

Jam Today... But Also Jam Tomorrow?

Latest FOMC, Liquidity and Treasury Funding



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MAY 03, 2024

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The bottom line from the recent slew of US policy statements is that the Fed and Treasury are clearly working together to control future duration supply. The latest FOMC and QRA statements show Fed Chair Powell and Treasury Secretary Yellen are adept and both are conscious of the need to preserve liquidity.

On the face of things, this is positive. However, our estimates still flag further liquidity problems for US regional banks over coming months. This will require a hastier run-down of the TGA than envisioned in the latest QRA statement and demand a bigger take-up of bills by credit providers in order to further monetize the deficit. We suspect that the Treasury's latest TGA projection of US\$850 billion for Q3, 2024 is a political gesture designed to signal there will be no 'spending spree' ahead of the Election. Hence, we cynically expect a much lower out turn.

The US monetary authorities are trying to cap duration issuance because the Federal Government cannot cap the size of the run-away public deficit. This will either mean that Treasury bill finance makes up a permanently larger share of funding than the 'assumed' 20%, and/ or policy-makers are forced to 'discipline' the markets in 2025 by hiking short-term interest rates to induce a recession and so force investors back into bonds at a lower average yield base.

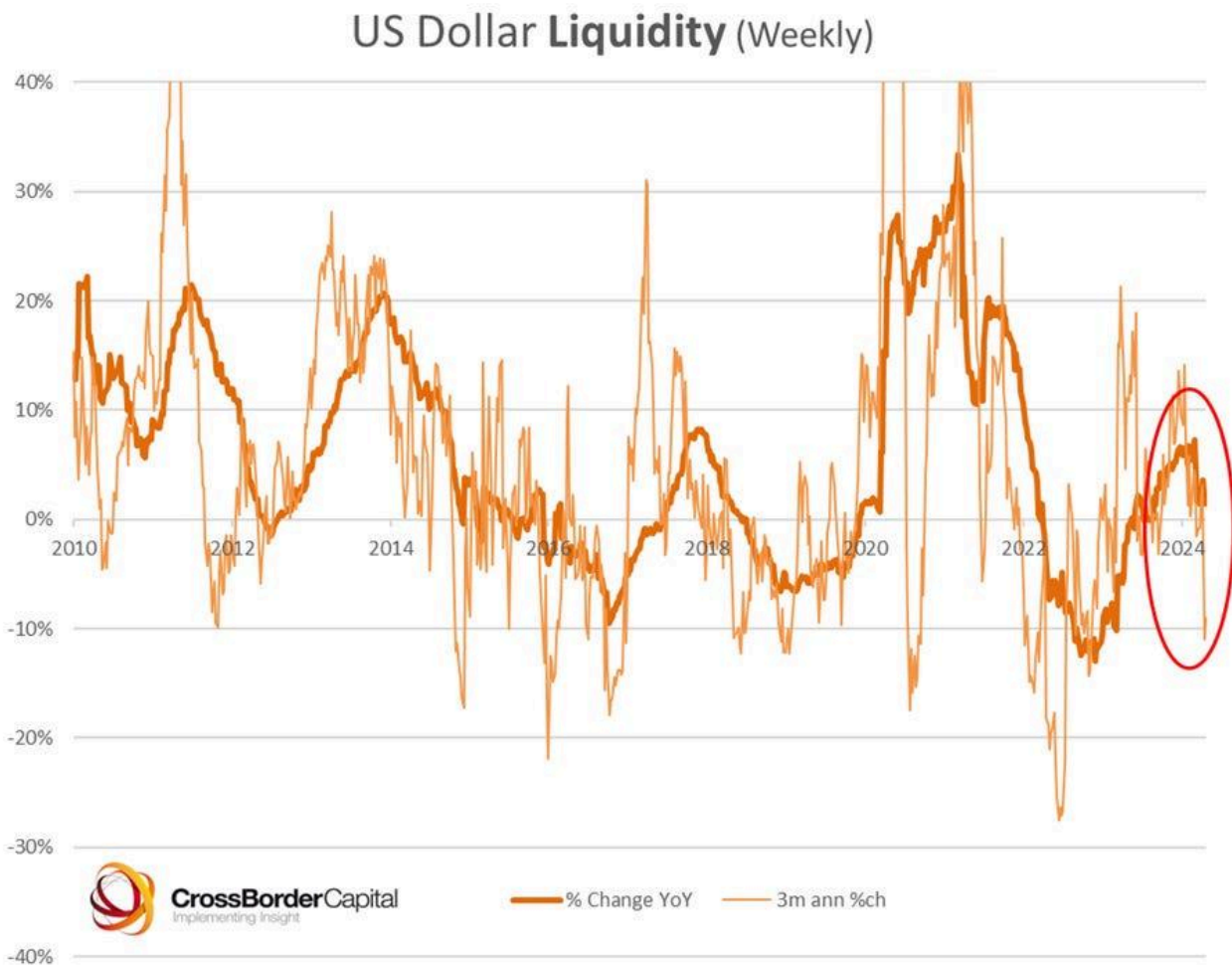
This means that **US Fed funds may not be reduced at all** from here (*pace* a possible token political gesture ahead of the November Election), and that the next move is up, sometime in 2H, 2025.

