Global Fixed Income Strategy

Invesco Fixed Income

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Global macro strategy

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The grand reopening, the US Federal Reserve, and bonds

The US economy is quickly moving to a post-COVID-19 world. As the vulnerable are vaccinated and the risk of death and hospitalization declines, we expect consumers to go back to activities that have been curtailed by the shutdown. This will likely benefit service industries, such as dining, hospitality, and travel, where there is plenty of capacity. Putting this spare capacity to work over a short period of time will likely lead to very strong growth for the balance of 2021. This service sector growth will be on top of the already strong goods-producing sector, so the overall level of economic activity is expected to return to its pre-pandemic trend by the end of this year.

This reopening will likely also be supported by continued easy monetary policy and unprecedented government spending. US fiscal spending directly related to the pandemic is likely to exceed 20% of GDP in total. This spending has bolstered balance sheets and allowed consumers overall to improve their household financial situations, even while the economy was in recession. Households are in a better position to increase their spending as we exit the COVID-19 shutdown than before the shutdown.

Despite this strong growth outlook, the US Federal Reserve (Fed) has signaled its intention to remain very stimulative and to keep interest rates close to zero for the foreseeable future. This is a marked change in the Fed's reaction function from the past when the Fed viewed its job as progressively raising rates to avoid economic overheating. As William McChesney Martin, former Chairman of the Fed famously said, the Fed's job was "to take away the punch bowl just as the party gets going." The current Fed has redefined this under the framework of average inflation targeting (AIT) to now be along the lines of "let's get this party going."

This new AIT framework was clear at the March Federal Open Market Committee meeting. The Fed's Summary of Economic Projections revised up growth expectations and inflation expectations sharply but made little change in projected short-term interest rates over the next three years. The Fed would like to see inflation durably above 2% and the economy at full employment before contemplating rate hikes. In other words, the Fed is likely to purposely allow the economy to overheat. For bond investors, this means that the Fed will not be raising rates anytime soon and will keep the short end of the yield curve pegged close to zero. Strong growth and a tighter labor market will likely keep upward pressure on the longer end of the yield curve, despite the short end being pegged close to zero. On the other hand, there will likely be some support for longer duration bonds from a global relative value perspective. Much of the global developed bond markets have negative yields, making the US attractive on a relative basis.

The interplay of these forces is likely to keep fixed income volatility high. Indeed, in recent months, fixed income volatility has risen even as equity volatility has remained low on a historical basis. In February, fixed income volatility rose while the Volatility Index (VIX), a widely followed measure of equity volatility, declined. This is an environment to favor credit over duration. With negative real yields in US Treasuries and a very strong economy, fixed income returns are likely to be lower than in recent years.

Currently, US Treasury real yields (yield after inflation) are still negative across much of the yield curve, and real yields are unlikely to rise in the near term to a level that would mean a serious change to risk assets, in our view. Bottom line, we expect a red-hot US economy complemented by an easy Fed to support risky asset markets in the near term. Upward pressure on the long end of the US yield curve is likely, and Treasury volatility may remain elevated, but we do not expect real yields to reach a level where they create an issue for growth or for risky assets in the near term.

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Interest rate outlook

US: Neutral. US growth expectations continue to rise, driven by aggressive monetary and fiscal stimulus and a likely full reopening of the economy by mid-year. Our forecast for 2021 US growth is now above 7%, which returns the economy to its pre-pandemic trend by the end of the year. This means the economic damage caused by the pandemic is likely to be fully repaired by the end of the year. Given this outlook, the Fed will likely not need to provide continued monetary policy support by year-end. In the near term, we expect upward pressure on yields to be limited by the steepness of the yield curve, as the Fed maintains low rates at the short end of the curve, and the demand for yield from global investors, many of whom face negative or zero interest rates at home. This demand is likely to cap yields in the near term and keep the 10-year US Treasury note in a range, although we expect volatility to be higher. We expect the top of the range to be 1.75% in nominal terms, which should roughly translate into -0.50% in real terms. This level of interest rates should be supportive of the US economy and financial markets.

