The Bank Treasury Newsletter
The Chart Deck
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Ethan M. Heisler, CFA
Editor-in-Chief
The Bank Treasury Newsletter
Ethan.Heisler@thebanktreasurynewsletter.com
www.thebanktreasurynewsletter.com

THE BANK TREASURY NEWSLETTER

In This Month's Chart Deck

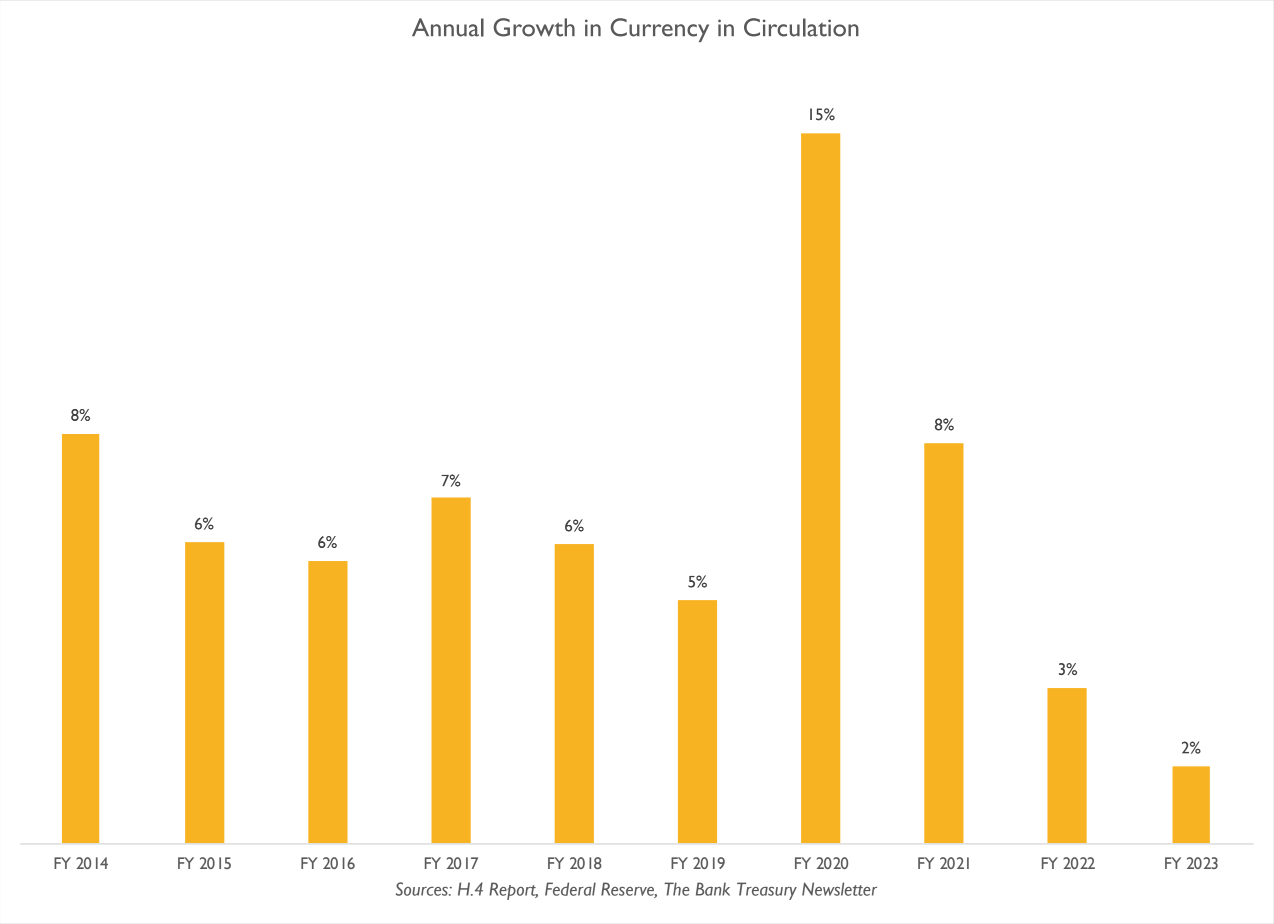
- The Consumer Price Index for December 2023 increased by 3.4% annually which is down from a 9.1% peak recorded in June 2022, but still above the Fed's 2% target for inflation. Economists have not unraveled exactly what caused the surge in inflation, whether it was supply-induced because of trade interruptions during the Covid lockdowns, demand-induced because of Government stimulus, labor-induced because of worker shortages, or some combination of these factors and others-induced. For that matter, they are just as fuzzy as why inflation has come down, other than to credit the decline to the Fed's rate hikes.
- One reason for the inflation trends up and down since Covid that they have not seriously explored is the growth of currency in circulation, mostly $100 bills, which at $2.3 trillion equals 11% of the money supply measured by M2 ($21 trillion). There was a surge in currency in 2020, and to a lesser degree in 2021, well above average growth of currency since the Global Financial Crisis (GFC) (Slide 4), and this might have contributed to the inflation surge, as consumers sometimes tend to spend excess cash in their pockets to make payments just to dispose of the cash for purchases that they might have otherwise held off making. Coincidentally, annual growth in currency in circulation dropped dramatically after 2020=21, to 2% in 2023, which might have taken some of the fuel out of the CPI readings reported in the last year. While foreign residents were a driving force in currency growth through much of the last decade, which increased their share of currency in circulation to 46% in 2020 from 40% in 2013, their share eased back since 2021 and fell to 44% in 2023 (Slide 5). Thus, domestic resident spending habits, not those of foreign residents, have been driving paper money growth since Covid. As the stimulus money faded, slower currency growth followed, reining in consumer spending and tempering inflation.
- The latest minutes from the Federal Open Market Committee (FOMC) indicated that the Fed is beginning to think about ending Quantitative Tightening (QT) and to begin that process at some yet unspecified date by cutting the monthly caps for Treasurys and Agency MBS, currently set at $60 billion and $35 billion, respectively. The Fed's System Open Market Account (SOMA) fell by $1.3 trillion, to $7.2 trillion this month, since it began QT 18 months ago, which included $4.7 trillion of Treasurys and $2.4 trillion of Agency MBS. Because it was simultaneously shrinking SOMA while it raised rates, it caused the prepayment speeds on its Agency MBS holdings to slow and led them to run off at half of the $35 billion monthly cap rate. Consequently, most of the decline to date in the SOMA is attributable to the run-off of Treasurys ($1 trillion) rather than Agency MBS ($0.3 trillion). This has increased the overall convexity of the SOMA and if QT continues this way could complicate the Fed's balance sheet normalization (Slide 6) plans, especially if it suddenly pivots and turns more hawkish contrary to its latest guidance. Notably, mortgage rates rallied since the fall as the market became ever more convinced that rate cuts are on the way this year (Slide 7), though the fair value of MBS portfolios has not recovered sufficiently to erase bank treasury negative Accumulated Other Comprehensive Income (AOCI) problems.
- Bank treasurers, especially since the failure of Silicon Valley Bank (SVB) and Signature Bank, New York (SBNY) last March, are reluctant to shift cash into Agency MBS, and if they buy bonds at all, banks might stick with Treasurys. But for now, they are content to sit with their excess deposits at the Fed earning the overnight rate, a decision made easy for them by the fact that the Fed's overnight rate is the highest paying rate on the yield curve. In addition, bank treasurers who do want to extend the duration in their bond portfolios beyond even 1 year to lock in returns will incur a negative term premium for their troubles, a function of the increasing certainty by the market that rate cuts are on the way (Slide 8).
- Bank supervisors want to encourage banks to turn to the Fed's discount window when they need an emergency loan instead of going to the Federal Home Loan Banks (FHLBs), but history (Slide 9) suggests that banks have turned to the window in times of stress, even without the terms of enticement offered with the Bank Term Funding Program, which is expected to end this March. Generally, the banking industry has an aversion to borrowing money from the Fed, even for daylight overdrafts over the Fedwire, and the Fed's decision to adopt an ample reserve policy after the GFC dampened demand to practically nothing which was down to $1 billion of average daylight overdrafts in Q3 2023 (Slide 10).
- Banks and their business customers find their operating landscape that includes many risks and uncertainties, and cyber risk and business continuity top their wall of worry (Slide 11). Indeed, the financial industry remains one of the leading targets for cyber attacks (Slide 12), the ransomware attack last November on the International and Commercial Bank of China being only the latest example of how even the largest, most sophisticated institutions, despite their heavy investment in firewall protections remain vulnerable to attack . Geopolitical risk adds to the complexity of forecasting economic and interest rate trends this year (Slide 13).

