

## US Money Markets: Slow calm to steady state

With the Fed buying bills and bank reserves steady-to-rising, repo circumstances have slowly tamed. The effective funds rate remains elevated, though, and the war had pushed a small basis premium into the US dollar. Flows into money market funds remain, and bank deposit inflows have been strong. The prognosis is still for lower rates



Inflation expectations are keeping rates elevated, but longer term we do see rates coming down

### Money markets and the Iran war – rates ultimately end up lower

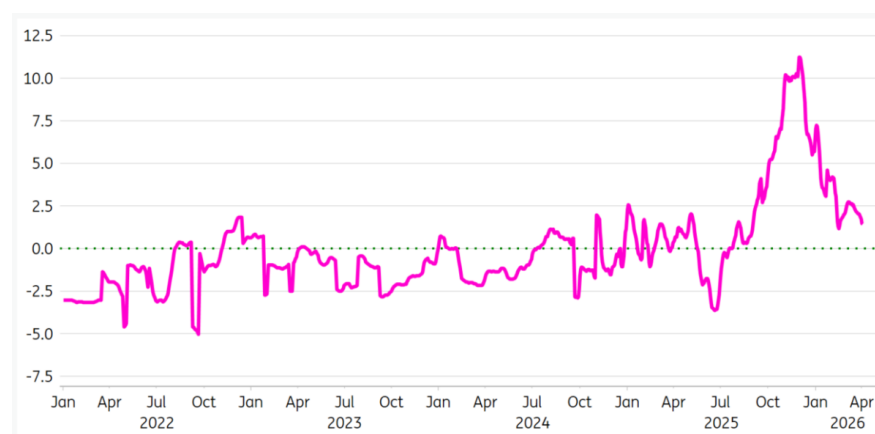
The Iran war manifested in a material elevation in short-term inflation expectations. The US 2y break-even (market inflation) rate is around 3.1%, and to hit that break-even average, there is the threat that actual inflation heads for 4%. Given that, the Federal Reserve is unlikely to cut rates. And the Fed could even come under pressure to hike rates to help face down rising inflation expectations.

On the assumption that the war winds down in the next couple of weeks, and the flow of vessels through the Strait of Hormuz shows a material pickup, our central view is that the Fed does not hike, and instead eventually cuts in the coming quarters. Taking all into consideration, our thinking

sees the funds rate unchanged for the immediate few months, with the next big moves still more liable to be lower.

## Fed funds rates versus the SOFR rate

SOFR *minus* effective Fed funds rate)



Source: Macrobond, ING estimates

## SOFR has become less tight, but the effective funds rate is still refusing to edge back down

The effective funds rate used to trade just 8bp above the funds rate floor. The ratchet higher to 14bp through September/October 2025 prompted the policy of renewed T-bills buying. The backstory saw bank reserves dip below US\$3tr, and repo had shown a marked tendency to tighten, with bank reserves at sub-US\$3tr. That repo tightness, in a relative value sense, was the genesis of the rise in the effective funds rate. Rate cuts have dominated, of course, but the issue is the rise in the effective funds rate within the (25bp) funds rate range.

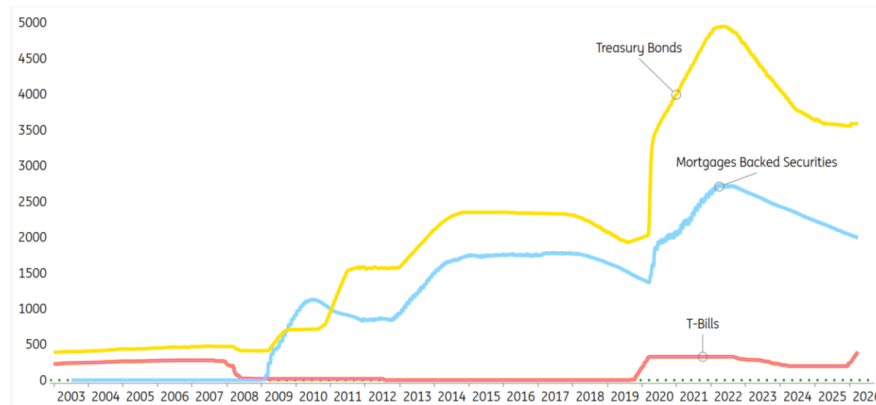
The effective funds rate has refused to budge from the 3.64% level. And by the way, that's just 1bp below the rate paid on reserves (3.65%). It's actually tough to get to 3.65%, as then eligible counterparties have a choice between two windows (reserves vs funds rate). It should not go above, though.