Europe: Neutral. Our near-term outlook for the European bond market is constructive, as the European Central Bank (ECB) bond purchase program is expanded to counter the recent back-up in yields. The ECB made clear that it would not tolerate higher borrowing costs in the euro area, and, as such, we expect yields to remain in a tight range, despite the upward pressure on the US Treasury market. Additionally, the very slow vaccine rollout across Europe and rising case count have pushed back the easing of lockdown restrictions across the region and delayed the anticipated rebound in growth further into the second half of the year.

China: Overweight. We have turned more bullish on China onshore government bonds, as we have started to see the potential for a peak in economic growth, and thus government bond yields, in the near term. In terms of market technicals, caution among onshore investors indicates their likely light positioning in the rates market. In terms of policy, the People's Bank of China (PBoC) has maintained its relatively cautious approach in open market operations as part of the government's "no sharp-turn" macro policies, but this has been largely priced in by market participants.

Japan: Neutral. Japanese government bond (JGB) yields have been volatile in the last month due to the increase in US and European bond yields and uncertainty about Bank of Japan (BoJ) policy. 10-year JGB yields spiked to a high of 17 basis points (bps) on February 26 but had retraced to 8 bps by March 23.[1] The decline in yields occurred despite the fact that the BoJ widened the yield target range to +25bps/-25bps from +20bps/-20bps, and perhaps reflects the announcement that the BoJ will carry out fixed rate purchase operations of JGBs on consecutive days if the upper range of the yield target is threatened. The greater commitment to maintain the yield range might offset some recent disappointment that the BoJ has not increased quantitative easing (QE) purchases already. In addition, there was some speculation of an even larger adjustment in the yield range prior to the March BoJ meeting.

UK: Neutral. 10-year gilt yields have retraced the entire COVID-19 crisis rally, with the market shifting from pricing cuts this year as recently as January, to a first 25bp hike from the Bank of England (BoE) in late 2022 or early 2023. As a result, the risk to yields no longer appears clearly skewed to the upside, although the likely continued acceleration of growth and inflation will likely limit the scope for lower yields, particularly in the context of higher gilt issuance net of QE, as the BoE appears likely to taper purchases going forward.

Canada: Neutral. The economy is opening more slowly, as the vaccine rollout has been delayed by supply issues. Higher commodity prices continue to provide a tailwind for many provinces, especially given ongoing fiscal spending needs during the pandemic. Household balance sheets continue to strengthen, which should support consumer spending, given pent-up demand. Inflation pressures remain muted so far but are likely to rise in the near term, given supply pressures and base effects compared to last year. Market pricing of a Bank of Canada rate hike in 2022 is premature, in our view. We continue to find relative value in Canadian 5-year bonds versus 5-year US Treasuries.

Australia: Neutral. Valuations are starting to look attractive, in our view, but the improving domestic and global growth outlook likely limits the scope for lower yields. We believe it will be hard for the market to completely price out the potential end of QE and a future hiking cycle.

1. Source: Bloomberg L.P. Data as of February 26, 2021, and March 23, 2021.

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Currency outlook

USD: Underweight. We expect the US dollar to weaken over the medium term, as the Fed keeps yields low relative to other countries. While we expect US growth to recover in 2021, we believe the Fed's inflation regime will support lower yields for some time. A risk to this view could be a pick-up in demand for the US dollar if US growth significantly outpaces global growth. That is not our baseline expectation, however, as we also expect global growth to show signs of recovery, even if delayed somewhat relative to the US.

EUR: Neutral. The euro is likely to remain under pressure as the weak growth outlook in Europe and rising COVID-19 cases (which contrast sharply with the turbo-charged growth expectations in the US) weigh on the currency. Much will likely depend on how quickly the vaccine rollout can be completed and economic restrictions lifted, which currently appears some way off.

RMB: Neutral. We expect tight range-bound trading for the renminbi against the US dollar in the near term as the US dollar consolidates. Recent Chinese policy moves have pointed toward easing appreciation pressure on the Chinese currency. For example, more channels have been opened for capital outflows, and currency fund-raising by financial institutions has been tightened. We expect a continued favorable fundamental backdrop for the renminbi, as supported by the strong export data in the first two months of the year.