List of Slides

- Annual Growth in Currency in Circulation, *Sources: H.4 Report, Federal Reserve, The Bank Treasury Newsletter*
- U.S. Currency in Circulation Held Outside the U.S., *Sources: Z.1 Report, Federal Reserve, The Bank Treasury Newsletter*
- Evolution of SOMA Holdings Since QT Began, *Sources: H.4 Report, Federal Reserve, The Bank Treasury Newsletter*
- Average Mortgage Rates, *Sources: FRED, St. Louis Fed, The Bank Treasury Newsletter*
- Term Premium 0-Coupon Bond, *Sources: FRED, St. Louis Fed, The Bank Treasury Newsletter*
- Discount Window Borrowings, *Sources: H.4 Report, Federal Reserve, The Bank Treasury Newsletter*
- Average Daylight Overdrafts, *Sources: Federal Reserve, The Bank Treasury Newsletter*
- Leading Risks to Businesses Worldwide, *Sources: Allianz, Statista.com, The Bank Treasury Newsletter*
- Share of Cyber Attacks Across Worldwide Industries in 2022, *Sources: IBM Ponemon Institute, Statista.com, The Bank Treasury Newsletter*
- Geopolitical Risk Index, *Sources: Geopolitical Risk Index, The Bank Treasury Newsletter*

Did A Surge In Currency Fuel Inflation?

Currency in circulation may only account for 11% of M2, but could a surge in supply of cash in 2020 have contributed to the surge in inflation that followed? Is the fact that its growth fell to just 2% in 2023 contributing to bringing inflation down?



