BNY

iFlow

SHORT THOUGHTS

August 27, 2024

Watch Out for a Dash to Cash

- We will not know if liquidity is scarce until repo markets show it
- Repo rates have been well behaved recently; could firm in coming days
- iFlow shows the dash for cash is in play again

We'll know we have a liquidity shortfall when we see it

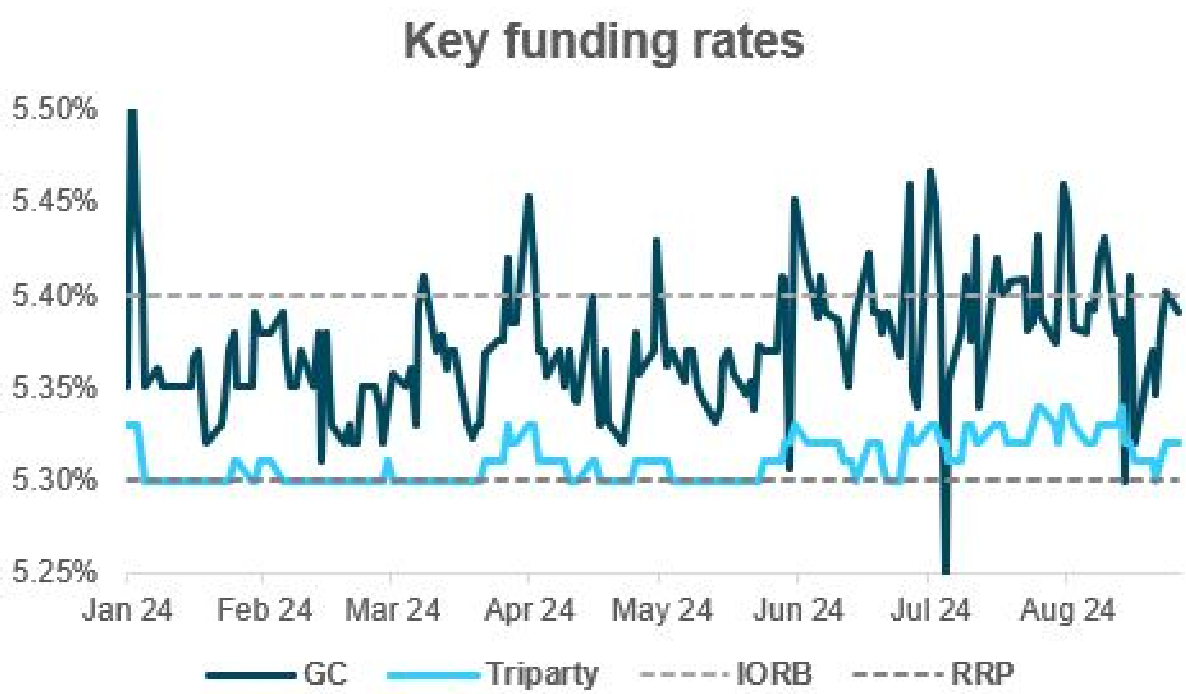
When bank holdings of reserves transition from abundant to merely ample, it will test both funding markets and the Fed. Quantitative tightening would likely end, there could be upward pressure on funding rates – from federal funds to repo, and liquidity is generally challenged. Last week we commented on a series of posts on the New York Fed's Liberty Street Economics blog which dealt with identifying when Fed reserves have transitioned from an abundant regime to an ample regime. Currently we agree with their conclusion that reserves appear to still be abundant.

We do wonder however whether this transition will be felt in the markets when it happens – it will not be seamless, and it could be associated with a liquidity squeeze. The NY Fed posts offer five indicators that could signal the move from abundant to ample, one of which we replicated in our piece from last week. This was the elasticity of the federal funds rate to changes in the quantity of system-wide reserves. We observed that that elasticity is currently zero. But that estimation has a look-back of 6 months' worth of weekly data. Week-to-week or day-to-changes in elasticity would be obscured if it takes that long for old data to fall out of the regression.

Three of the other indicators are not available to the public without a significant lag. The blog post does a decent job of explaining them, so we refer our reader to the link above. The main point is that only the fifth indicator in their suite is available in real time and daily – the behavior of repo markets. This sets up a potential funding squeeze upon the occasion of the transition from one reserve regime to the other. We very well might not know until it hits markets.

