Liquid Insight

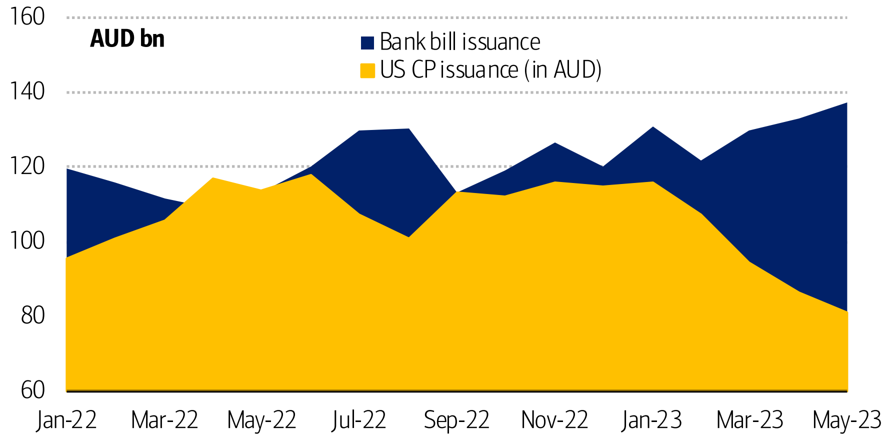
Bank bill issuance is surging – why is bills-OIS not shifting?

Key takeaways

- Bank bill issuance is surging as AU banks rotate away from US CP and TFF unwind offsets seasonal tailwind to cash.
- We still like paying Sep23 BOB as home loans outpace household deposits and AU system-wide liquidity is in decline.
- Yet evidence of effects of declining or outright cash levels on BOB spreads is weak and our conviction is falling.

By Oliver Levingston

Chart of the Day: Major banks' bill issuance surges to five-year high as US CP issuance falls
Major AU banks have rotated into long-term paper, short-term domestic bills



Source: BofA Global Research, Crane Money Markets, APRA

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Major Australian banks' bill issuance surged to a five-year high in May 2023 (Chart of the Day). US CP/SOFR spreads for majors issuing 9mth paper widened to over 52bps (~BBSW+50bps), up from 36bps in January 2023 (Exhibit 1). Cash and deposit balances have declined by more than $40bn since January and the majors are relying on long-term funding to fill the gap (Exhibit 2).

90d bank bills-OIS basis (BOB) spreads have remained rangebound since we recommended paying September 2023 a month ago (Australia Rates Watch: How would the debt ceiling deal impact AU rates markets? 31 May 2023). We still like paying Sep23 BOB (see here for all open trades) as falling cash piles and a rotation out of US Commercial paper narrow funding options for banks and RBA TFF maturities more than offset a seasonal upswing in ES cash from declining government deposits in Q3. However, weak evidence of a relationship between liquidity and BOB lowers our conviction and we will look to

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APRA = Australian Prudential Regulatory Authority

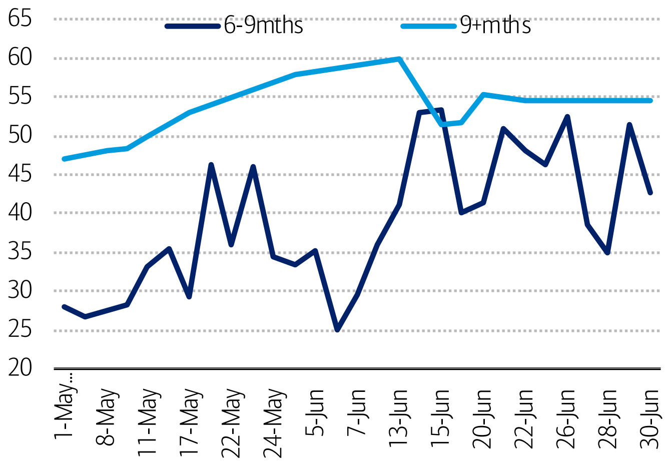
RBA = Reserve Bank of Australia

CP = Commercial Paper

TFF = Term Funding Facility
BOB = Bills-OIS basis
OIS = Overnight indexed swap
ES = Exchange Settlement

reduce risk if the trade does not perform in the next 4-6 weeks.

