The Bank Treasury Newsletter
The Chart Deck
July 2023

THE BANK TREASURY NEWSLETTER

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In This Month's Chart Deck

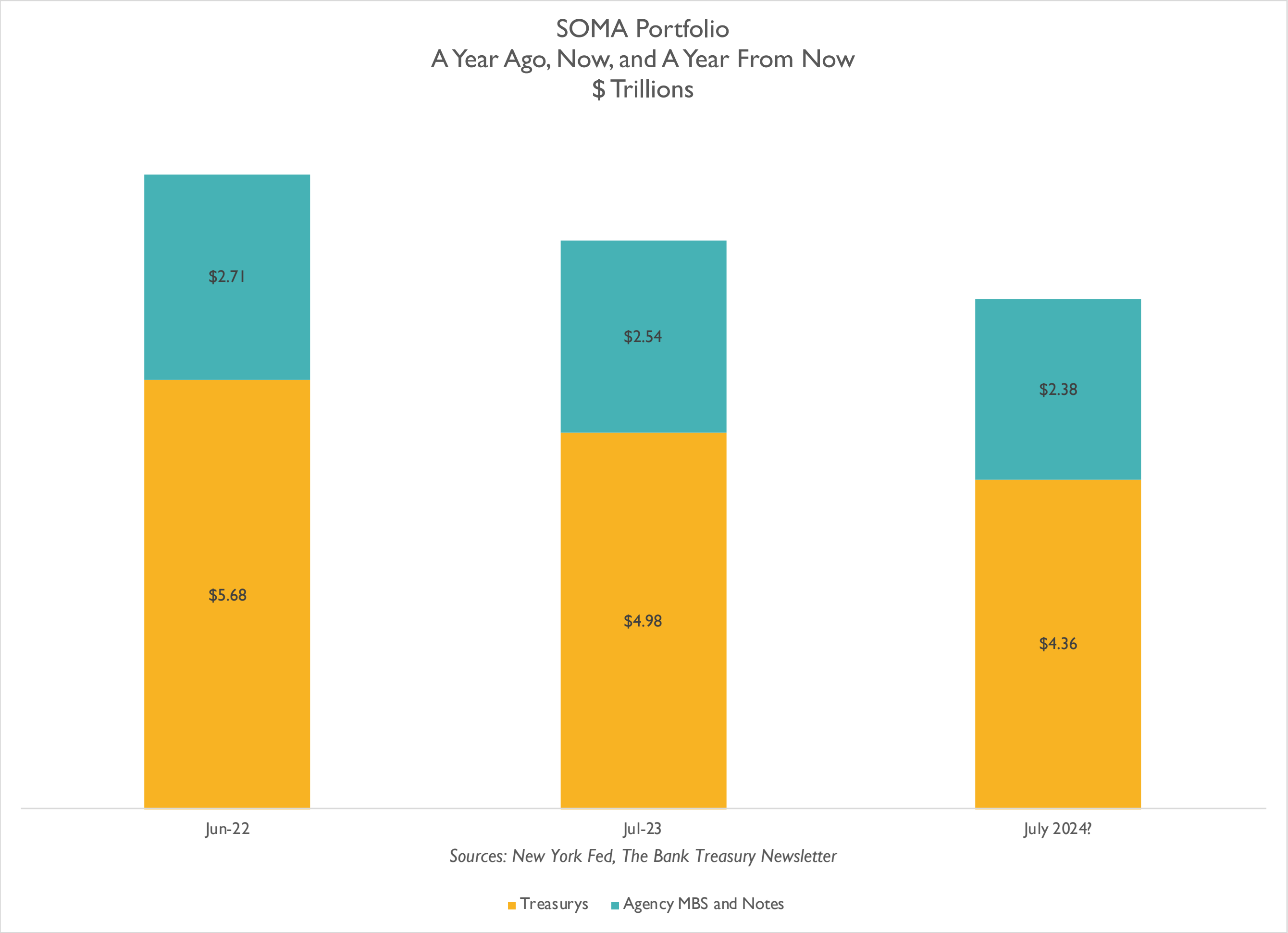
- The Federal Open Market Committee (FOMC) not only met this month to raise the target range for the Fed Funds rate by another 25 basis points, but also to decide to continue with its Quantitative Tightening 2 (QT2) policy to shrink further the size of its System Open Market Account (SOMA) portfolio. SOMA equaled $7.4 trillion this month (Slide 4), down $1.1 trillion since QT2 began in June 2022. At it its present pace, the balance of SOMA should fall to $6.7 trillion by July 2024, a level which would still be more than $2.5 trillion more than what it equaled before the Fed began Quantitative Easing 2 (QE2) in March 2020. QT should be highly correlated to the run-off of bank deposits in the system and was until the failure of Silicon Valley Bank and Signature Bank last March. But after an immediate outflow surge from bank deposits into money market funds that boosted the fund balances to a record $5.9 trillion at the end of June, commercial bank deposit balances began to rebound (Slide 5), reaching $17.4 trillion this month. Moreover, even with QT continuing apace and with the Treasury rebuilding its Treasury General Account (TGA), reserve deposits, which are normally positively correlated with a change in the SOMA balance and negatively correlated with a change in the TGA balance, inched slightly higher in the last quarter (Slide 6).
- M2, which includes checking deposits and money market fund balances, continued to slide lower as it has been doing since QT2 began last year (Slide 7), matching the $1.1 trillion decrease in SOMA, falling from a peak of $22 trillion in June 2022 to $20.9 trillion this month. The Treasury debt refunding calendar since the debt ceiling resolution is sure to add further pressure on money supply (Slide 8), but so far, the Fed cut its Reverse Repo Facility (RRP), by $0.6 trillion, to $1.7 trillion (Slide 9) rather than reduce reserves or pause QT. The build-up of the RRP has been a source of consternation for bank treasurers who blame it for reducing liquidity in Treasury markets, but it anchors the Secured Overnight Financing Rate (SOFR). The positive spread between SOFR and the RRP (Slide 10) since the beginning of this year, in contrast to the negative spread that persisted last year is a sign that conditions are tighter this year in the repo markets than they were last year. Tightening by the Fed has not only impacted short-term markets but has echoed across the yield curve, causing it to invert to levels not seen in 40 years. A 0-coupon 5-year bond premium, after surging last summer above 0% for the first time since 2018, plunged back deep into negative territory since the beginning of the year (Slide 11).
- While the Fed pursues QT, it also remains committed to maintaining ample reserves, a policy where the Fed keeps more reserves than needed by banks by an ample margin. Since 2008, this policy has had a significant salient effect on the financial system. For example, in payments, ample reserves are why daylight overdrafts by banks, once a significant risk facing the payment system, are just a fraction of what they once were (Slide 12). The payment system is set for further changes, because on July 20th, the Fed launched FedNow, a digital payment system for direct account-to-account (A2A) payments. FedNow will join other privately-run real-time payment providers, most notably, Zelle, though with its $500,000 limit per transaction it will have wider business applications beyond retail. According to a 2023 survey by Worldpay, A2A payments accounted for just 9% of payment methods used in retail e-commerce in the U.S. last year, a market where credit cards still dominate payments (Slide 13).

