

US Rates Watch

Fed funds drop: lower USD demand

Overnight fed funds drops vs IORB

The effective federal funds rate (EFFR, FF) settled into a slightly lower range over the past week. EFFR dropped 1bp and is now trading 8bps below IORB (Exhibit 1). There is no clear catalyst for the EFFR drop but we believe it is consistent with lower USD need & still easy funding conditions. We expect upward pressure on O/N funds in 2H '23.

EFFR drop drivers: FF volumes, FHLB debt, USD access

The EFFR drop reflects a rate on the cusp. The initial EFFR drop on June 15 took place with stable FF percentiles & volumes (Exhibit 2, Exhibit 3). The 99th percentile of the FF range subsequently declined for a time & EFFR volumes initially increased. These dynamics are generally consistent with a slightly lower EFFR print. We discuss in detail below.

FF volumes & FHLB debt: FF volumes have recently been elevated at the same time FHLB debt has been paid down (Exhibit 4). We read these dynamics as suggesting that (1) commercial banks have been repaying precautionary FHLB advances, and (2) FHLBs are long excess liquidity & are lending this in the overnight unsecured market. If bank funding conditions remain stable, we expect limited FHLB advances & excess cash in FF.

Lower FHLB debt outstanding reflects reduced bank funding stress. Reduced stress would also imply lower need for banks to source O/N liquidity in FF.

USD access: USD funding access also appears plentiful as seen through (1) lower O/N Eurodollar borrowings, (2) reduced USD funding premium in cross currency (XCCY) basis.

O/N Eurodollar borrowings can be seen via the spread between overnight bank funding rate (OBFR) & FF volumes (Exhibit 5). Recall, OBFR is a measure of wholesale, unsecured, overnight bank funding costs calculated using FF, certain Eurodollar transactions, and other domestic deposit trades. A decline in the spread between OBFR & FF suggests less Eurodollar borrowing demand or less need to borrow O/N USD.

The XCCY basis also reflects reduced USD funding premium in shorter-dated tenors. Both EUR/USD & JPY/USD 3m XCCY basis spreads imply some of the weakest premium to acquire USD in the post-SVB period (Exhibit 6).

We continue this discussion on the next page...

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IORB = interest on reserve balances

O/N = overnight

FHLB = Federal Home Loan Bank

FDIC = Federal Deposit Insurance Corporation

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EFFR appears to have dropped with the combination of (1) higher FF volumes b/c likely lower FHLB advances, and (2) plentiful USD access. Another theory that we feel is unlikely is higher FDIC premiums.

Domestic banks only make up 10% of FF transactions. This is largely because FDIC deposit insurance fees impact the relative attractiveness of FF borrowings for domestic banks vs foreign banks. An increase in FDIC fees would increase the effective cost of borrowing FF to arb IORB. The higher FDIC assessment fees following the SVB and Signature Bank failures, which will not be implemented until 2024, are likely to continue to discourage domestic bank participation in the FF market but unlikely the driver of the recent drop in the EFFR.

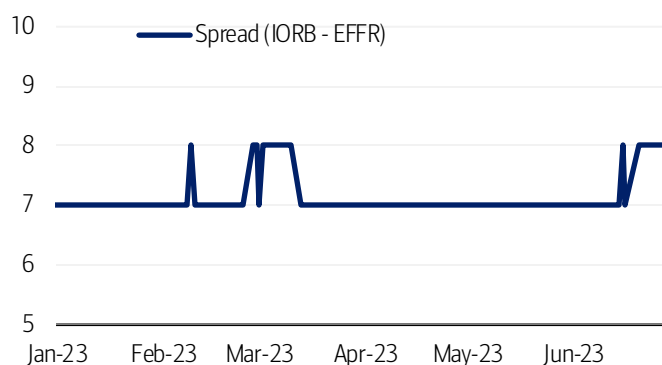
EFFR drop may hold near term, unlikely medium term

We respect the signals from money markets: O/N funding appears easy & bill supply has been taken down smoothly. We remain skeptical easy funding will hold.