Exhibit 1: Majors' US CP spreads to BBSW are wide
Surgeing front-end XCCY basis in mid-June weighed on short-dated CP



Source: BofA Global Research, Bloomberg

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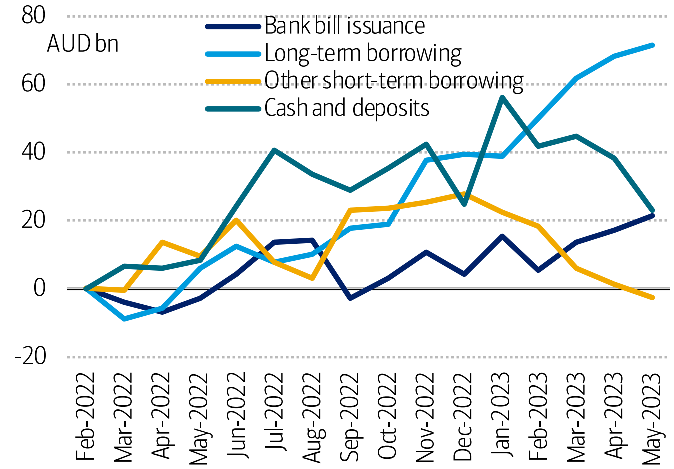
Exhibit 2: Bank bills, long-dated issues fill gap left by declining cash
BOB should now be more sensitive to IG credit spreads



Source: BofA Global Research, APRA

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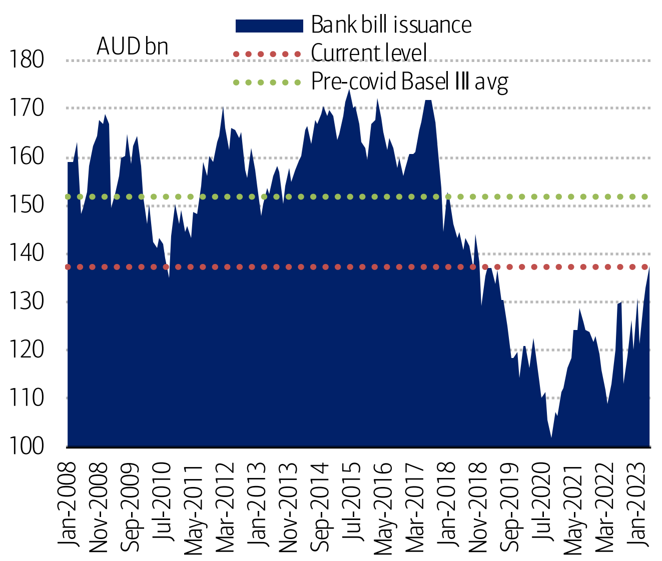
Long term borrowing costs key to near-term moves

Bank bill issuance is still about AUD15bn below pre-pandemic, Basel III levels (i.e. Q1 2015- Q4 2019), which we see as a likely near-term ceiling (Exhibit 3). Unlike short-term paper, long-term borrowing costs have remained contained so banks have scaled up long-term borrowing at the same time as cash holdings rise (Exhibit 4).

Exhibit 3: Bank bill issuance has surged near 5-year high
Bank bill issuance could rise to 2015-2019 levels



Source: BofA Global Research, APRA

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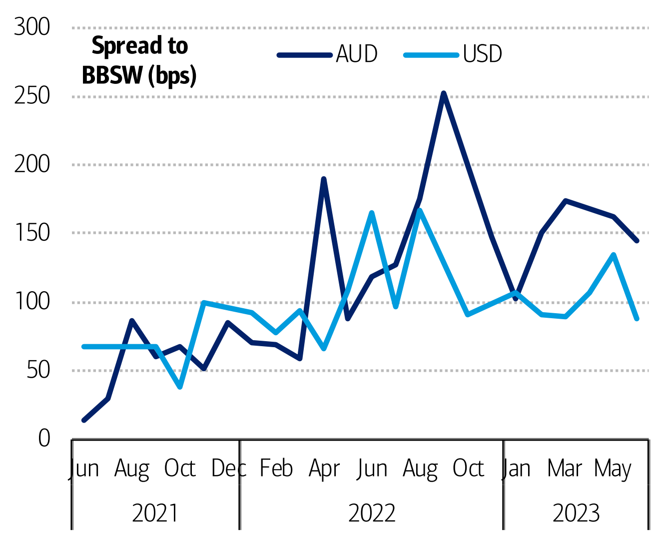
Exhibit 4: Tight credit spreads make long-term issues attractive
Major banks terming out offshore funding, raising domestic bill issuance



Source: BofA Global Research, Bloomberg

* Floating-rate spreads swapped back to BBSW.