List of Slides

- SOMA Portfolio, A Year Ago, Now, and A Year From Now, *Sources: New York Fed, The Bank Treasury Newsletter*
- All Commercial Bank Deposits, *Sources: H.8 Report, Federal Reserve, The Bank Treasury Newsletter*
- Reserve Deposits, *Sources: H.4 Report, Federal Reserve, The Bank Treasury Newsletter*
- M2, *Sources: FRED, St. Louis Fed, The Bank Treasury Newsletter*
- Net T-Bill Issuance, *Sources: SIFMA, The Bank Treasury Newsletter*
- RRP, *Sources: H4 Report, Federal Reserve, The Bank Treasury Newsletter*
- SOFR-RRP Spread, *Sources: New York Fed, FRED, St. Louis Fed, The Bank Treasury Newsletter*
- Term Premium of 5-Year Zero Coupon Bond, *Sources: FRED, St. Louis Fed, The Bank Treasury Newsletter*
- Daylight Overdrafts, *Sources: Federal Reserve, The Bank Treasury Newsletter*
- 2022 E-Commerce Payment Methods in the U.S., *Sources: Worldpay Global Payment Report 2023, The Bank Treasury Newsletter*

Shrinking SOMA

90% of Agency MBS held by the Fed is tied to 30-year mortgage loan collateral, which is why its Agency MBS holdings will shrink much slower than the $35 billion monthly QT cap set by the Fed. Its Treasury holdings, on the other hand, should run off as planned, at $60 billion a month. Over the next year, Treasurys equal to $1 trillion are scheduled to mature.