We continue to expect the investment market profile we previously outlined: (1) **short-term liquidity ‘air pocket’** through Q2, 2024; (2) **medium-term rally** to a peak in the liquidity cycle in late-2025, with a set-back triggered by policy-tightening, and (3) **long-term strong uptrend in liquidity** driven by *fiscal dominance* and increasing monetization of high levels of government debt.

The Liquidity ‘Air Pocket’

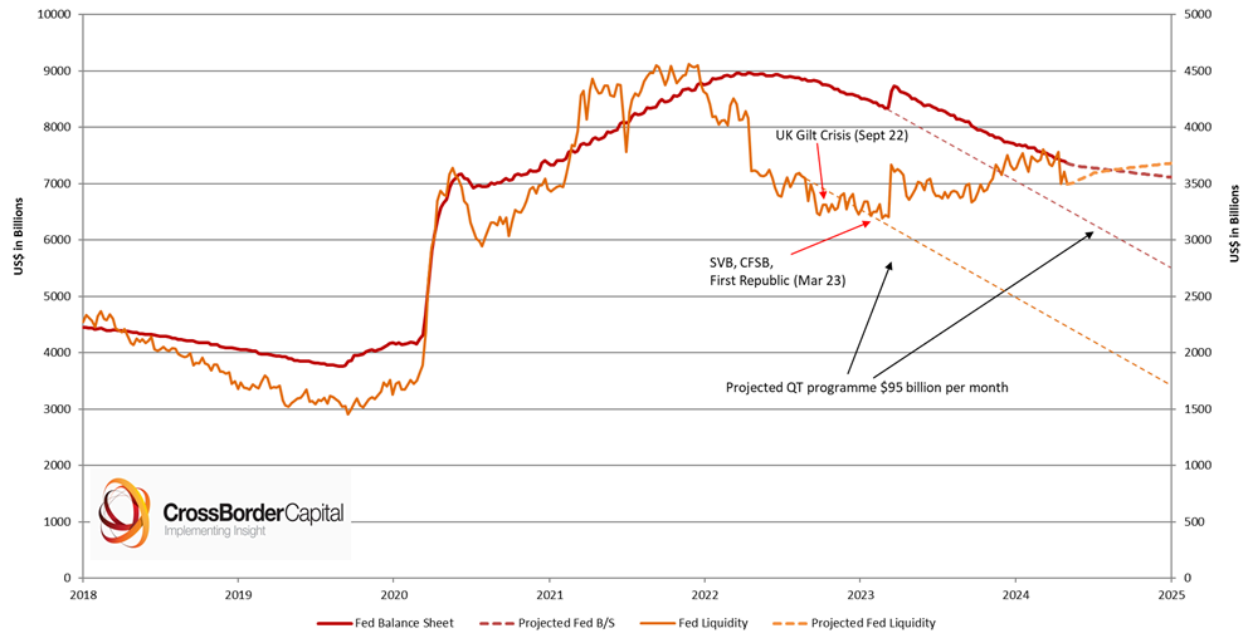
Markets are currently being buffeted by our predicted liquidity ‘air pocket’.

The scale of the bump is starkly visible in the chart below. This measures US dollar Liquidity, an aggregate made up of the US dollar component of the World monetary base. Latest data highlight a sharp tumble in the pace of expansion.



The reasons for the setback largely come down to **weaker US Liquidity**, which, in turn, can be explained by the April 2024 tax filing deadline and the associated jump in the size of the Treasury General Account (TGA) to test US\$1 trillion. The following chart shows this drop in Fed Liquidity and its projected path over the forthcoming months, using the latest assumption from the May 2024 Quarterly Refunding Announcement (QRA) from the US Treasury. Admittedly, Fed Liquidity climbs back, but, as is emphasized in the next chart, not only does this appear to be a relatively slow return, but it also warns that **US banks' reserves dip and remain below the 'adequate' threshold** that we have estimated.