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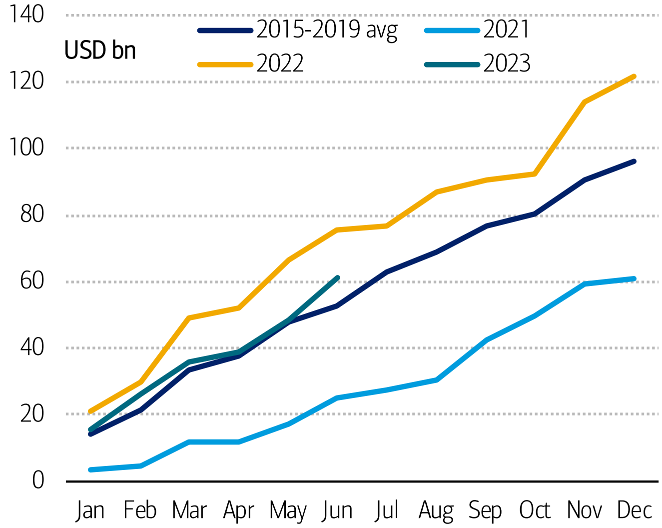
Exhibit 5: 2023 term funding outpaces pre-pandemic avg
Although levels have stepped down since 2022 after March bank stress



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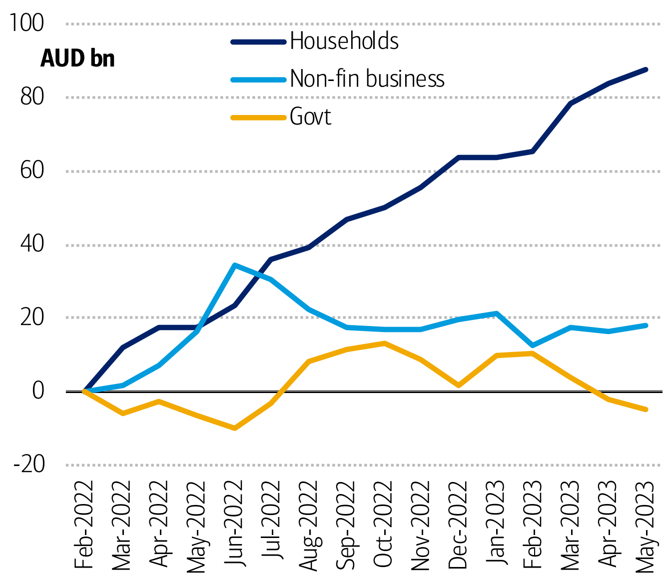
Household sector driving funding gap

One of the major drivers of shorter cash has been a fall in non-financial deposits. Since the end of the RBA's Bond Purchase Program (BPP) in February 2022, household deposits have surged while an initial rise in business deposits faded from mid-2022 (Exhibit 6). Housing loans, which represents the bulk of credit issued to households, have outpaced deposits since the end of the BPP and look set to continue weighing on the asset-liability gap that banks need to fund (Exhibit 7).

Exhibit 6: Household sector diverges from business, government
Household deposit growth driving cash balances



Source: BofA Global Research, Bloomberg

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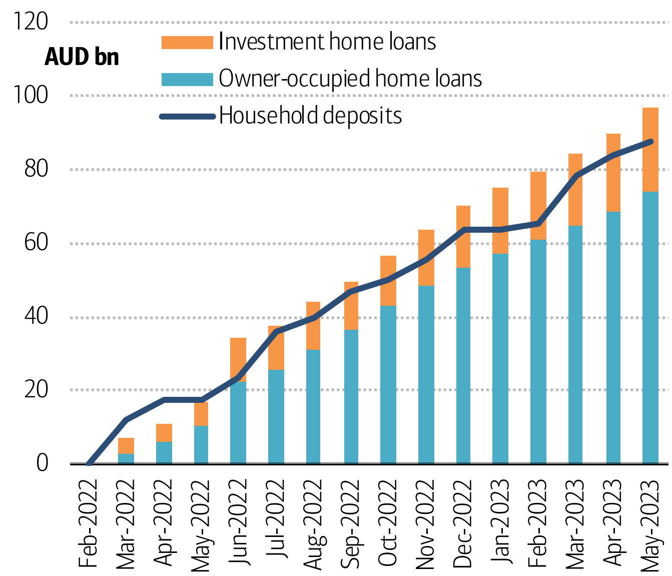
Exhibit 7: Household credit continues to outpace deposit growth
Funding gap unlikely to narrow in near term



Source: BofA Global Research, Bloomberg

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Term Funding Facility maturities will more than offset rebound in cash

TFF repayments will double between June and July, draining system-wide liqudiity (Exhibit 9). On the flipside, government deposits should fall seasonally over the next two months, increasing the size of exchange settlement balances at the RBA as cash shifts from public to private sector balance sheets (Exhibit 11).