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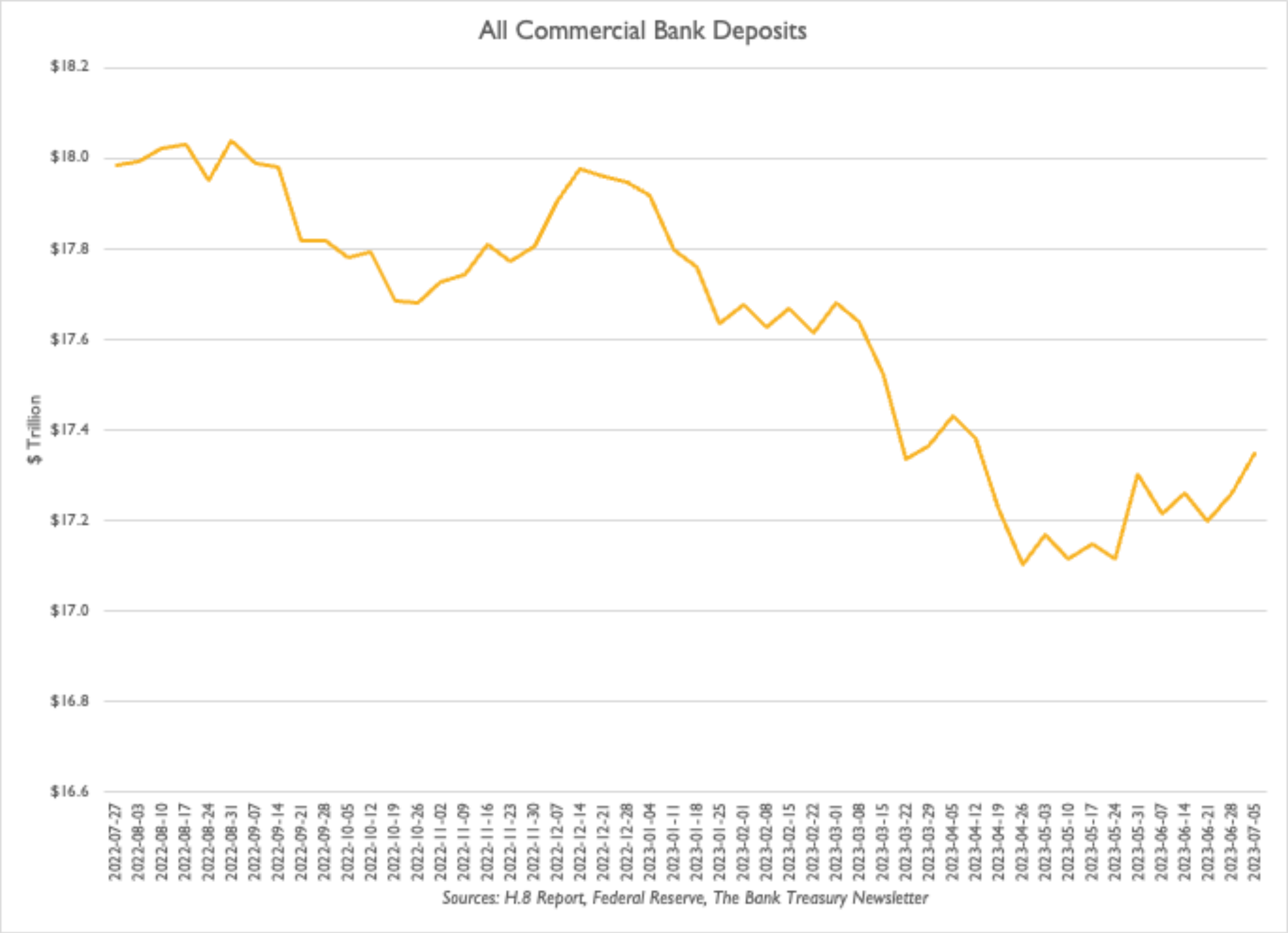
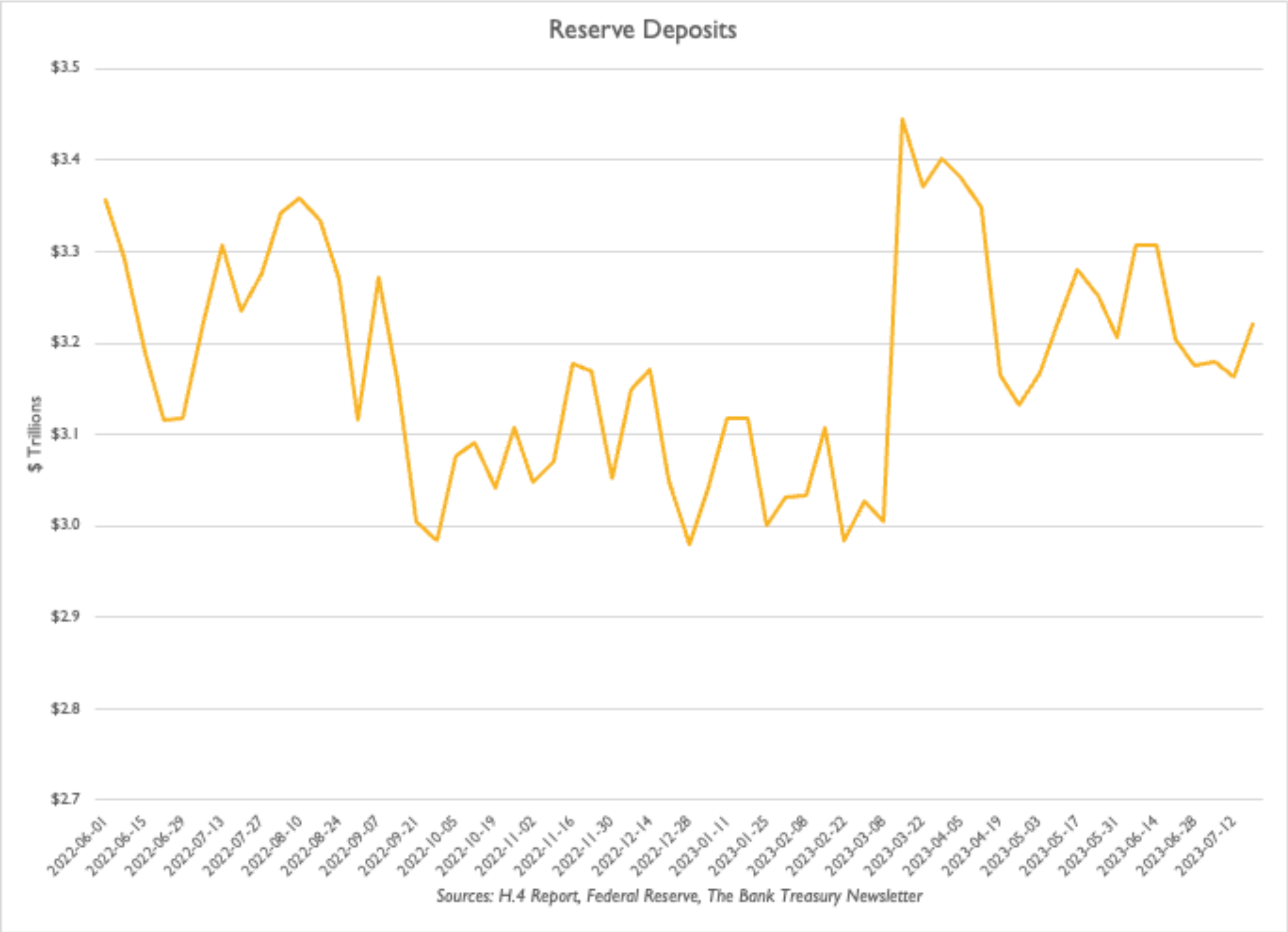
Deposits Comeback

After plunging by $0.5 trillion after SVB and SBNY failed in March to hit a annual low of $17.1 trillion, deposits have since increased by $0.3 trillion, to $17.4 trillion this month. This trend is notable given the significant pressures deposits continue to face, especially competition from money market funds which continued to climb through the end of June, reaching $5.9 trillion.