US Fed Balance Sheet: Actual and Net Liquidity



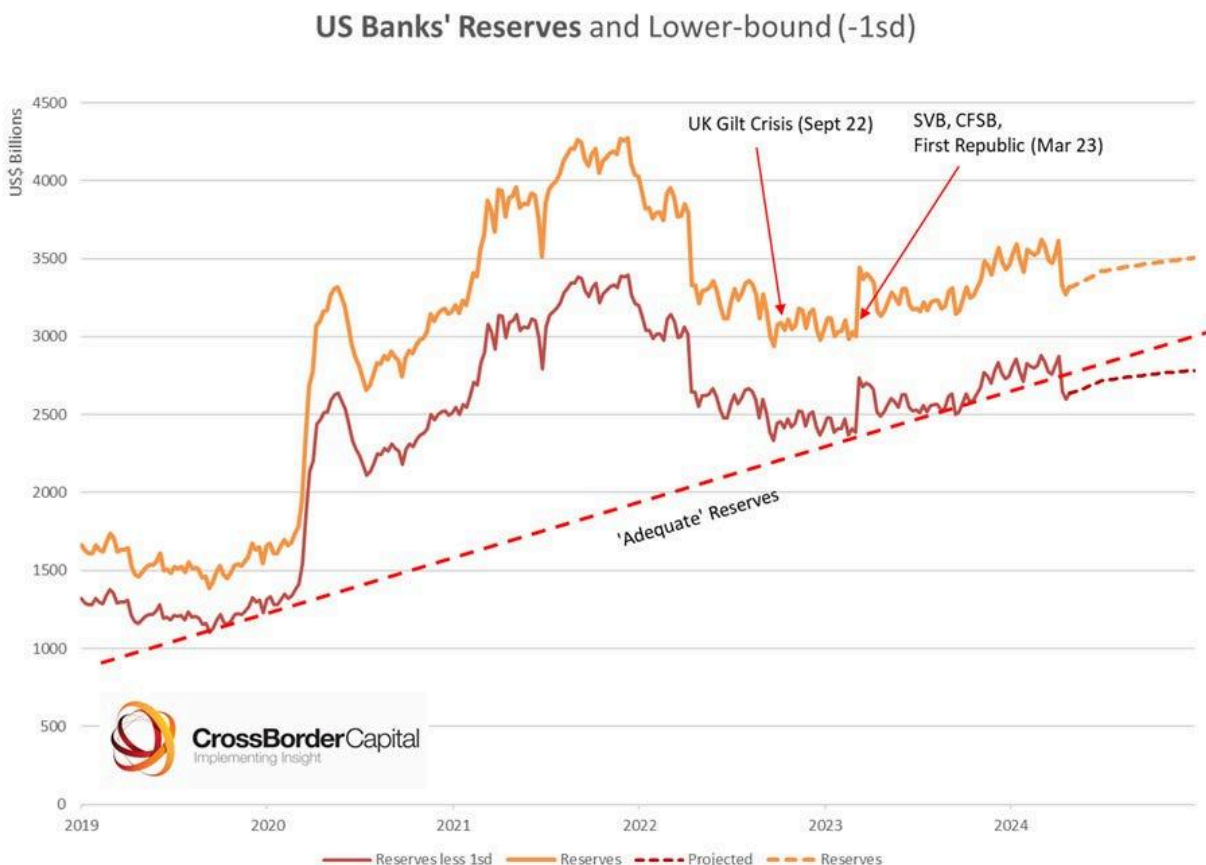
Regional US Banking Tensions?

The chart below shows US banks' reserves and a one standard deviation lower bound. The latter gives a measure of the skew in reserves away from the vulnerable and cash-stretched smaller regional banks. Tensions often arise when the lower band approaches or even breaches the 'adequate' reserve threshold. The chart warns that we are in a dangerous area. More liquidity will be needed.

The US Treasury and Federal Reserve surely know this? We have long argued that balance sheet policy is mainly about *financial stability*. Consequently, we conjectured last year that the March/ April 2024 period would see a welcome reassessment of the Fed's QT policy and a likely reduction in the size of Treasury roll-off from the balance sheet. So far, so good.

Indeed, the latest late-May FOMC duly delivered by cutting the scale of Treasury QT from a US\$60 billion monthly ceiling to only US\$25 billion, implicitly 'adding' US\$420 billion back to markets in a full year. **This confirms to us that the US**

monetary authorities are mindful about maintaining adequate money market liquidity.