Australian Government deposits have stepped up seasonally into the end of the financial year, weighing on private sector deposits (Exchange Settlement balances) held at the RBA. Assuming government deposits return to their annual average of $63bn by by the time of the bank bill futures roll on 7 September 2023, seasonal fluctuation will boost ES balances by $28 billion. However, over the same period, about $38bn in TFF maturities will drain liquidity from the system, leading to a net reduction of around $10bn.

Exhibit 9: TFF maturity schedule
TFF repayments double from June to July 2023

	TFF unwinds	TFF cumulative maturities
12-Apr-23	2.11	2.11
19-Apr-23	0.099	2.209
26-Apr-23	0.638	2.847
03-May-23	0.384	3.231
10-May-23	0.445	3.676
17-May-23	0.185	3.861
24-May-23	0.253	4.114
31-May-23	0.646	4.76
07-Jun-23	0.249	5.009
14-Jun-23	4.305	9.314
21-Jun-23	0.486	9.8
28-Jun-23	1.41	11.21
05-Jul-23	1.529	12.739
12-Jul-23	1.33	14.069
19-Jul-23	7.139	21.208
26-Jul-23	1.327	22.535
02-Aug-23	2.557	25.092
09-Aug-23	1.21	26.302
16-Aug-23	3.026	29.328
23-Aug-23	6.168	35.496
30-Aug-23	3.439	38.935
06-Sep-23	10.653	49.588
13-Sep-23	5.676	55.264
20-Sep-23	6.089	61.353
27-Sep-23	14.359	75.712
04-Oct-23	4.379	80.091

Source: BofA Global Research, RBA

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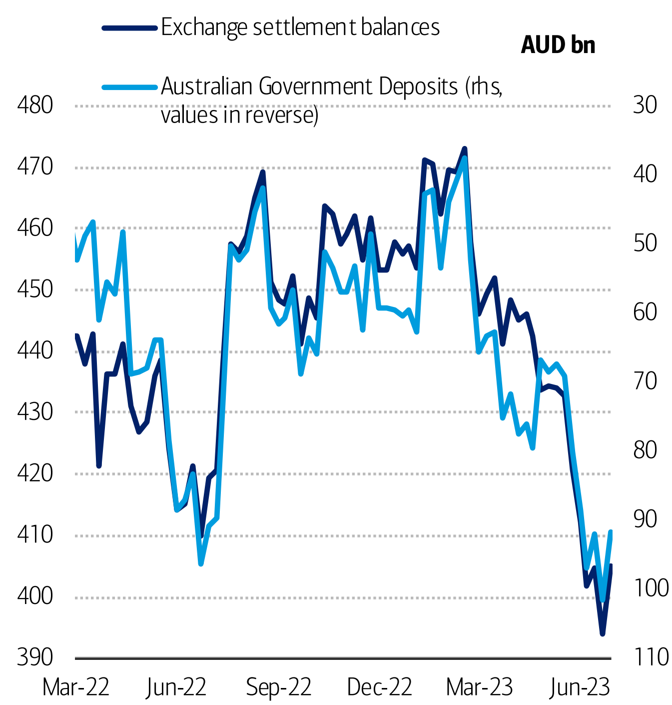
Exhibit 10: Government deposits move inversely to ES balances
ES balances have fallen as AU government deposits have increased



Source: BofA Global Research, RBA

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Does it matter?

The impact of falling liquidity (in the form of cash balances at the RBA) is uncertain. We theorise that the rate of decline in excess liquidity at the RBA (i.e. surplus exchange settlement balances) should lead forward-looking markets to price wider bill-OIS spreads (Exhibit 11). Yet there is little statistical evidence of a relationship between these two variables. Even as the 90d change in surplus ES balances has declined at a record pace to the end of June, September 2023-starting BOB has remained rangebound.

For demonstration purposes, we assume 1st BOB spreads widen to our target level (18bps) by 7 September and then remain at those levels as system-wide liquidity falls again over the subsequent three months. The forecasts do not appear dissonant with the shape of the data but nor is there a statistically significant relationship we can observe.

Another argument clients have presented rests on the stock, rather than flow of ES balances. Put simply, BOB cannot widen until ES balances return to pre-pandemic levels. In the second half, liquidity will fall markedly as TFF repayments come due but even still, ES balances will remain at least $250bn above pre Quantitative Easing (QE)/ zero-interest rate policy (ZIRP) (Exhibit 12). Once again, we cannot find a statistically significant relationship between the size of cash balances held at the RBA and BOB spreads.