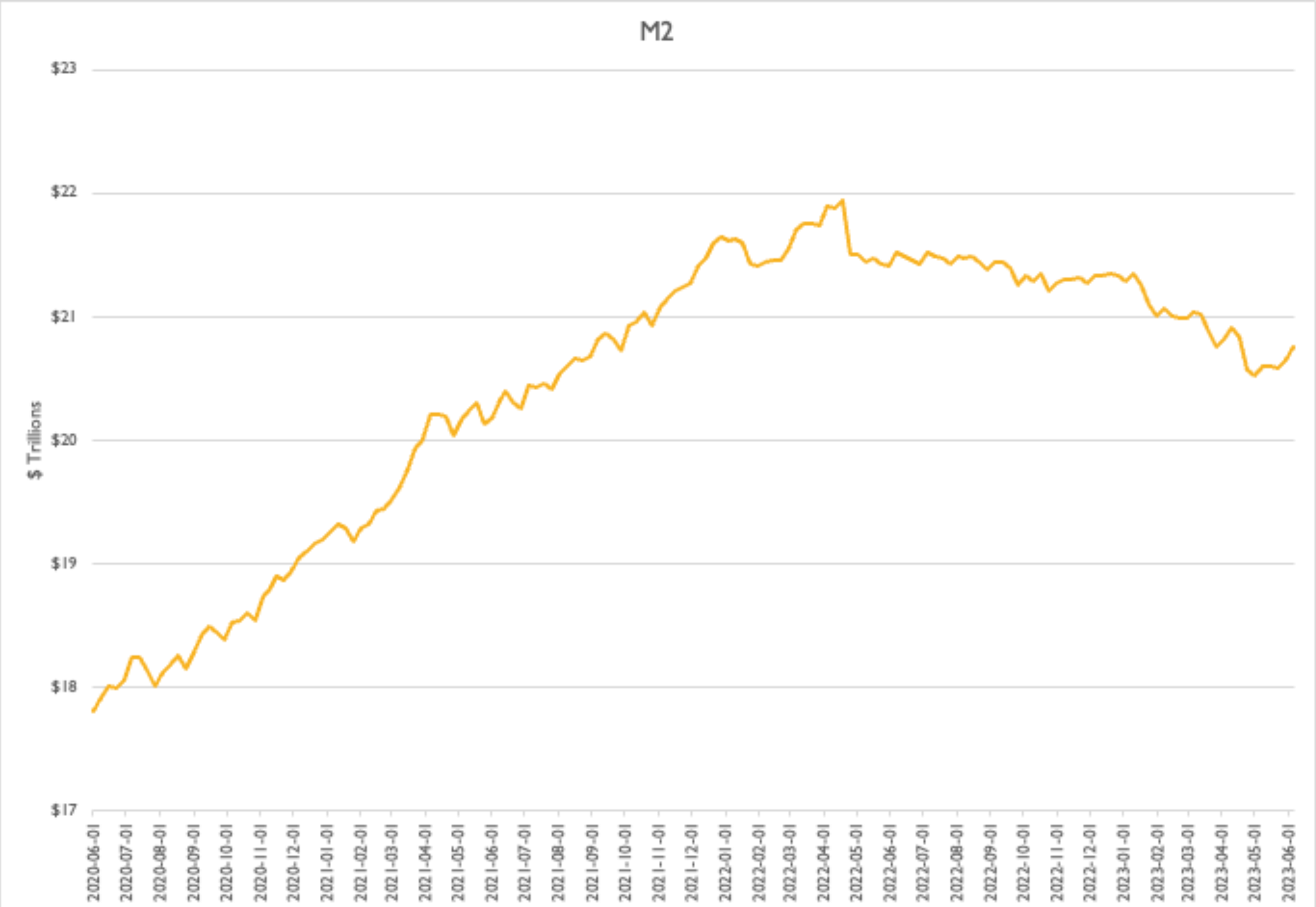
Stable Reserves/Stable Deposits

Bank reserve levels are relatively unchanged since the end of last year, even though SOMA shrank by $0.5 trillion, to $7.6 trillion, and even though since the beginning of June, the Treasury replenished the balance in its TGA account.