Elevated repo rates in July were something we kept an eye on. We concluded at the time (see here) that we did not think persistent and slightly higher repo rates were indicative of a funding shortage associated with the quantity of reserves, but rather temporary factors – like bill settlements and cash preferences – were behind the moves. Exhibit 1 below shows that both the tri-party and general collateral rates have come back in since the beginning of August and trade below the 5.4% interest rate on reserve balances (IORB), although somewhat above the reverse repo offer rate of 5.3%. Moreover, during the period of market volatility at the beginning of the month, these rates remained quite well behaved.

Exhibit #1: Repo Rate Behave



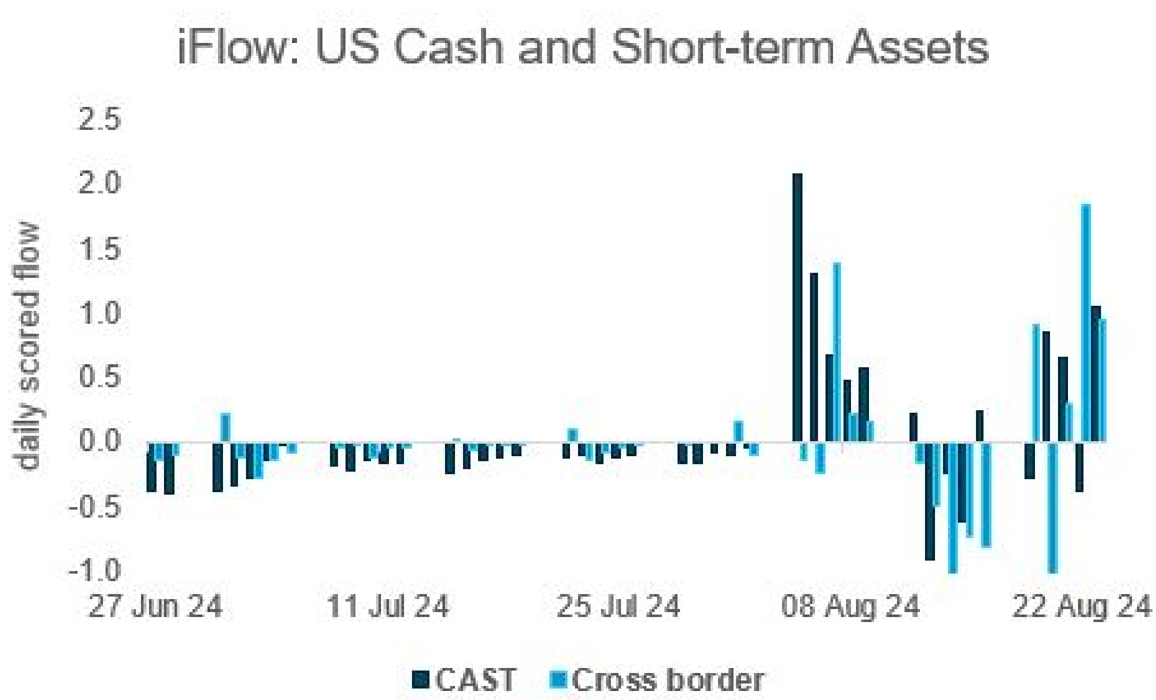
Source: BNY Markets, Bloomberg

Over the very short term – perhaps the next week or two – we would expect to see some firming of these rates as over $100bn in T-bills settlements come due, as GSCE cash exits the market, and month-end effects will be present. This firming should represent any imminent funding squeeze associated with system-wide liquidity, so we expect them to come back in by the end of next week – just in time for the Fed to start cutting interest rates.

Money market funds' (MMFs') assets under management grew to another record last week, over $6.2tn according to the Investment Company Institute. The Crane data put the total AUM at north of $6.5tn. Money is moving into cash and cash-like assets, and we can see it in our iFlow data as well. While this trend has been ongoing for some time with the MMFs, the iFlow data show real money asset managers really started moving into cash at the beginning of the month with the onset of broad financial market volatility.

Exhibit 2 below shows, from iFlow, daily flows (scored) into Cash and other short-term assets (CAST) for both total and cross border investors. For most of this past summer, cash had been shunned until market volatility commenced on August 5th. For a week cash was sought – although cross border investors were less quick to move than their domestic counter parts. From August 12 through the 16th, these cash positions were drawn back down, but have reaccelerated since, with cross border flows the major factor in the current rush to cash. We find it noteworthy that cash again is in vogue, especially as market conditions have recovered from mid-month on. As we mentioned above, cash could be scarce over the next several days, so we are curious to see if this preference shown in iFlow will endure.

Exhibit #2: Back into Cash



Source: BNY Markets, iFlow

Please direct questions or comments to: iFlow@BNY.com

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CONTACT JOHN

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