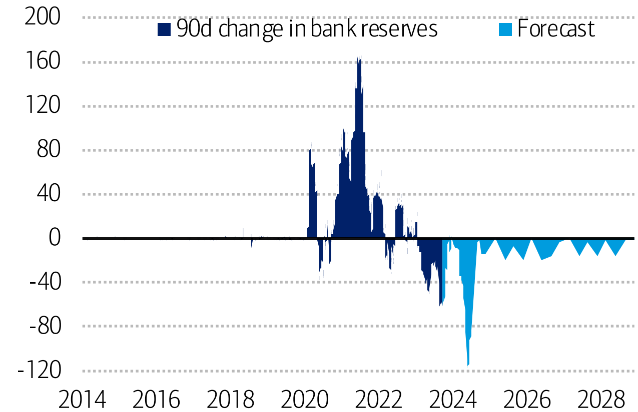
Exhibit 2: 90d change in AU surplus bank reserves (AUD bn)
Drain in reserve balances (less minimum requirements)



Source: BofA Global Research, RBA

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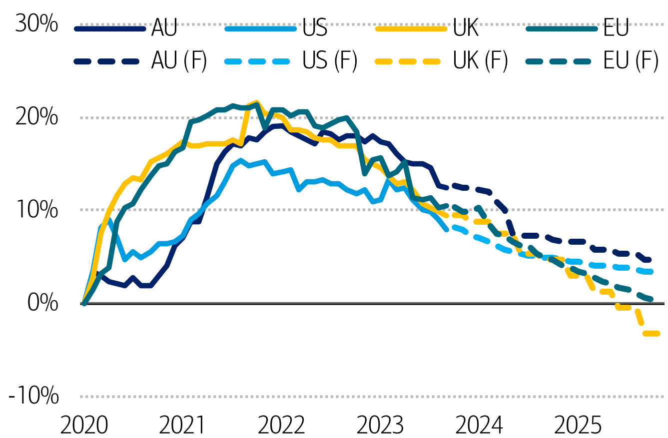
International backdrop

Australian TFF repayments in 2024 will also occur against the backdrop of declining global liquidity. We forecast central banks' balance-sheet reduction will further deplete excess liquidity in the US, UK and Euro Area but the timing, speed and effects will vary. For some markets, excess liquidity could return to pre-pandemic levels in the next 18-24 months (Exhibit 3).

Exhibit 3: Excess liquidity, % GDP (Dec 2019 = 0)
UK and Europe to return to pre-pandemic liquidity profile by Q4 2025



Source: BofA Global Research, RBA, Federal Reserve,BoE, ECB

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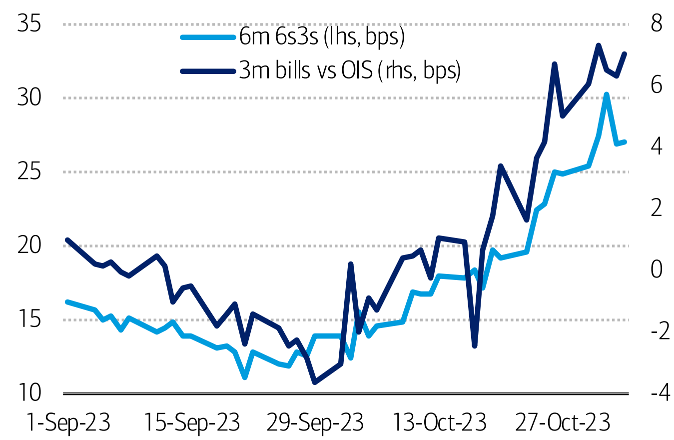
Exhibit 4: Funding market spreads showing signs of tightness
Forward bank bill term structure steeper, 3m bills-OIS wider



Source: BofA Global Research, Bloomberg

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US

The Fed has been drawing down its excess liquidity, which we define as total reserve balances plus the Fed's ON RRP, via quantitative tightening (QT) since June 2022. QT involves allowing maturing US Treasuries and MBS to roll off of the balance sheet up to a $60b and $35b monthly cap, respectively.