QT Shrank Money Supply

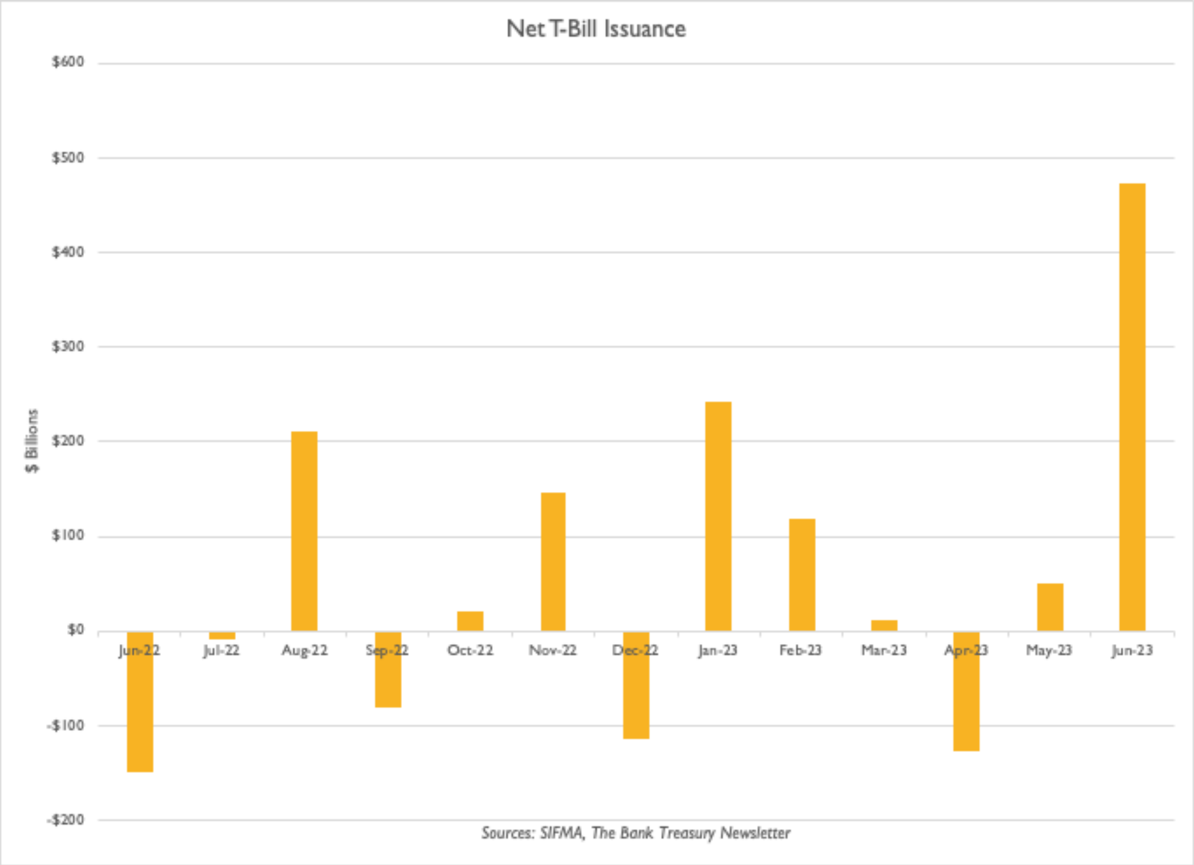
M2, which incorporates M1, which includes checking accounts, currency in circulation, and other liquid assets, and also counts money market funds in the sum, at mid-month equaled $20.9 trillion, down $1.1 trillion since the start of and in line with the decrease in SOMA.



Sources: FRED, St. Louis Fed, The Bank Treasury Newsletter

M2 Faces Treasury Refunding Pressure

Having mostly rebuilt its TGA account back to $600 billion as it planned, the Treasury's plan for Q3 2023 is to borrow $733 billion net of maturing debt. These funds will either have to come out of bank accounts or money market funds.



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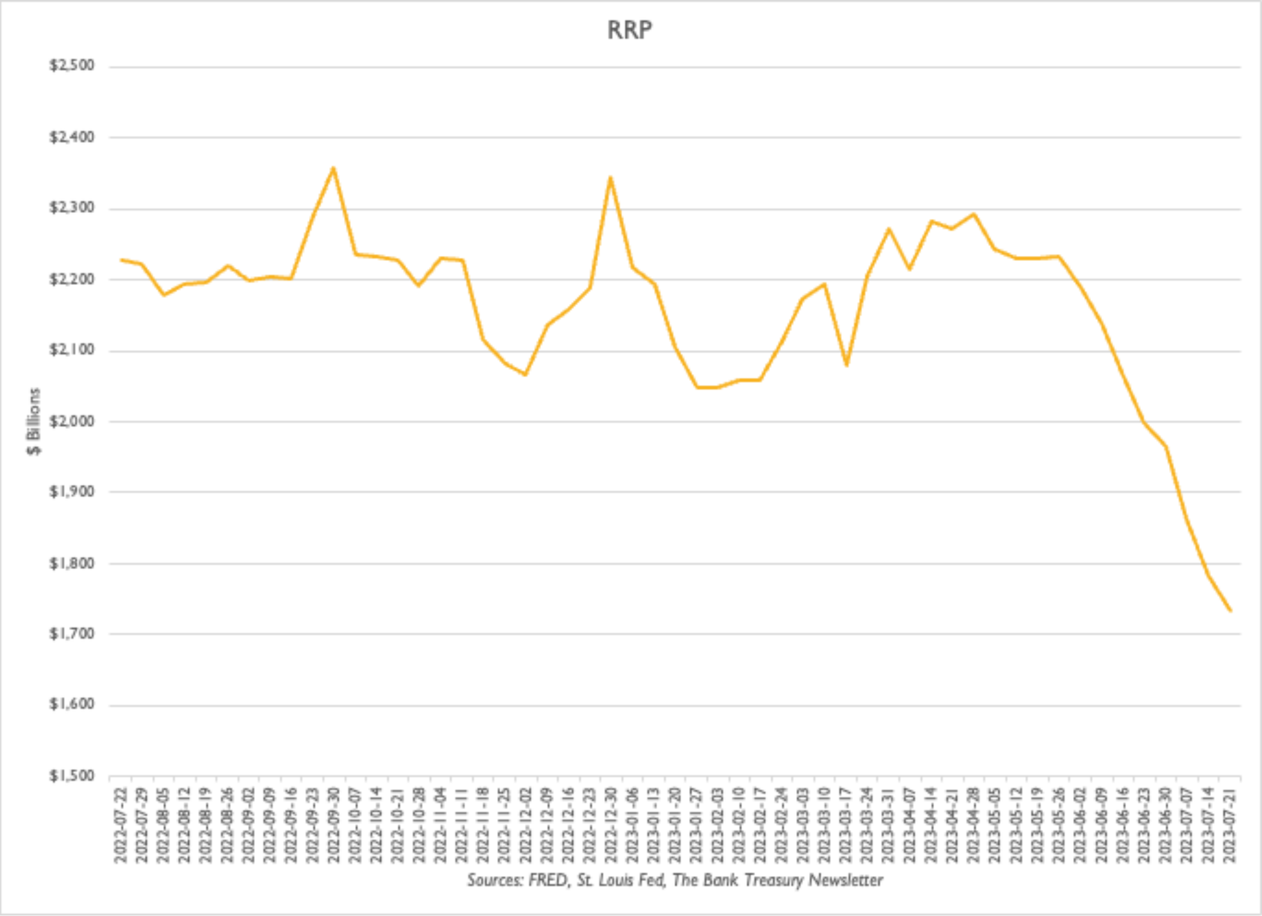
The Fed Cuts Its RRP

The Fed reduced its RRP facility, which should be positive for the Treasury repo markets.