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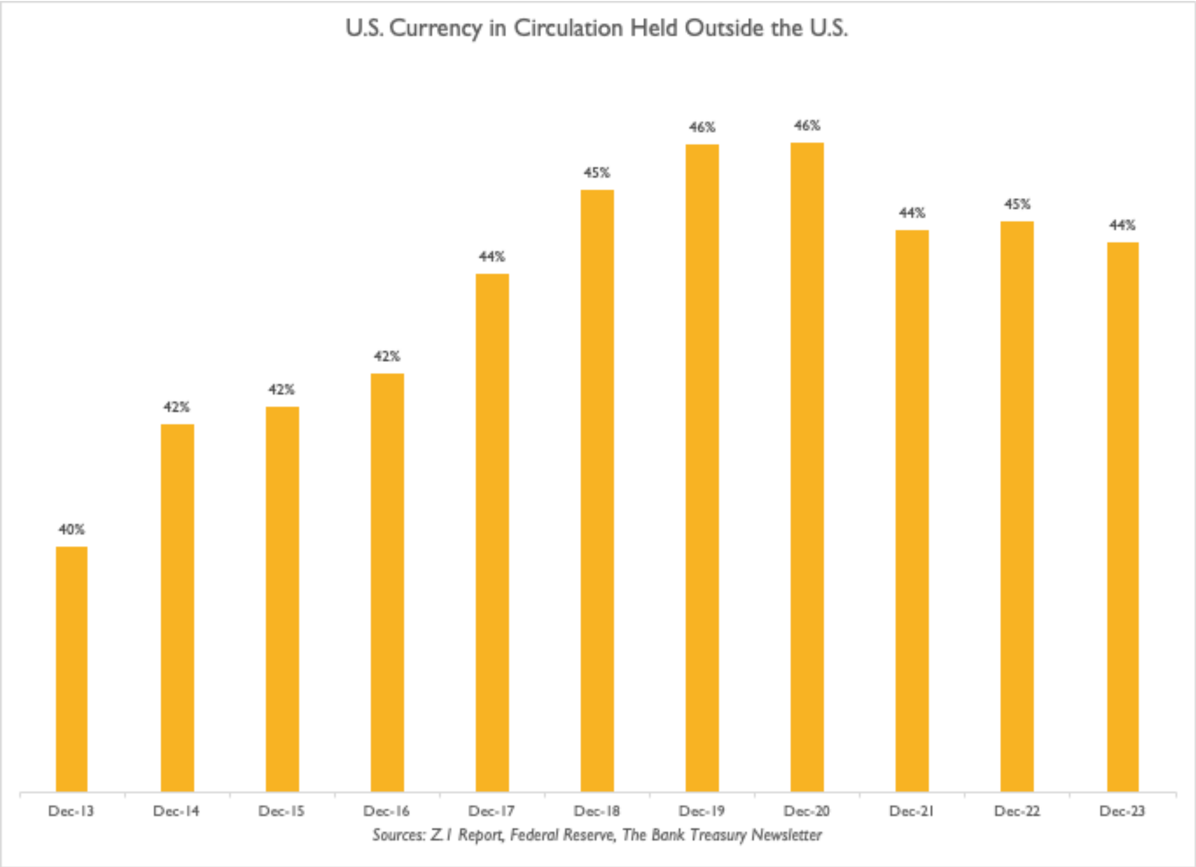
Foreigners Have Eased Off Dollars

Foreign demand for $100 bills was the driving force for growth in currency in circulation for most of the past decade, but since 2021, foreign residents slowed demand for dollars.



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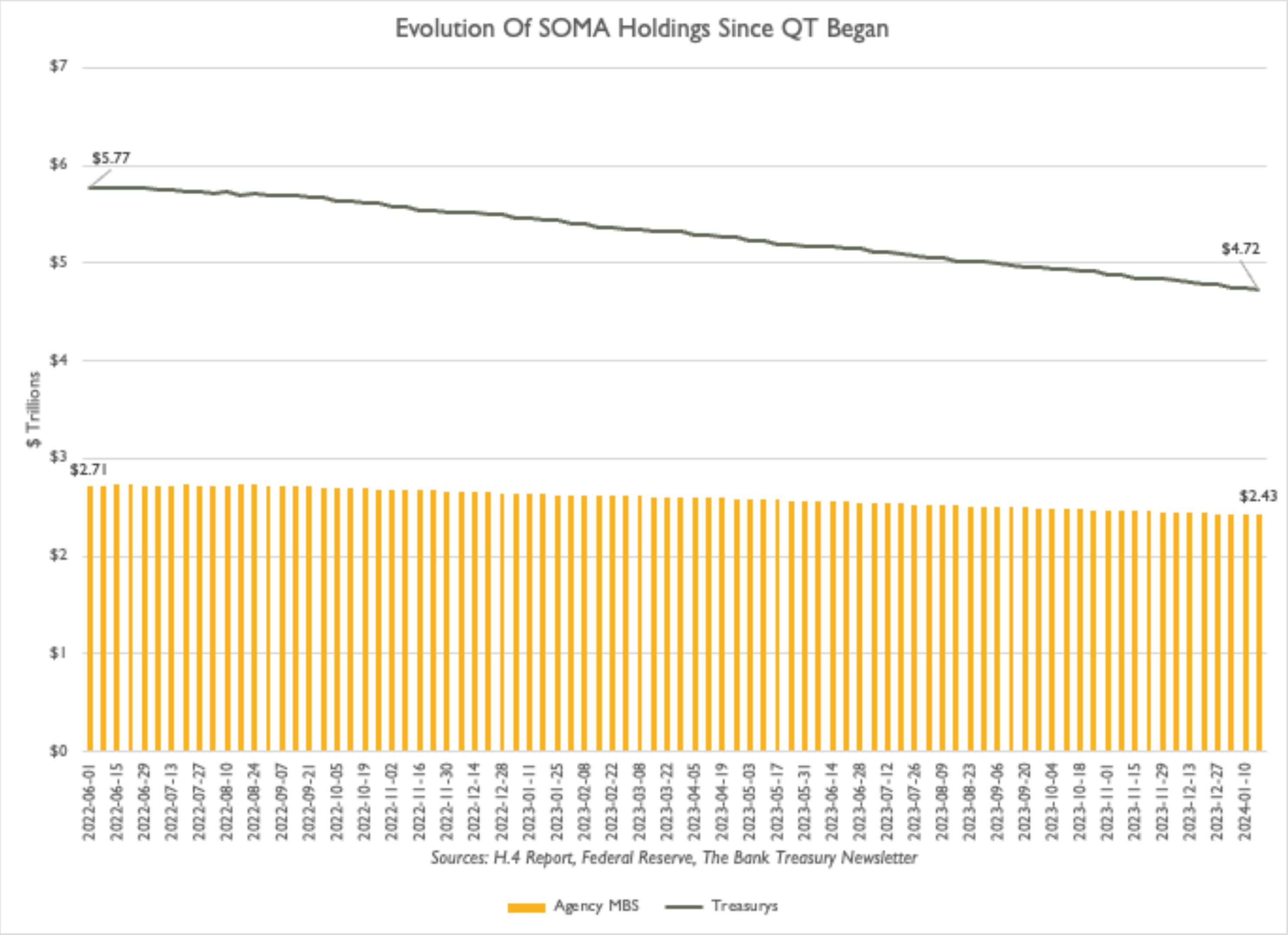
Treasury QT Outpaces MBS QT