We continue to expect the strong UST bill supply surge will place upward pressure on money market rates over time. Higher money market rates should increase bank funding costs, including EFFR. The process may take longer than we initially expected but end point is likely same. Expect further cheapening & for EFFR to revert higher in 2H '23.

Exhibit 1: EFFR spread to IORB (bps)

IORB-EFFR spread has widened from 7bps to 8bps in the past week

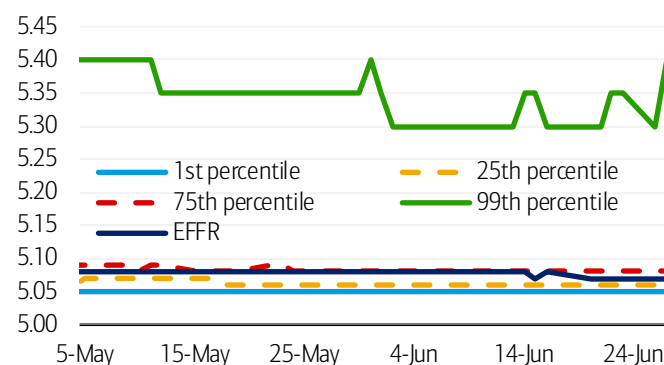


Source: Bloomberg

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Exhibit 2: Fed fund percentiles (%)

FF percentiles are stable outside of the 99th percentile



Source: Bloomberg

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Exhibit 3: Fed fund volumes (\$bn)

FF volumes have recently stabilized around \$130b

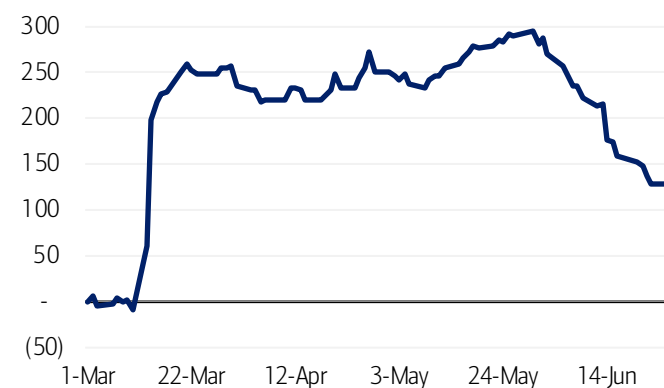


Source: Bloomberg

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Exhibit 4: Cumulative growth in FHLB debt since March 1 (\$bn)

Daily FHLB cumulative debt is roughly \$119bn higher since March 1



Source: Bloomberg, FHLB Office of Finance. Note: we use estimates of daily net issuance

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Exhibit 5: Overnight Eurodollar Volumes (\$bn)

Backed out from OBFR – EFR volumes

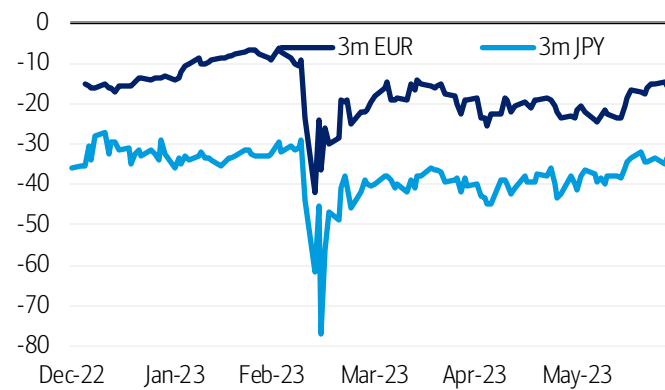


Source: BofA Global Research, Bloomberg

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Exhibit 6: EUR / USD & JPY / USD 3m XCCY basis (bps)

Current spreads imply lower premium to acquire USD



Source: Bloomberg

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