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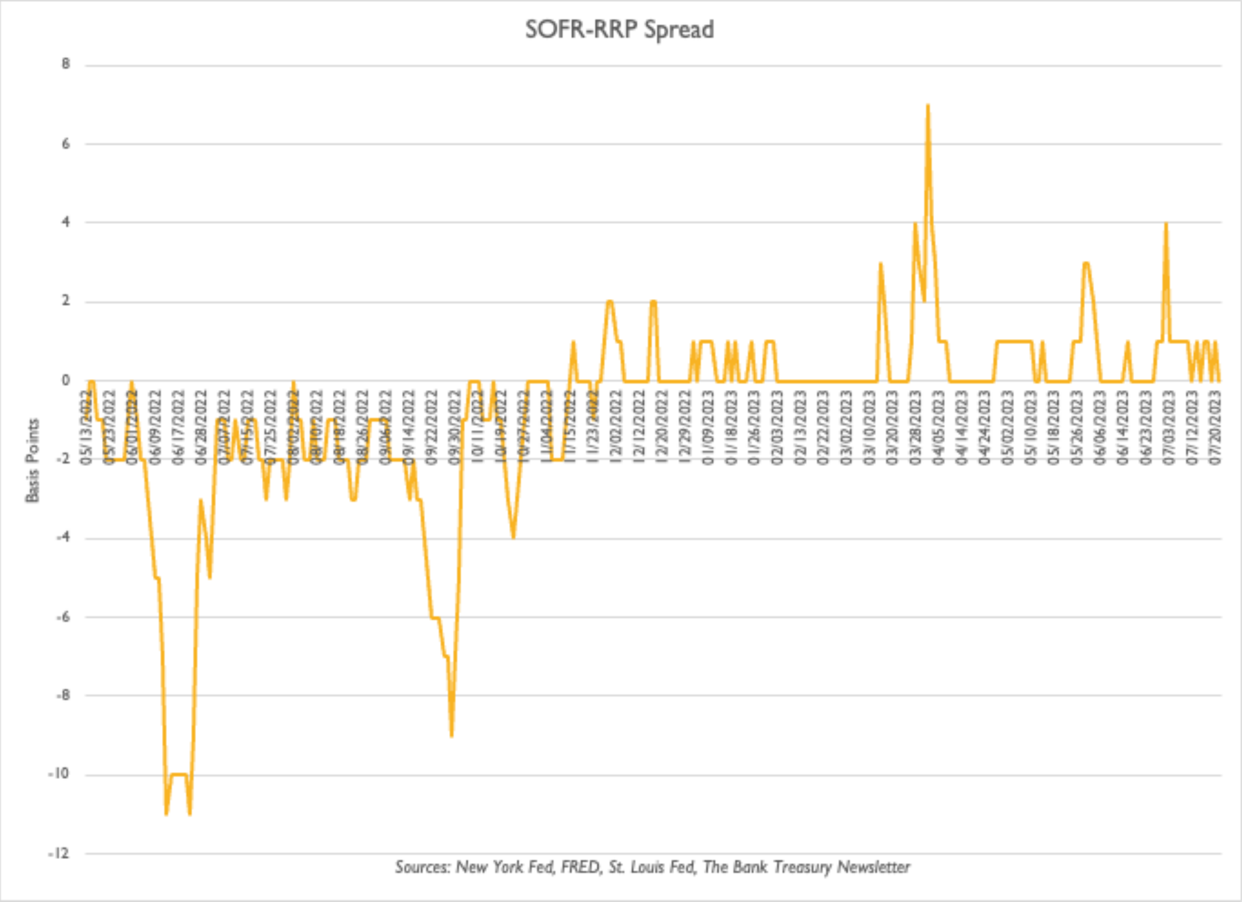
Will Lower RRP Mean Easier Repo Markets?

Without the RRP to take their overnight cash, money market funds will be available to provide more cash for dealer financing in the repo market, which needs to run smoothly considering the Treasury's sizeable refunding plans. In H2 2022, during the first six months of QT2, the average basis between SOFR and the RRP was -2 basis points, which flipped since the new year to +1 basis point, an indication that as the RRP reached its peak earlier this year, enough liquidity had been drained from repo markets to have finally made a difference in the rate dealers paid for overnight financing.



