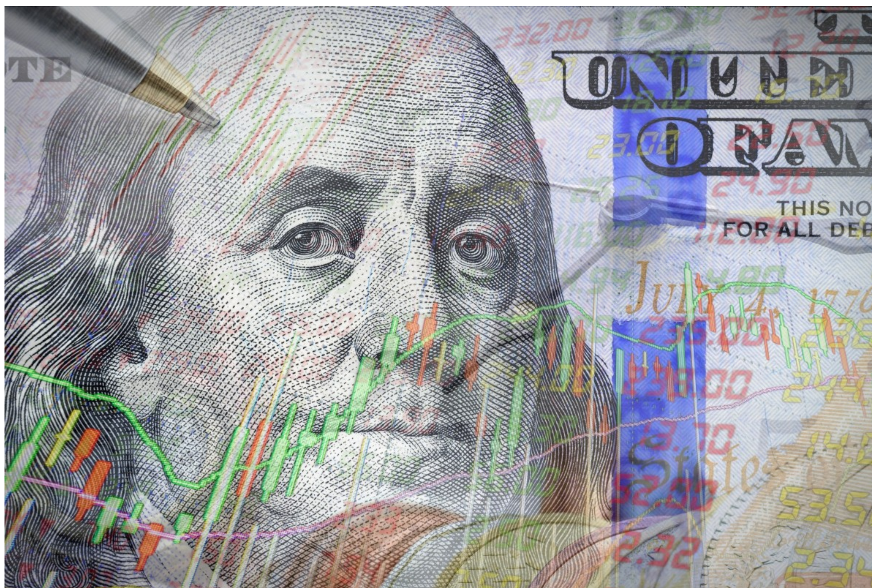
US Money Markets: Stability in bank reserves, but changes are coming

Liquidity circumstances are ample currently, but bank reserves are primed to fall in the coming months, likely re-tightening conditions. There is value in market repo versus the Fed's reverse repo facility, and bills issuance remains strong, causing a cheapening there. Terming means taking lower rates, but concessional versus where rates will get to



Government Funds have seen a renewed rise in holdings of Treasury Debt

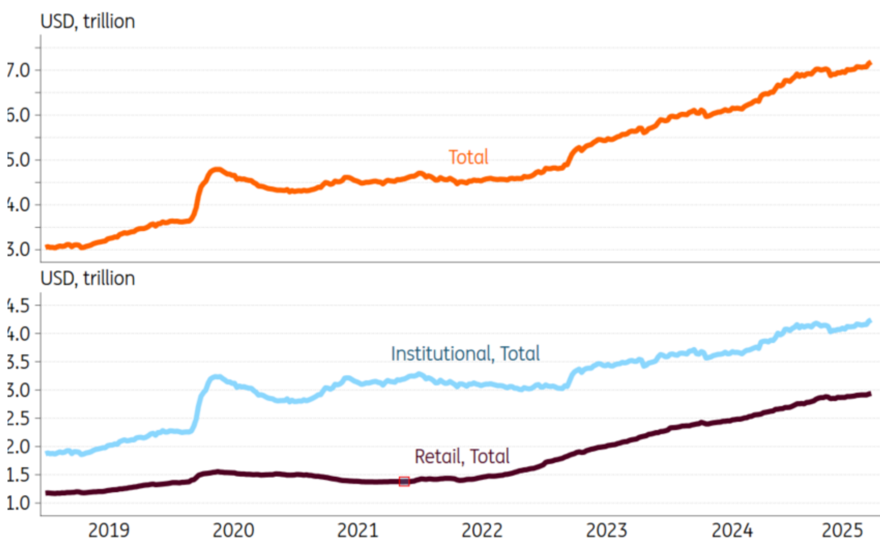
Money market funds continue to attract strong inflows, holding at some 23% of GDP

Inflows to money market funds picked up again following a brief hiccup, where some liquidations were seen around 'Liberation Day'. Institutional demand remains most robust for Government Funds, while the biggest growth in Retail holdings is in Prime Funds. Institutional demand for Prime Funds remains lacklustre, mostly due to a lack of spread improvement on moving away from Government Funds.