The other competition for avenues for market liquidity is repo, as encapsulated by the SOFR rate (basically an amalgamation of repo rates). Different players in the market with varying rights in the reserves bucket or the reverse repo bucket will see SOFR as an alternative rate that gets deployed from a relative value perspective. This is important for framing where the effective funds rate actually sits. SOFR should, in theory, trade below the effective funds rate, as it is a collateralised rate. So there is a whole relative value trade going on in this space.

And in the funds market, we also need to account for the Federal Home Loan Banks. They provide funds to typically smaller banks. The Federal Home Loan Banks cannot post in the Fed's reserves bucket, but they can post at the Fed funds rate. In fact, they tend to be dominant players in the current funds rate market, especially as the commercial banks will prefer to post at the higher excess reserves rate. Bottom line, they are effective funds rate influencers.

## The Fed's bond and bills holdings

USD, billions

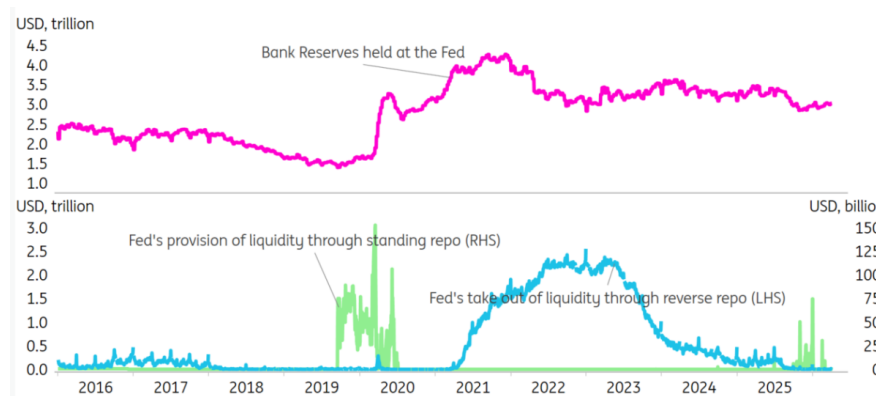


Source: Macrobond, ING estimates

Since the Fed re-commenced T-bill buying in mid-December 2025, it has bought a cumulative US\$200bn. Overall, the Fed's holdings of all securities (including bills) are up US\$155bn, to US\$6.3tr. That has coincided with a rise in bank reserves by US\$180bn, to just over US\$3tr (helped by a moderate spend down in the Treasury cash balance). Given the net balance sheet expansion, the Fed should be disappointed that the effective funds rate has not eased lower, even if only by a few basis points.

## Bank reserves at the Federal Reserve

Alongside the Fed's repo (adding liquidity) and reverse repo facilities (taking out liquidity)