The balance of Treasurys in the Fed's SOMA portfolio since QT2 began is slowly shrinking relative to the balance of its Agency MBS, which has slower prepayment speeds because of higher mortgage rates.



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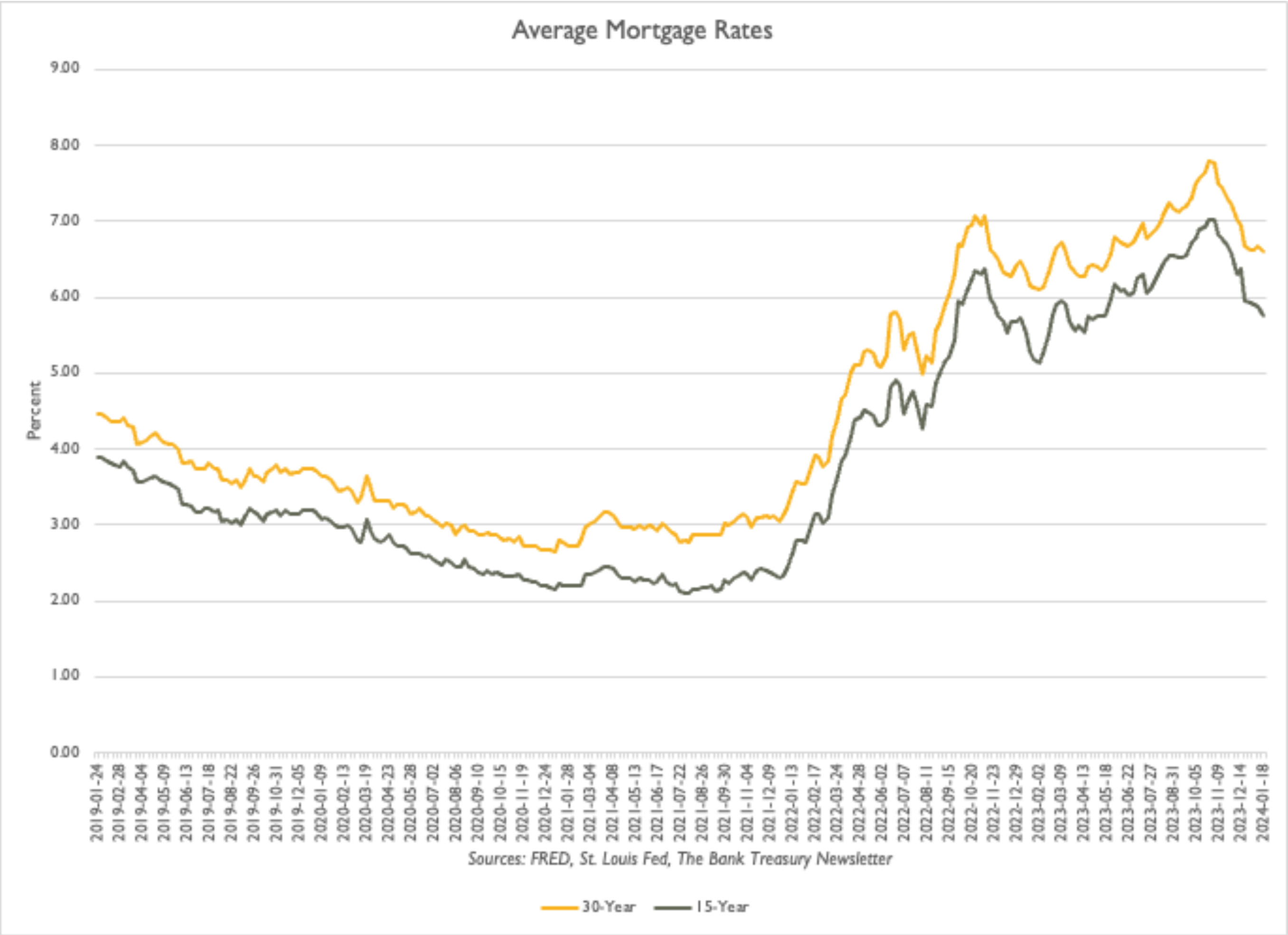
Mortgage Rates Ease

Bank investment portfolios see some relief from negative AOCI as mortgage rates pulled back from peaks reached last November.