As a percentage of GDP, money market funds remain comfortably over 23%, not far off the prior high of 27% in 2009. So far, the rate-cut talk is just that, and money market funds continue to

churn out reasonable returns on a 'zero risk' product.

Money Market Funds - Institutional vs Retail

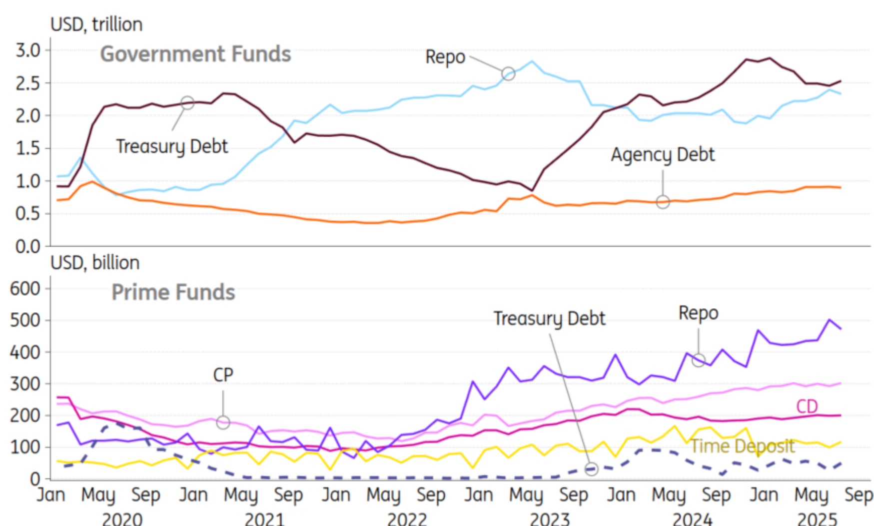


Source: ING, Macrobond

Government Funds have seen a renewed rise in holdings of Treasury Debt (effectively bills). Extra bills issuance is being employed to take pressure off coupon issuance and to build up the cash balance at the Treasury after the rise in the debt ceiling, as a part of the wider 'Big Beautiful Bill'. This should help to maintain a concession in bills. Expect Repo to be downsized relative to Bills in the immediate few months as a result.

In Prime Funds, Repo (reflecting equity repo) exposures remain elevated. Exposure to commercial paper (CP) has been gradually rising, while certificates of deposit (CD) and ordinary deposits have been steadier to a tad lower. The oomph in Prime is in Repo and CP.

Money Market Funds - Breakout of investments



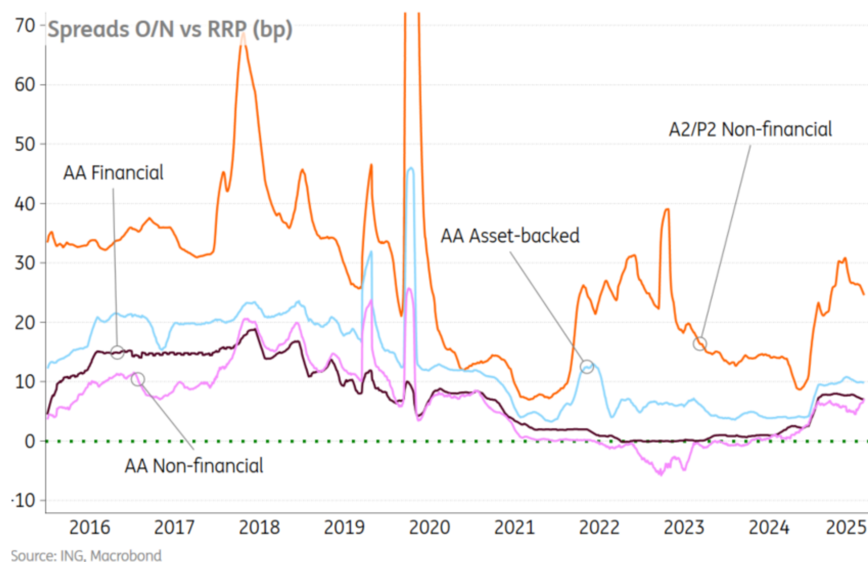
Source: ING, Macrobond

The Fed's reverse repo facility remains a poor alternative to market repo and bills

In terms of attainable rates, the entire spectrum of overnight commercial paper rates remains comfortably above the Federal Reserve's reverse repo rate, in part a reflection of the 5bp move down to the funds rate floor since the December FOMC meeting. This reduces the attractiveness of the Fed's reverse repo facility and continues to increase the relative attractiveness of market repo.