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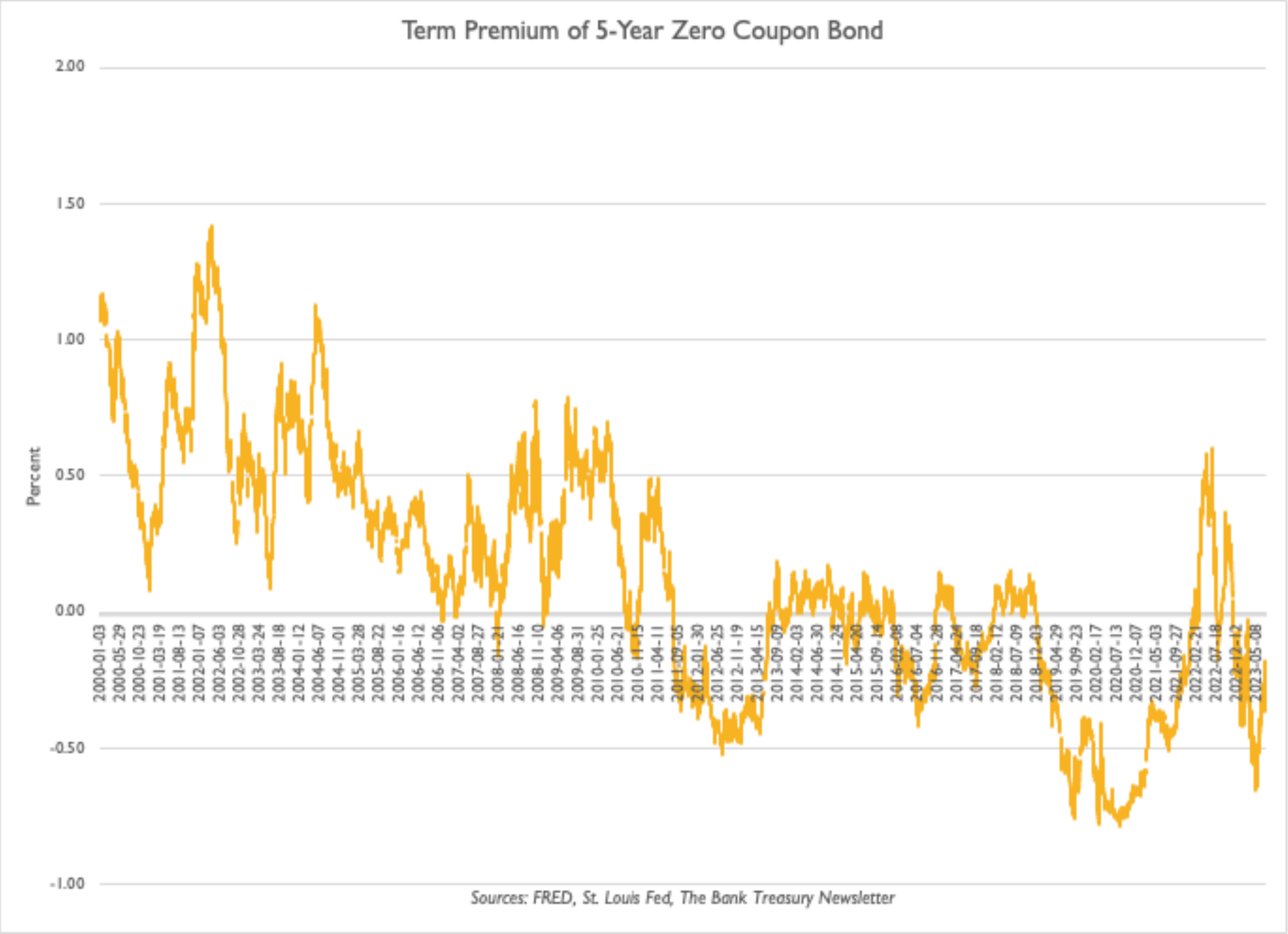
Term Extension Still Does Not Pay

Based on current rates, an investor would earn a higher return on an overnight risk-free investment rolled daily for five years, than could be earned on a Zero-Coupon 5-year bond.



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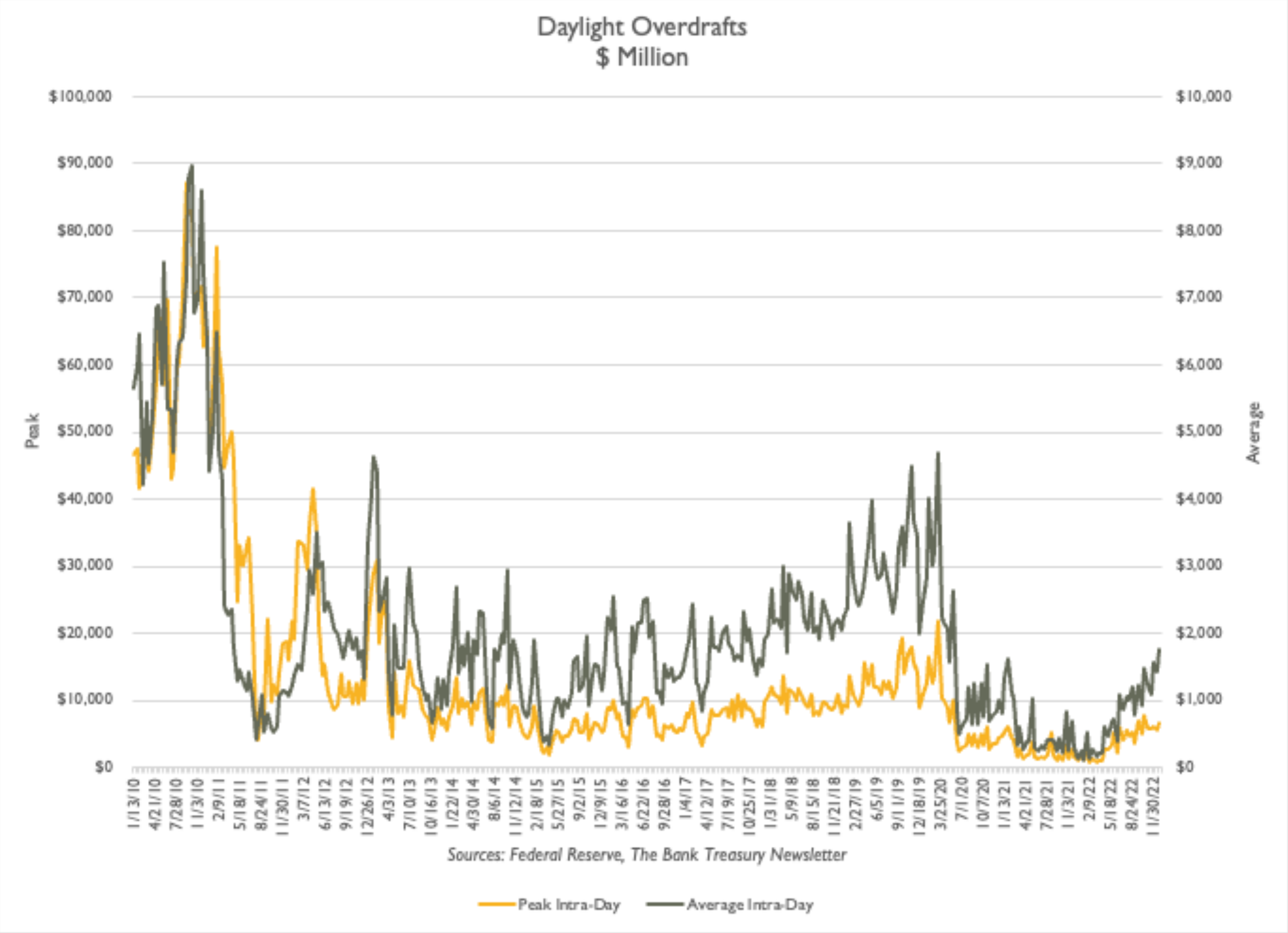
Ample Reserves Keeps Payments Stress Low