Source: Macrobond, ING estimates

## Bank reserves are steady now that the Fed is back in the business of buying bills

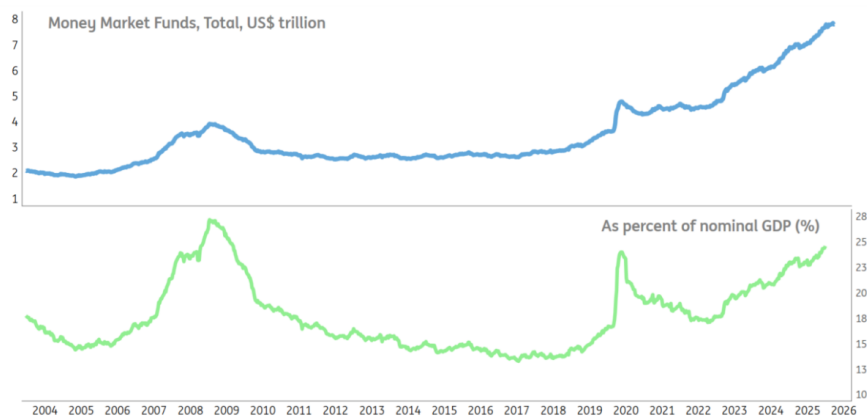
Then there is the complication of a transition from the current excess reserves environment, potentially back towards a "scarce reserves" environment, as indicated by Kevin Warsh (but without specifics). Selling the bonds is relatively straightforward; far less straightforward is how to get back to the prior regime for reserves management and how the funds rate is set, along the way, and in the future.

One aspect that can help here is the revision to the leverage ratio requirements as of 1 April 2026. The fact that the larger banks will, as a result, have more capacity to buy Treasuries and/or engage in repo is potentially a huge benefit. The weak link in the current structure has been the capacity for tightness in repo to bully the effective funds rate higher, primarily on a relative-value play. Larger banks in the game could and should tame the tendency for repo to over-tighten at times.

There is a link here with reserves, too, as the Federal Reserve has reverse-engineered a logic that repo tightness was associated with the fall in excess reserves to a level that exacerbated repo tightness. While a clear link between the two is not necessarily obvious, one does exist. We saw the same when the Fed went through its first quantitative tightening exercise in 2019, which culminated in a brief but severe repo tantrum. It was calmed through a Fed decision to buy bills to help add bank reserves. Fast-forward to 2025, and we saw the same, as the Fed resumed buying bills on repo tightness (since mid-December 2025, and ongoing).

## Money market funds remain on the rise

Also on the rise as per cent of nominal GDP



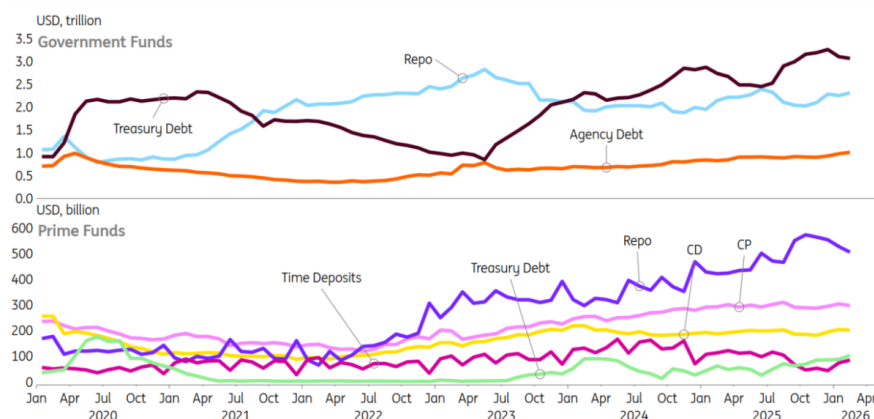
Source: Macrobond, ING estimates

## Money market funds are maintaining holdings while bank deposits are on the rise

Inflows to money market funds remain firm, with both institutional and retail participating. Prime funds continue to see their fair share of the increase. As a percentage of GDP, total money market funds are now approaching 25%, not far off the previous high of 27% in 2009. So far, the rate-cut narrative has not been a material issue, mostly as a return of 3-4% still represents a decent return on what is effectively a 'zero risk' product. The latest data shows money market funds holding steady, while large bank deposits have seen some decent inflows. At the margin, there have been some moderate institutional outflows from money market funds, while retail is holding steady. Not particularly big moves.