JPY: Neutral. The Japanese yen has been one of the worst performing major currencies in the last month. It has suffered as global bond yields have moved higher because Japan is perceived to be unlikely to hike interest rates, and hence interest rate differentials have widened as the market prices in tighter policy in the US and elsewhere. Japanese exporter hedging demand might limit the scope for further upside, and it is possible the Fed will try to talk down the move in short-term US yields, potentially capping the USD/JPY exchange rate in the near term. However, as the trend appears to be toward tighter US monetary policy due to its strong growth recovery, the downside for the USD/JPY exchange rate looks relatively limited as well.

GBP: Overweight. The UK's outperformance in rolling out the COVID-19 vaccine has been largely priced into the pound, which currently trades at the top end of the post-Brexit referendum, trade-weighted range. While the positive impact of the vaccine may no longer be as powerful a driver for the pound, the negatives from Brexit could start to get more attention. The UK's dispute with the European Union over the implementation of the Northern Ireland Protocol is moving into focus, and the market is debating the prospects for Scottish independence, as we approach the Scottish Parliamentary elections in May, in which the Scottish National Party is running on a platform of redoing the 2014 independence referendum.

CAD: Overweight. The Canadian dollar has been the best performing currency in 2021, so some pause may be warranted, but we maintain a positive view on the currency. Terms of trade improvement on the back of rising oil prices is supportive for the outperformance of the Canadian dollar, in our view. Import growth remains muted as the border with the US remains closed, preventing the historical trend of consumer spending. Canada's high nominal bond yields compared to other G10 economies is another attractive feature of the Canadian dollar at this time.

AUD: Neutral. The global backdrop remains positive for the Australian dollar, with commodity prices still high and risk sentiment buoyant. However, the downward trend in the US dollar is now increasingly in question, as US fiscal stimulus potentially creates an environment where US growth outperforms the rest of the world and brings forward the timing of Fed hikes. As a result, the upside for the AUD/USD exchange rate going forward might be limited, even if the Australian dollar outperforms lower-yielding currencies, such as the euro and Japanese yen.

Global credit strategy

This section highlights the key themes driving Invesco Fixed Income's global credit research process and views. Themes are updated based on evolving trends and expectations.

Global investment themes

Asset class themes
Investment grade (IG): Favorable and improving corporate fundamentals are modestly offset by tighter credit valuations

Rationale
We maintain a neutral assessment of US IG credit. We are encouraged by strength in corporate fundamentals and capital allocation policies that have generally been creditor-oriented during 2021. Nevertheless, we remain cognizant that recent inflation data and yield curve steepening present challenges for policymakers, despite previously stated patience in remaining accommodative. Uncertainty remains about (i) fundamental weakness stemming from COVID-19-related global macroeconomic impacts, (ii) fixed income and broader capital market volatility, and (iii) increasingly stretched global credit valuations. That said, fundamentals have continued to improve, and we expect Q1 2021 earnings to show year-over-year growth, with a continued focus on balance sheet strength and de-leveraging.

We expect to see fundamental improvement in sectors more exposed to COVID-19-related economic restrictions. The new issuance market continues to allow even the most challenged sectors to raise liquidity and address near-term maturities, reducing pressure on the banking system and providing a degree of patience from ratings agencies. Nonetheless, downgrades to high yield continue to be a major concern for ratings-sensitive investors. Accordingly, spread dispersion within the index and among names most at risk of downgrade continues to persist, underscoring the necessity of remaining vigilant in both sector allocation and security selection as corporate fundamentals continue to slowly improve.

In Europe, we maintain a neutral allocation to European IG credit. Although the vaccine approval triggered a rally in credit spreads, taking us back to, or inside, pre-COVID-19 levels in large parts of the market, vaccine rollout is proving more challenging in Europe. While we maintain optimism about the strength of an eventual macroeconomic recovery in 2021, this is tempered by our view that the European rollout will lag other regions, which means that corporate operational performance will likely recover more slowly than elsewhere. Fortunately, ratings agencies appear to be adopting a relatively lenient approach, focusing on the medium-term outlook, which has allowed the pace of rating migration to slow. We expect issuance levels to remain moderate, and the ECB's acceleration of its bond purchasing program suggests that the technical backdrop is likely to remain supportive. While this could allow modest spread compression, we see carry as the predominant driver of excess returns from here.