Banks complete the payment process by transferring reserves between their accounts at the Fed. If a payer bank does not have sufficient reserves on hand to complete payment, it can borrow reserves on an intra-day basis. The Fed's ample reserve policy significantly reduced the need for intra-day loans, a stress point in the payment system that existed before 2008.



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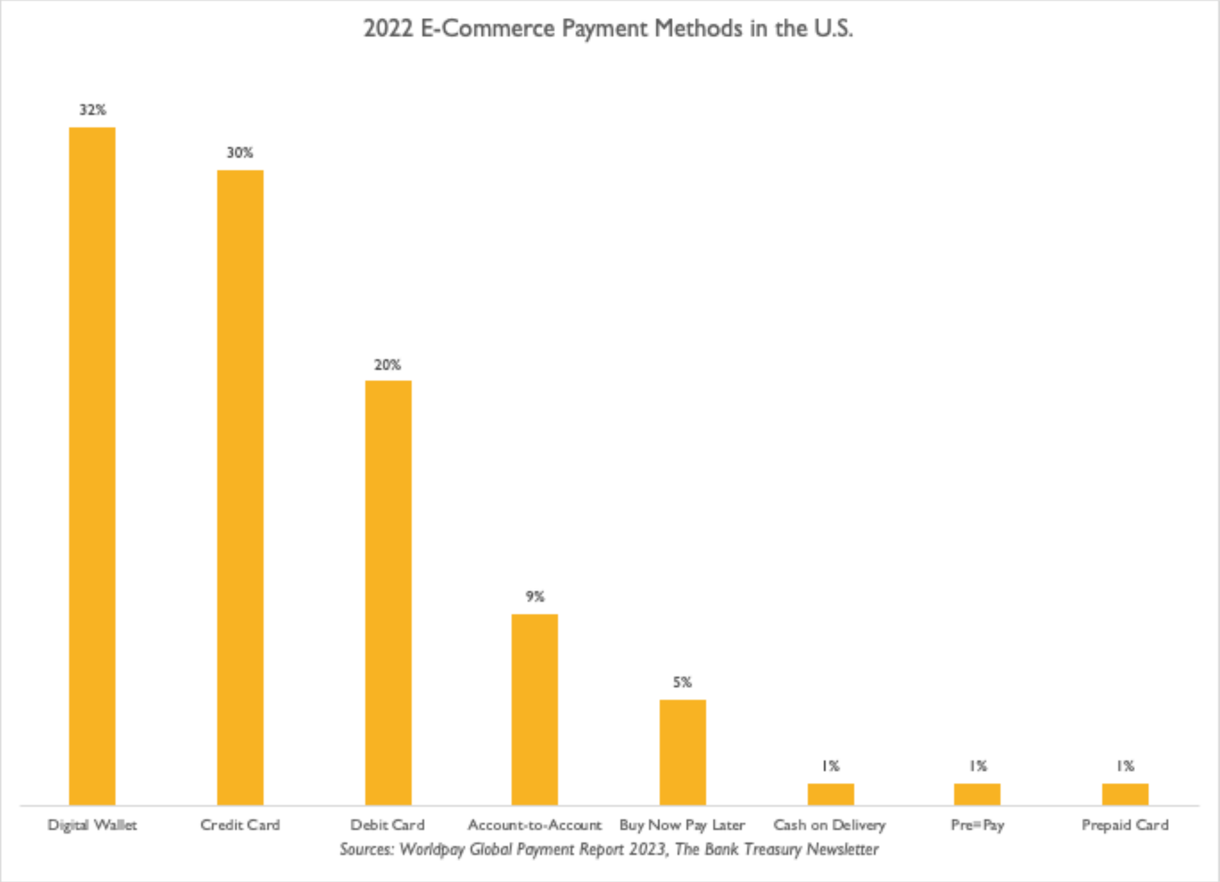
Cards Dominate The Digital World (For Now)

Credit cards remain the dominant payment method in retail transactions. Even a payment that is made using a digital wallet used on a mobile device, is usually tied to a credit card. A2A payments remain a distant fourth at least in the retail space as a method of payment. The industry's participation in FedNow, which the Fed launched this month, and which will have wider applications for businesses, has been slow. Only 26 banks were approved to date.



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