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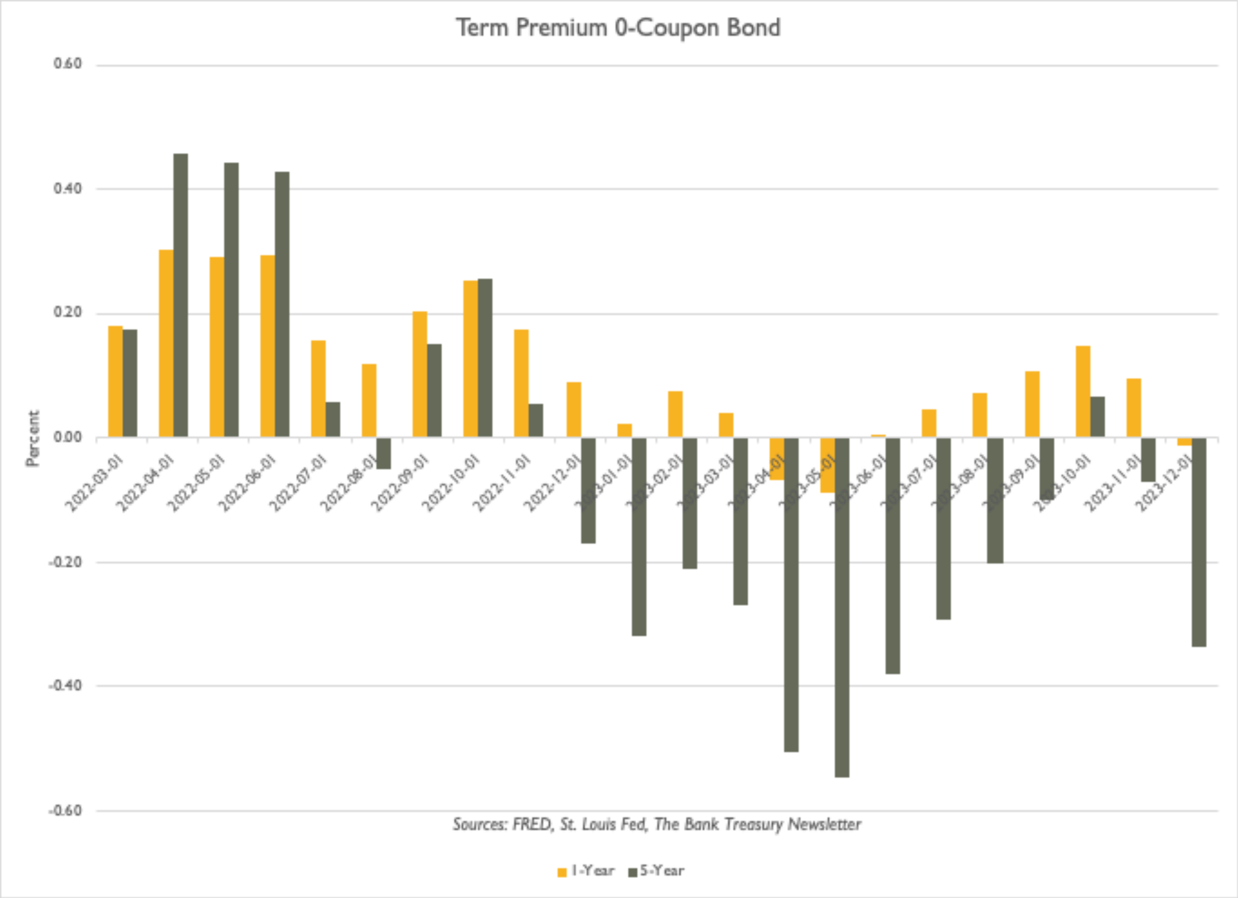
Penalty For Term Extension Increases

The markets became convinced last month that the Fed will cut rates this year, which might have helped send the term premium on intermediate-term securities back down to negative territory. A bank buying a 0-coupon 5-year Treasury at today's price would pay a penalty for the term extension compared to simply rolling the proceeds in an overnight investment at Fed for the same term.