The 'New' Fed/ Treasury Accord

A few days later to reinforce this point, the following Treasury QRA statement also squeezed future coupon supply. The table below gives the main details.

After a jump in the supply of coupon duration in the June quarter, both the September and December quarters are likely to see small dips in supply.

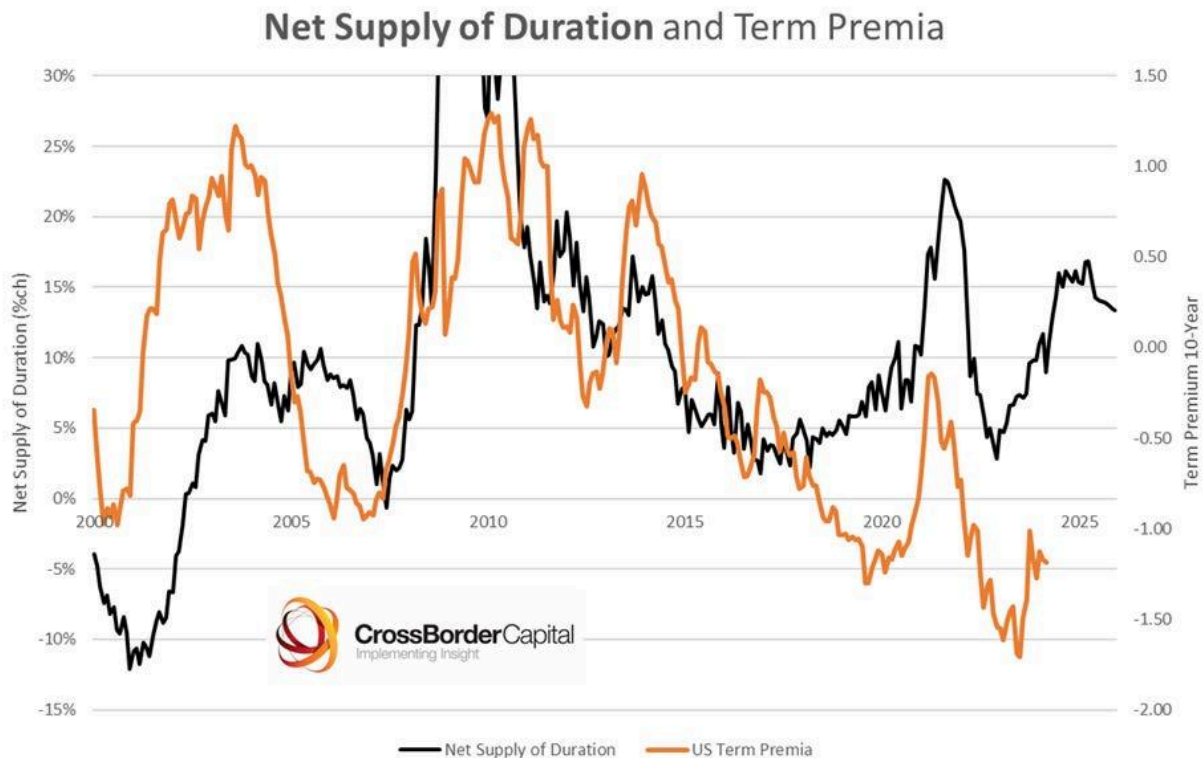
Together the Fed and the Treasury appear to be trying to preserve liquidity by 'targeting' a steady supply of duration (i.e. new coupon supply plus revised pace of QT).

Treasury Funding and **Duration Supply**, 2024

	Q1A	Q2E	Q3P	Q4F
Debt Sales	748	243	847	850
# Bills	409	-297	290	300
# Coupons	339	540	557	550
Change in TGA	6	-25	100	0
Funding	742	268	747	850
QT (Treasury Roll-off)	173	125	75	75
Duration Supply	512	665	632	625