## Money market fund holdings

Government Funds on top, and Prime Funds on the bottom



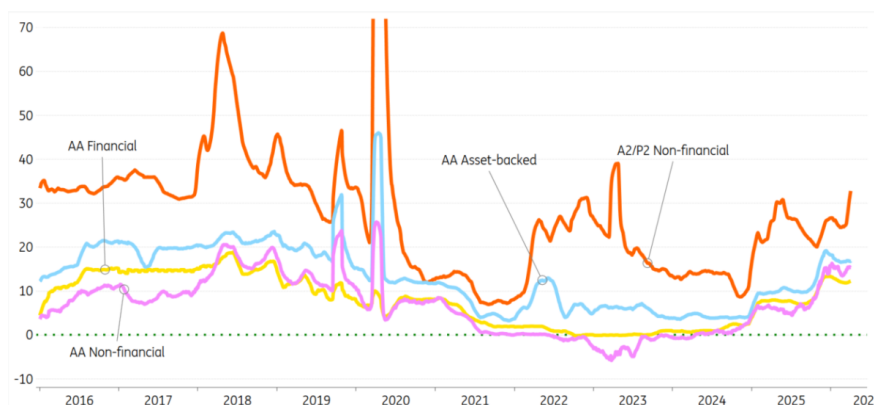
Source: Macrobond, ING estimates

In terms of specific exposures, Government Funds have seen a renewed rise in holdings of Treasury Debt (effectively bills). Extra bills are being issued to take pressure off coupon issuance. This should help maintain a concession in bills. Repo has been downsized relative to bills' holdings as a result, although repo has been on the rise recently.

In Prime Funds, repo (reflecting equity repo) exposures remain elevated, albeit off prior highs. Exposure to commercial paper (CP) has been gradually rising, while certificates of deposit (CD) and ordinary deposits have been steadier to a tad lower. Bank deposits have seen resumed rises, mostly into the larger banks (less so into the small banks).

## Commercial paper alternatives

As spreads above the Fed's reverse repo rate (bp)



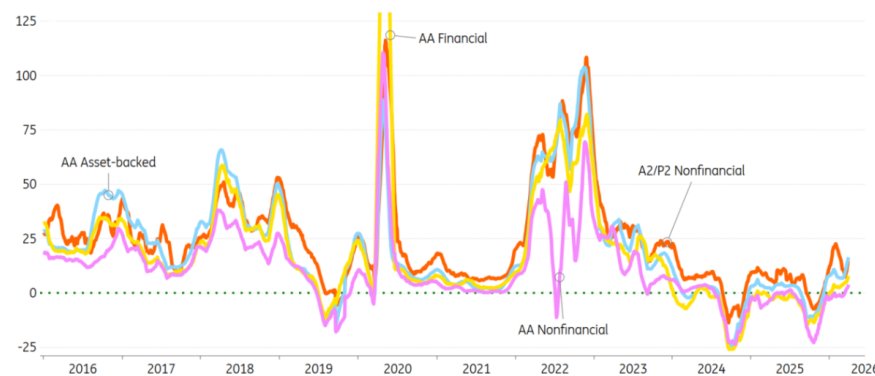
Source: Macrobond, ING estimates

In terms of attainable rates, the entire spectrum of overnight commercial paper rates remains comfortably above the Federal Reserve's reverse repo rate. This has reflected past relative tightness in repo, which has acted as an upward drag on other rates from a relative-value perspective, and on a concessionary T-bills environment.

With the Fed still technically in rate-cutting mode, we should see a mild concession when terming out. But that concession has recently reverted towards a premium, especially for the lower-rated product. If the Fed is to cut rates later in the year, then terming out in spread products at current levels could be seen as a decent play.

## Terming out

From overnight (o/n) to three months (3mths), bp



Source: Macrobond, ING estimates

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