At the same time, CP spreads are not yet quite as wide as they were during the pre-pandemic years, but they are edging towards these types of levels, as shown in the chart below. A larger concession has been built into A2/P2 rates, but no more than the fair valuation of risk.

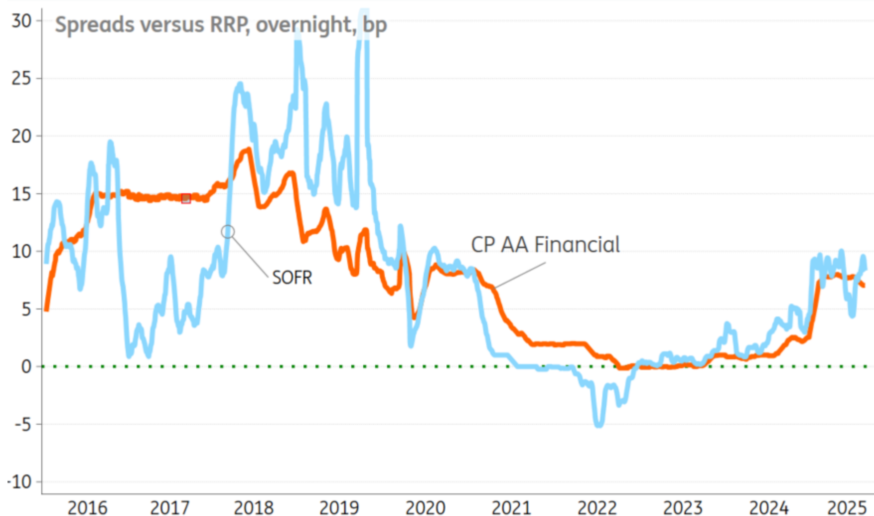
Commercial paper versus the Fed's reverse repo rate



Source: ING, Macrobond

The relevance of the Fed's reverse repo facility has been downsized significantly from a relative value perspective, as better repo terms are now typically attainable on the market. The reverse repo window will continue to be accessed primarily around quarter (and month) ends, as counterparties turn to the Fed's facility to bridge liquidity gaps driven by regulatory window dressing requirements.

General collateral versus the Fed reverse repo facility, and financial CP

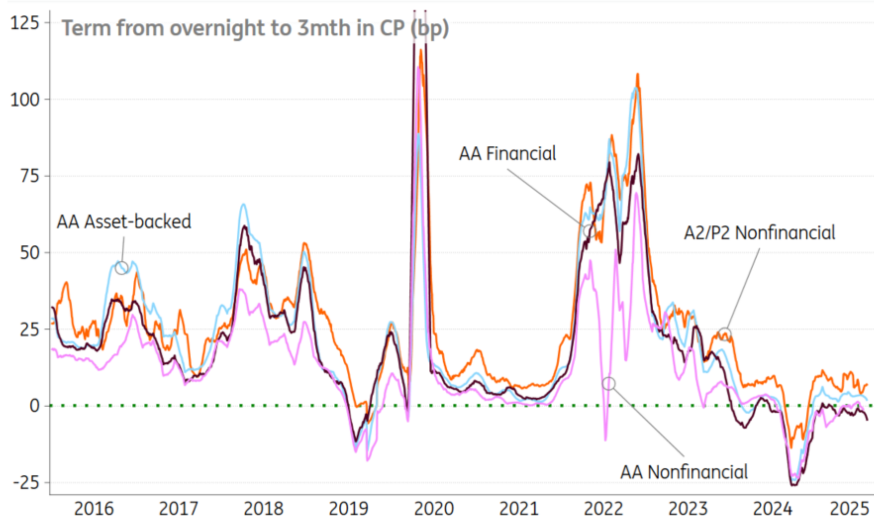


Source: ING, Macrobond

With the Fed expected to cut, terming out comes with lower rates, but still at decent forward levels

With the Fed still technically in rate-cutting mode, terming out comes with an absolute rate concession. But there is still value in terming out as a means of locking in currently attainable rate levels, which tend to under-represent the full extent of likely cuts on a 12-month horizon. We expect the Fed to cut by 125bp in the coming 6-12 months.