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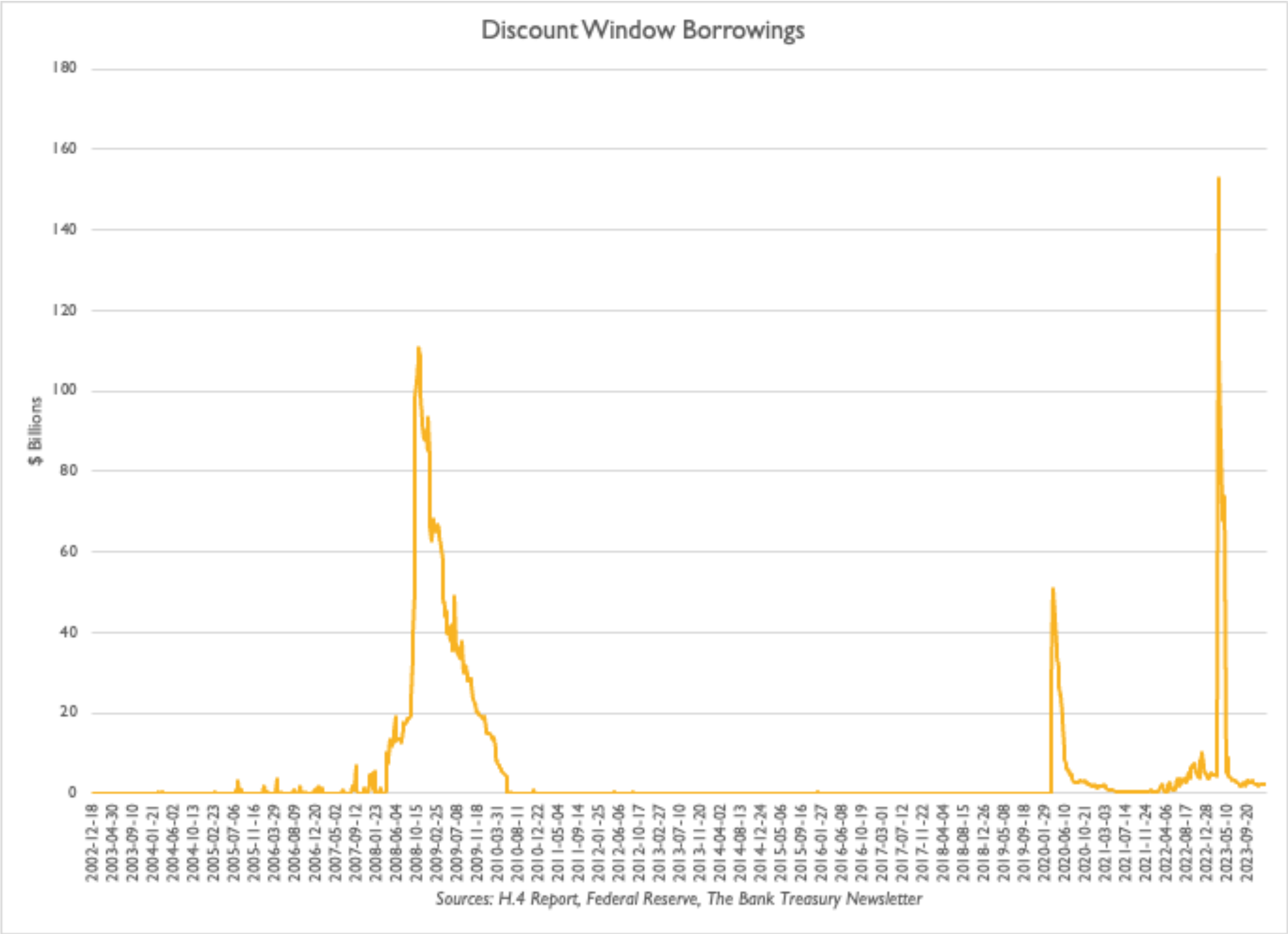
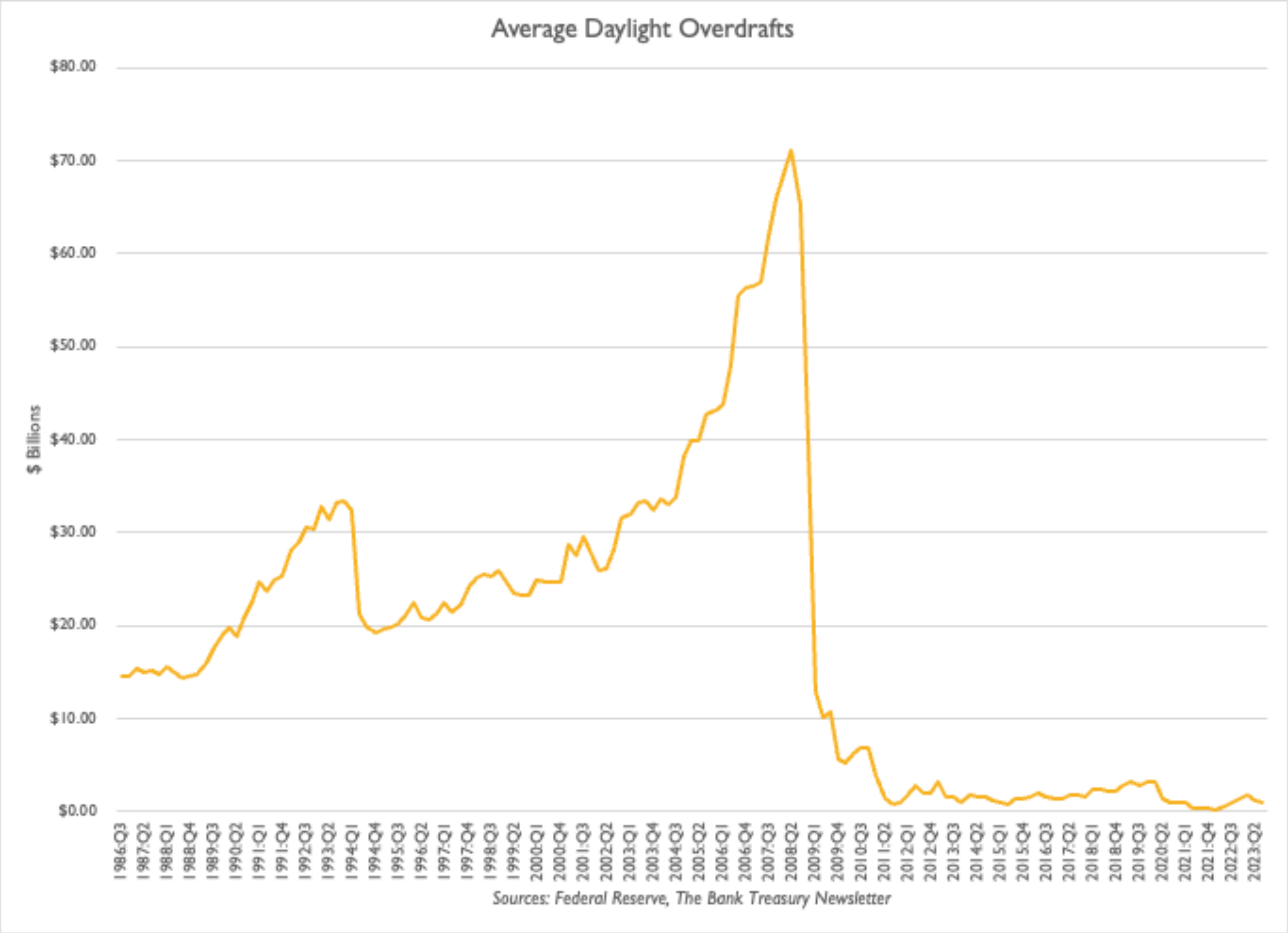
Crisis Borrowing From The Window