In addition to QT, the Fed's Bank Term Funding Program (BTFP) could contribute to a reduction of excess liquidity. The program is slated to wind down by March 2025 but we see risks it could be extended if rates are not lower or if banks are liquidity challenged. Currently, the BTFP is at its peak of $109b in loans outstanding. We expect it to remain around these levels until at least March 2024, the new loan expiration date. We see risks the new loan expiration date could get pushed forward until March 2025.

We expect the Fed will keep pushing to shrink excess liquidity until (1) US recession / sharp economic slowdown (2) UST market functioning issue (3) US bank reserve scarcity. The Fed baseline as published in the NY Fed Open Market Desk annual report sees QT ending with reserves / GDP at 9%. In the Fed's baseline for QT and incorporating BTFP loan reduction, we estimate excess liquidity will decline by $1.2tn in 2024 with an additional $500b in 2025. This Fed base case would see reserves hit 9% of GDP and ON RRP at $0. Risks are skewed to QT ending earlier due to bank behavior that implies they are liquidity scarce (see the report Fed QT: banks fighting to keep liquidity); this risk case could see Fed QT end as soon as the ON RRP facility reaches zero which we project in 2H '24 or 1H '25. If reserve scarcity happens earlier than the Fed projects, the standing repo facility (SRF) will act as a soft ceiling on repo and will function as an automatic stabilizer to add liquidity back into the system.

Euro area

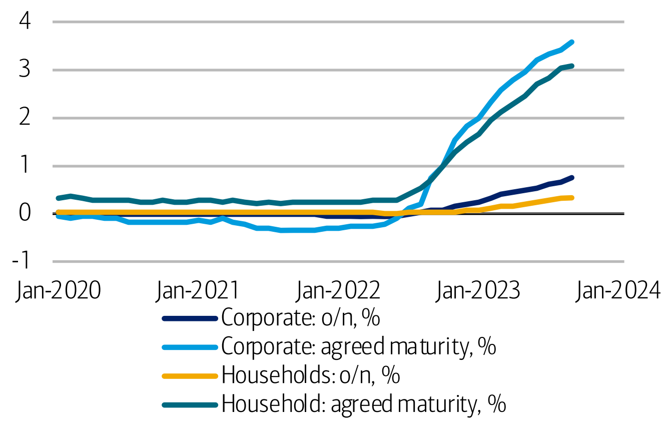
The euro area equivalent of the TFF is the targeted longer-term refinancing operation (TLTRO) programme. TLTRO operations started maturing in September 2022, but there remains €0.5trn outstanding from a peak of €2.1trn. All TLTROs will mature by the end of 2024 and these maturities will contribute more to the Eurosystem's balance sheet decline than QT in 2024.

Euro area banks are responding by terming other liabilities, such as customer deposits and debt issuance (Exhibit 5). This serves two purposes: 1) replace the loss of term funding from TLTROs and 2) lock in reserves for HQLA. We forecast euro money market rates to widen in 2024 as excess liquidity declines on the Eurosystem's balance sheet reduction and an expected increase in minimum reserve requirements.

UK

The UK equivalent of the TFF is the TFSME (Term Funding Scheme with additional incentives for Small and Medium Enterprises). Nearly three quarters of TFSME loans will mature by end-2025 (Exhibit 6). Our Quantitative Tightening (QT) and TFSME maturity calculations imply reserves at the Bank of England (BoE) approaching the Preferred Minimum Range of Reserves (PMRR) by end-2025. We estimate that reserves will drop by over £100bn over the course of 2024 and some £200bn over 2025 from current levels. The BoE's latest estimate of the PMRR lies in the region of £335-495bn (Hauser, 3 Nov). To test where the true PMRR might be, the Bank has introduced a weekly market-wide Short Term Repo (STR) facility which offers unlimited amounts of reserves against Gilt collateral at Bank Rate. More will likely need to be done to ensure alternative liquidity sources as reserves decline in the UK.