A: actual; E: estimated P:projected F: forecast

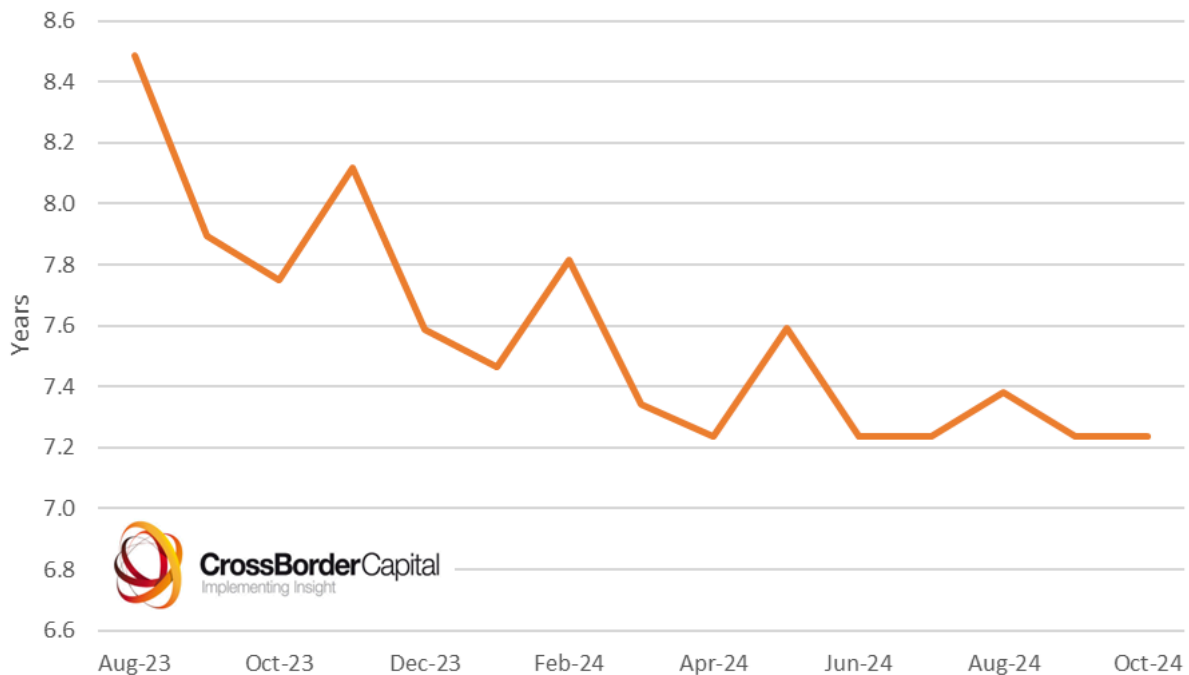
Excess duration supply is a major driven of term premia, which, in turn, have lately been largely responsible for major swings in Treasury bond yields. The chart below compares the growth of duration supply to our estimates of Treasury 10-year term premia. The chart underscores their close positive correlation and it suggests that our projections of future duration supply are consistent with, at least, a 100bp rise in term premia, and, hence, higher 10-year yields. Assuming no change in policy rate expectations this could catapult 10-year yields through 5½%.



This risk shows how important it is for US monetary authorities to manage the future supply of duration. They are already hard at work. The next chart indicates by how much the **average maturity of Treasury issuance** is slated to fall over the next few months. Again because shorter duration securities require less balance sheet space, this will help to preserve liquidity conditions.

However, as the earlier table confirms, **duration management comes at the cost of more Treasury bill issuance**. Bills will make up 26% of funding in calendar 2024, or well-above the assumed benchmark of 20%. **It appears that the Treasury/ Fed aim to issue a steady flow of duration, and then fund swings in the Federal deficit with bills**. Seasonally low Federal deficits, such as during the tax heavy June quarters, are then used to temporarily reduce bill supply.

Average Maturity of US Treasury Issuance



The key point to remember is that shorter duration bonds and Treasury bills are popular with credit providers. The more that credit providers buy these instruments, the more that the US Government is able to **monetize** its debt. **In other words, the public sector becomes a major driver of future liquidity creation.**

The focus of the US monetary authorities (Treasury plus Fed) on ‘duration management’ is a necessary corollary of the Federal Government’s inability to control the size of its deficit: mandatory spending is on a rising trend; defense spending is soaring and tax revenues are flagging.

This means that either greater monetization is inevitable, and/ or we should expect an attempt by policy makers to ‘discipline’ investors by sharply tightening monetary policy, say, in 2025. This would reduce inflation expectations, trigger a recession and so force investors back into Treasury bonds and (hopefully) deliver lower long-term interest rates.

Yet, sharply higher policy rates can only ever provide a temporary respite. We do expect a late-2025 monetary squeeze, which is consistent with a peak in the Global Liquidity cycle. But looking further ahead, *fiscal dominance* likely means more monetization and ever more liquidity. **It may be a bumpy ride in risk markets over the next few years, but these latest policy statements tell us that investing in monetary hedges like gold and cryptocurrencies, such as Bitcoin, make a lot of sense.**