Borrowings from the Fed’s discount window last March in the wake of the failure of SVB and SBNY exceeded borrowings in the middle of the GFC and the outbreak of Covid.



Ample Reserves Dampen Daylight Overdrafts

Since the GFC, after the Fed adopted a policy of maintaining ample reserves in the system, bank demand for daylight overdrafts to meet payment obligations over Fedwire fell to less than $1 billion.



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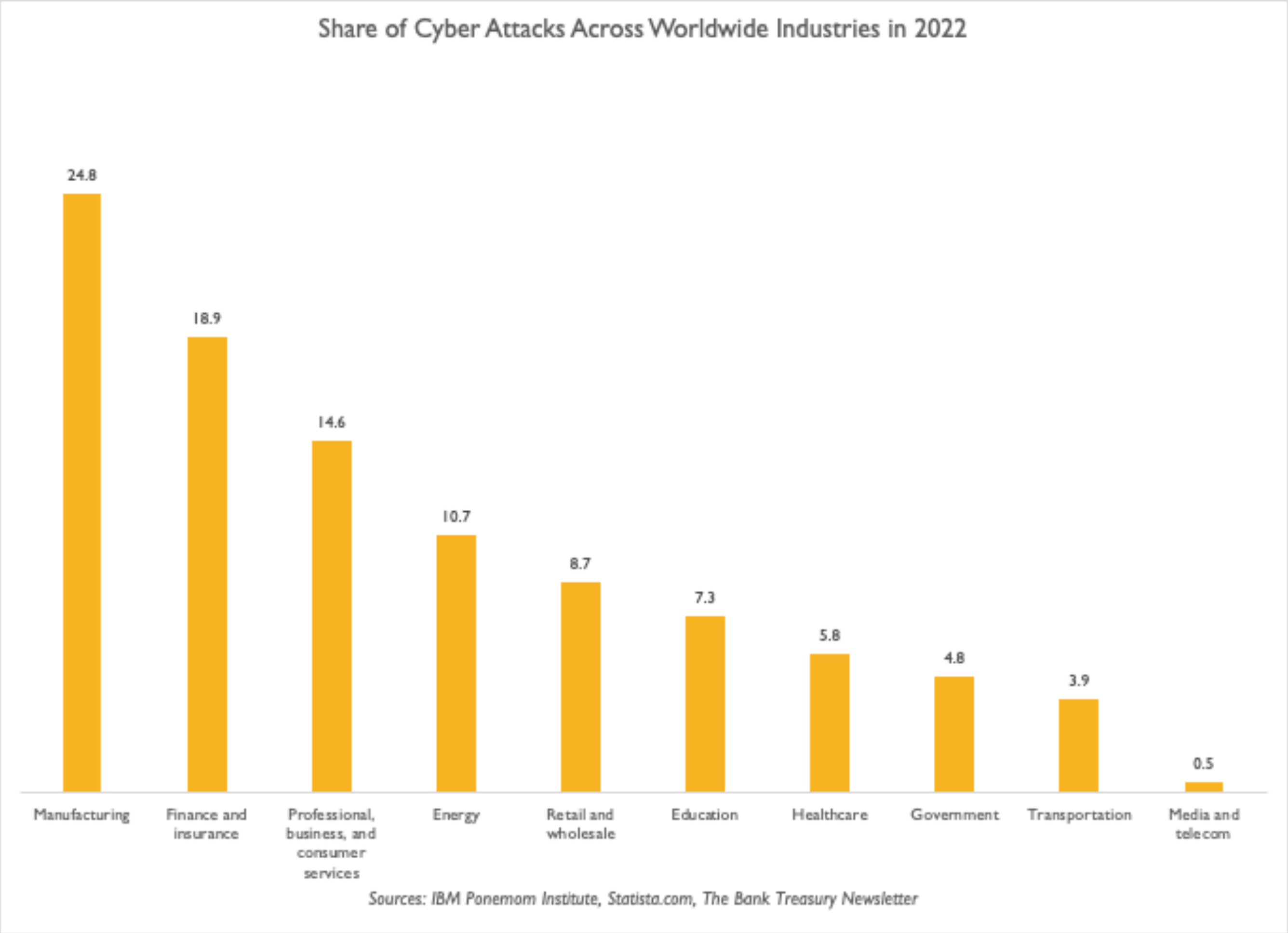
What Keeps Management Up At Night?