Exhibit 5: Rates on new deposits in euro area
Banks have attracted more term deposits by paying up



Source: ECB

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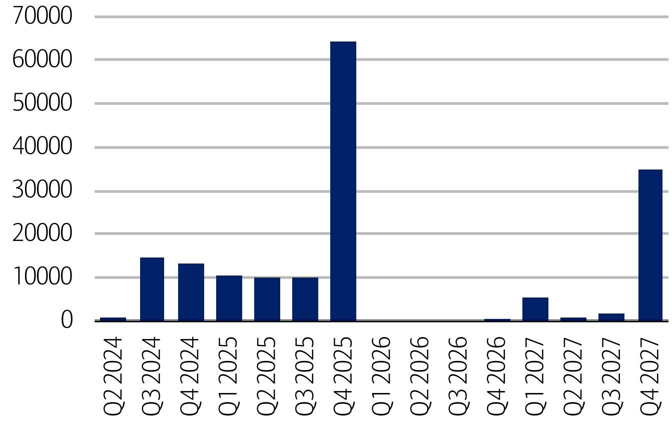
Exhibit 6: Estimated TFSME repayment schedule, £mn
Assuming no early repayments; 2026-27 repayments could be extended still



Source: BoE, BofA Global Research

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How we would trade in Australia

We like to position for wider bills-OIS spreads by paying June 2024 bills-OIS basis (BOB). TFF maturities are highly concentrated in May and June 2024 and will see a faster pace of reserve drain than at any point in Australian history. We forecast 3m bill-OIS spreads will return to their pre-pandemic historical equilibrium after the TFF concludes and note the 3m bill-OIS spread averaged 30bps in the five years to Feb 2020. We enter the trade at 15bps with a target of 30bps and a stop of 8bps.

Reserve shortages may occur more quickly after QE

The main risk to selling bill futures vs OIS is that liquidity will still remain more abundant than before the pandemic after the TFF has fully unwound. In the absence of more aggressive balance-sheet reduction by the RBA, banks' excess reserves as a percentage of GDP would remain significantly higher than in 2019 through 2024/25, and the cash buffers held by domestic banks provide them flexibility in managing their funding task.

Yet the spike in US money market rates in September 2019 when excess reserves were around 7% of US GDP demonstrated the change in reserve demand curves that typically occur after quantitative easing. Researchers at the Federal Reserve have found the reserve demand curve has tended to be nonlinear and may shift higher and steeper at higher levels of bank assets as a percentage of GDP. This means reserve shortages could occur when reserve balances are much higher as a percentage of GDP than in previous historical periods.[1] As our US strategists note, the Federal Reserve has endorsed this intellectual framework and now sees the lowest comfortable level of bank reserves at around 8% of GDP (see US Rates Watch: Fed QT, 22 September 2023).

Unlike major G10 peers, the decline in liquidity from Term Funding Facility repayments in 2023/24 is Australia's first ever attempt at draining liquidity after QE and it would be historically and comparatively unusual if excess reserves returned to pre-pandemic levels without reserve shortages.

Pay June 2024-starting 3m bills-OIS basis (BOB)

Moreover, June 2024 BOB is only pricing limited steps toward funding market normalisation. June 2024 levels are about 15bps below pre-pandemic equilibrium spread (c. 30bps) and we see a high likelihood of 3m bank bills cheapening to OIS as banks' TFF

[1] See Afonso, Gara, Domenico Giannone, Gabriela La Spada and John Williams (2022), *Scarce Abundant or Ample? A Time-Varying Model of the Reserve Demand Curve*, Staff Report 1019, Federal Reserve Bank of New York; Wright, Jonathan (2023), 'The Extent and Consequences of Federal Reserve Balance Sheet Shrinkage', *Brookings Papers on Economic Activity*, Fall 2022, pp. 259-275.