Overnight to 3-month term in commercial paper



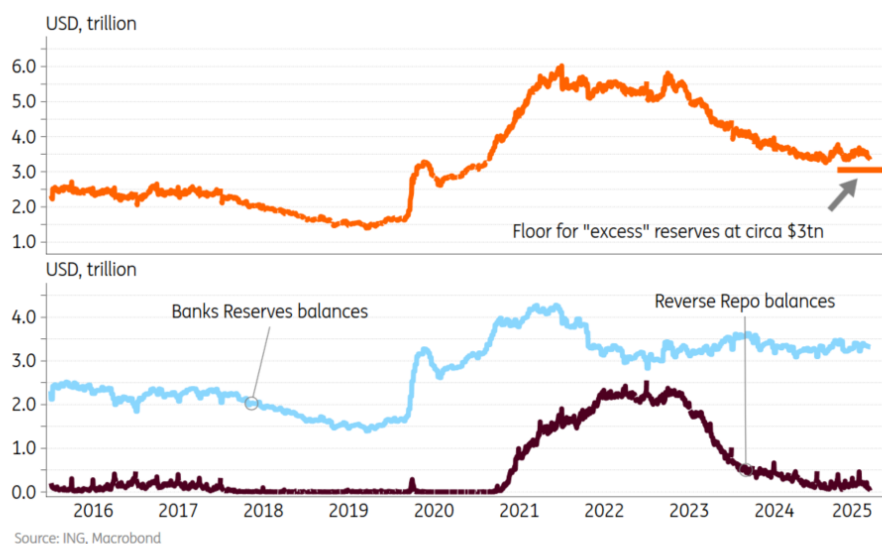
Source: ING, Macrobond

Bank reserves remain comfortable, but will come under falling pressure as the US Treasury continues to rebuild its cash balance

Currently, bank reserves are running at some $3.33tr. Adding the cushion of just under $50bn at the Fed's reverse repo facility, there is an overall 'excess' liquidity balance of some $3.4tr. Meanwhile, quantitative tightening (QT) is running at around $20bn per month (the $35bn cap on mortgage-backed securities roll-offs is never hit) and acts to reduce excess liquidity at that pace. Based on this, within the coming half year, the $3tr bank reserves floor will be hit.

The Fed needs to be careful here, as in 2019, the QT process pushed bank reserves down to the $1.5 trillion area, which caused some severe tightness. Back then, the value of US GDP was around $20tr. So, bank reserves hit around 7.5% of GDP. The thinking moving forward is that this needs to be closer to 10% of GDP. With the value of US GDP running at around $30tr, that implies a floor for bank reserves at around $3tr.

Bank reserves still ample, but will ultimately slip to $3tr this year



Currently, the Treasury has a cash balance of around $550bn. And it is likely to push this up by at least another $100bn – and possibly $200bn (through bills issuance). The extent to which it does will cause a reduction in other types of liquidity, most probably through a fall in excess reserves.

SLR adjustments in the coming months need to be monitored too

As an important aside, proposed changes to the Supplementary Leverage Ratio (SLR) for big US banks can add to bank demand for Treasuries and Repo. That said, banks won't rush to buy. A skew on balance sheets is more likely to be gradual. Banks are lenders first, and credit hasn't been notably constrained, especially with high reserves.

Is this impactful for Treasuries? For sure, if up-front inflows dominate. But a more gradual application would be less impactful. Still, it's a positive impulse. Just as the backing of stablecoins with Treasury bills is a positive for bills demand in the medium term, it also has a potential multi-trillion-dollar demand effect. Again, a positive. But this will only have a meaningful impact if accelerated, as supply is increasing significantly too.

It can also impact the weighting between bank cash reserves and their holdings of Treasuries. We'll continue to monitor this important space.

See more here.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

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