Cyber-attacks and business interruption continue to top the wall of worry for business leaders worldwide.

Cyber Risk: The Known Unknown

Despite heavy investment by banks in software designed to protect them from cyber attacks, financial institutions continue to get attacked and remain a major target for hackers.



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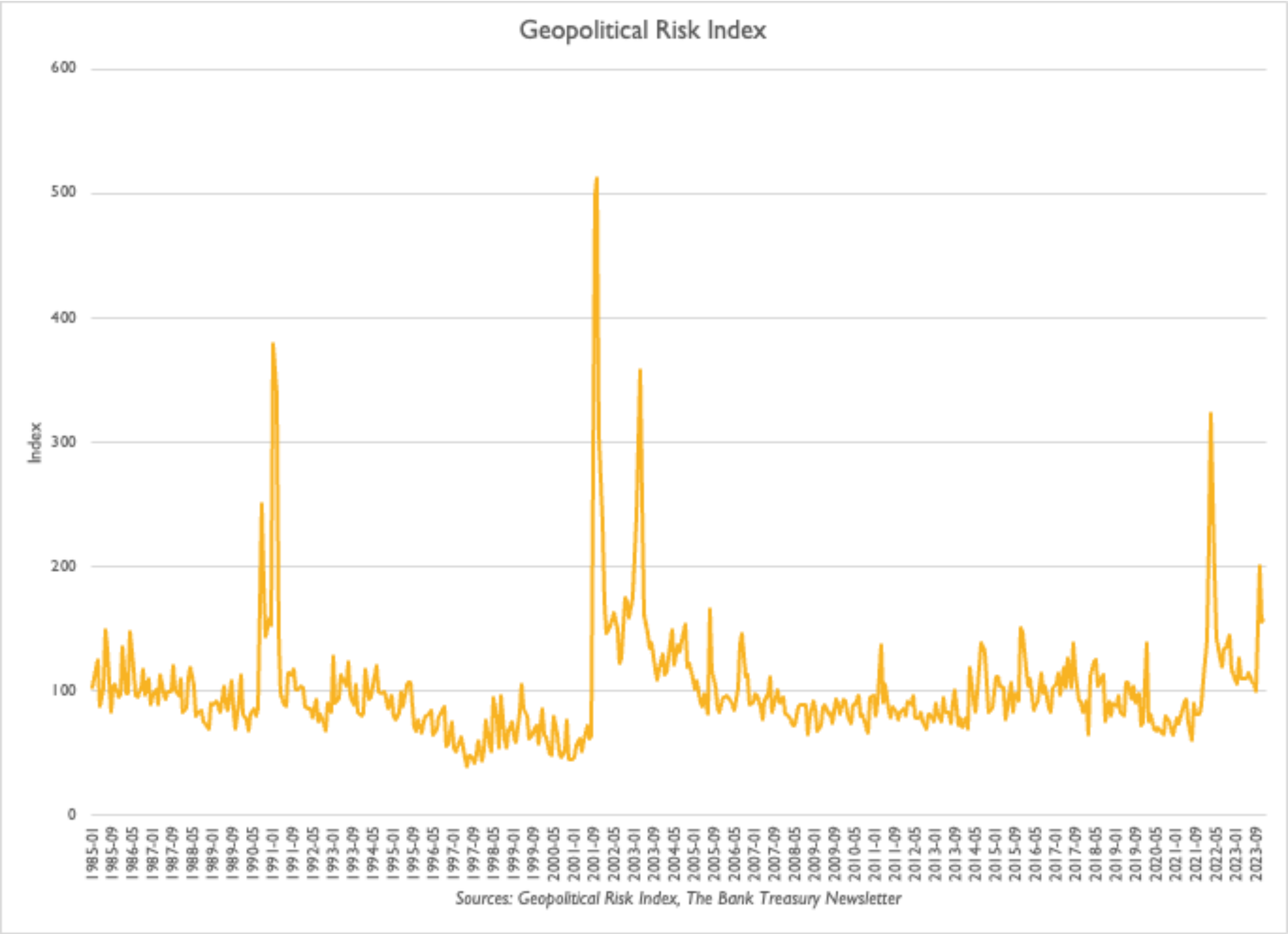
Geopolitical Risks Surged Again

Major conflicts around the world and political instability are among the wild cards that complicate economic and rate forecasts for 2024 and 2025.



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Ethan M. Heisler, CFA
Editor-in-Chief
Email: Ethan.heisler@thebanktreasurynewsletter.com
Cell: 516.359.0975

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