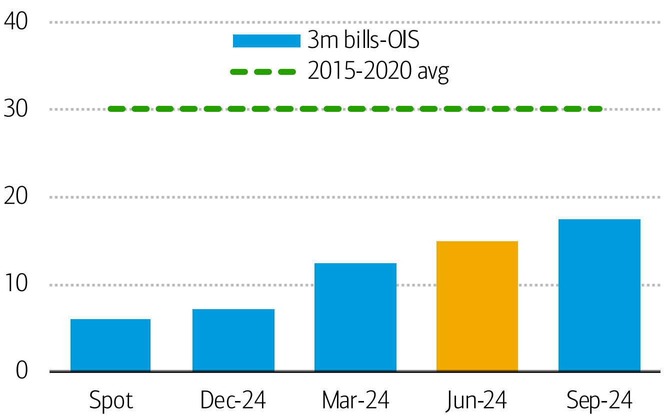
repayments approach in the first half of 2024 given the pace of liquidity drain in mid-2024.

In our view, the greatest uncertainty is whether reserve scarcity will reach pre-pandemic levels with excess liquidity in Australia around 7.5% of GDP. Yet even if post-TFF equilibrium rates are lower than pre-pandemic levels, given how large and concentrated maturities are in May and June next year, we also see meaningful upside risk of spreads overshooting their post-TFF equilibrium level as markets digest a step-change in bank reserves around mid-2024. **We recommend paying Jun24 BOB and enter the trade at 15bps with a target of 30bps and a stop of 8bps. As noted above, the risk to the trade is that excess liquidity in Australia will settle at a higher level after TFF repayments come due.**

Close Mar24 6m 6s3s trade

Our recommendation to pay March 2024-starting 6m 6s3s is above our entry level (current level 18bps, entry 15bps, target 27bps). On a technical basis, 6m BBSW daily volumes are showing early signs of rolling over (Exhibit 9). Similarly, spot 6m 6s3s curve is now at highly elevated levels vs recent history and may also be starting to inflect (Exhibit 10). We therefore close the trade.

Exhibit 7: Forward-starting 3m bills-OIS spreads
We recommend paying June 2024 3m bills vs OIS



Source: BofA Global Research, Bloomberg

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Exhibit 8: 3m bills-OIS spreads (bps)
Bills-OIS spreads tightened during quantitative easing

Source: BofA Global Research, Bloomberg

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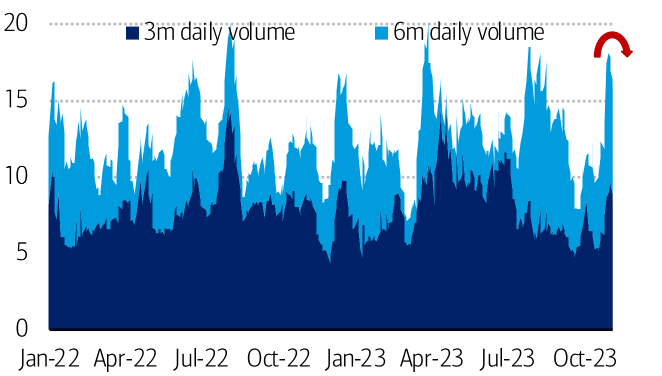
Exhibit 9: 6m BBSW daily volume in rate set window
6m daily volumes are volatile but showing signs of normalising



Source: BofA Global Research, ASX

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Exhibit 10: 6m 6s3s looks like it has temporarily peaked
We close the recommendation to pay Mar24 6m 6s3s

Source: BofA Global Research, Bloomberg

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- The only game changer**, Global FX Weekly**, 3 Nov 2023
- Yellen the dove, **Global Rates Weekly**, 3 Nov 2023
- Officials still against USD strength, **Liquid Cross Border Flows**, 30 Oct 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: The only game changer 03 November 2023

Global Rates Weekly: Yellen the dove 03 November 2023

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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com