Exhibit 9: ES balances are drawing down at historic speed
The pace of declining liquidity has not determined BOB spreads

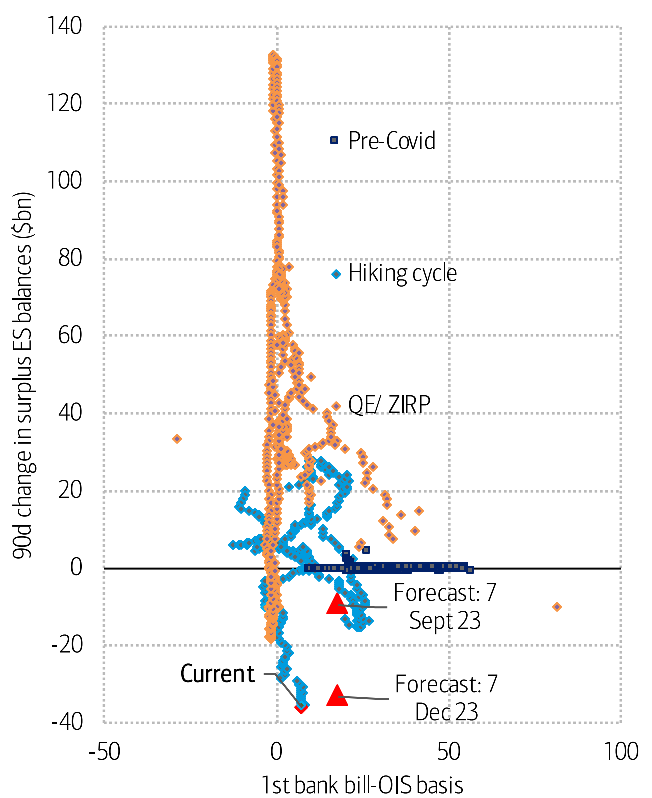

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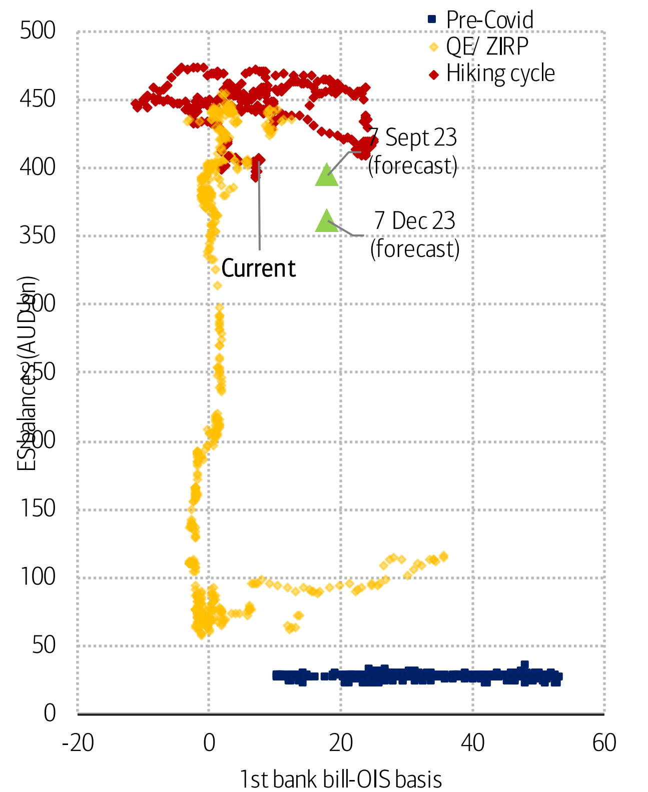
Exhibit 12: ...but the correlation does not appear significant
The stock of overall ES balances will remain high for years



Source: BofA Global Research, Bloomberg

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How to trade

There are three near-term catalysts we see for the trade to perform:

1. TFF repayments will double in July and continue to rise into September, draining system-wide liquidity and increasing bank funding tasks.
2. A rebound in housing credit (+4.8% month-on-month in May) should amplify bank funding requirements in the near term.
3. Bank funding should now be more sensitive to IG credit spreads, which should widen on a risk-off move.

The weak relationship between BOB spreads and liquidity nevertheless gives us pause and we will look for the trade to perform in the next 4-6 weeks or close our recommendation. If BOB spreads do not widen materially from here, we would recommend receiving front-end swap EFP, which we like to receive but declined to recommend because of the risks that BOB would widen (Australia Rates Viewpoint: Ready to receive: receive 10y swap EFP as RBA mulls bond sales 17 May 2023).

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- When carry rules **Global FX Weekly**, 30 June 2023
- In data denial **Global Rates Weekly**, 30 June 2023
- Change of heart, **Liquid Cross Border Flows**, 26 June 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: When carry rules 30 June 2023

Global Rates Weekly: In data denial 30 June 2023

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