Although we have a neutral stance on European IG credit spreads overall, we still see several attractive areas within the asset class. We believe that subordinated parts of the IG capital structure in financials and corporates can continue to compress. However, we think that name selection will be increasingly important to drive returns, now that valuations have largely recovered from the COVID-19 sell-off.

IFI strategy
We are neutrally positioned in US IG credit. We remain highly selective and opportunistic in global credit as spreads remain tight by historical standards, especially following 2021's positive capital market response to favorable vaccine developments. Corporate fundamentals continue to normalize, a trend which we expect to benefit corporate credit markets in the coming quarters.

High yield (HY): Improving global growth outlook, supportive fiscal stimulus, and accommodative central banks lead to lower potential default risks for high yield

Rationale
The accelerating pace of the COVID-19 vaccine rollout has led to improving global growth. Accelerating economic activity leads to increased revenues and improving earnings profiles for many companies. For high yield companies, improving earnings profiles generally mean lower default probabilities, which leads to tighter credit spreads. Additionally, strong investor demand has created positive market technicals, allowing many companies to access additional liquidity via new bond issuance. A robust new issue pipeline allows companies to extend maturity profiles, which is also a form of improved liquidity. All of these factors tend to lead to lower default events, which we expect in 2021.

IFI strategy
With valuations grinding tighter, we have generally reduced the overall beta in portfolios. While we expect further spread compression, the pace of gains will likely be more incremental, given overall spread levels. We continue to focus our efforts on single name selection where we expect fundamental credit improvement. It is our expectation that these names will outperform their peers, despite the aforementioned market performance. As we think about the impact of rising interest rates, we continue to adjust our exposure to more duration-sensitive credits and focus more on companies with strong fundamental credit catalysts.

US residential mortgage-backed securities (US RMBS): Valuations reflect softer technical environment while fundamentals remain solid, despite higher mortgage rates

Rationale

The tone of the US residential credit market turned more cautious in the latter half of February as interest rates rose and fixed income credit spreads widened. The fundamental backdrop remains solid, though investors are increasingly monitoring moves in mortgage rates and implications for affordability. We expect the extension of the foreclosure moratorium and forbearance relief to benefit mortgage credit investments and anticipate that high levels of borrower equity will limit foreclosure activity at the ultimate expiration of these programs. Technicals have deteriorated somewhat as issuance increased and investor demand moderated, pushing pricing spreads wider. We expect new issue supply to accelerate over the course of the year as conforming refinance activity declines and originators shift their focus to non-agency products.

IFI strategy

Divergent performance across the sector in recent weeks has created pockets of modest value, in our view. Spreads on government-sponsored enterprise (GSE) credit risk transfer securities have widened to more compelling levels, with recent vintage and deeper credit classes underperforming primarily as a result of increased extension risk. Further, we generally remain comfortable with most investment grade credit profiles in the sector and would look to take advantage of credit spread widening driven by primary market supply pressures. Prime jumbo senior classes are an exception, however, as we are more cautious on these profiles, given current agency mortgage-backed security valuations.

US asset-backed securities (US ABS): Fundamental outlook improving, technical trends remain favorable

Rationale

The passage of a third fiscal stimulus and other program extensions should support consumer collateral performance in the near term. In addition, the recent expansion of the vaccine and improving virus trends have strengthened both consumer and business confidence. Our expectations of higher US economic growth and potential further improvement in employment conditions remain longer-term positives. While ABS investor demand has moderated from extremely strong levels earlier in the year, technical trends remain favorable and are further supported by lower than average dealer inventories and normalizing new issue volumes. Several benchmark ABS spreads are at multi-year tights, and spreads on certain other ABS are now inside of pre-pandemic levels. We believe there are opportunities to outperform in select non-benchmark ABS and esoteric assets where fundamental improvements are expected to continue.

IFI strategy

We are focused on higher-rated bonds within the capital structure across benchmark and non-benchmark assets and top-tier names in certain esoteric US ABS sectors. We are also selective as tiering among sponsors and sectors has compressed. We expect positive technical momentum across certain non-benchmark ABS and higher yielding esoteric US ABS to continue, as current spread differentials versus corporates are still relatively attractive, in our view.

Global credit strategy

This section highlights the views of Invesco Fixed Income's credit analysts across a broad range of fixed income assets managed by Invesco.

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What does the American Rescue Plan mean for the state and local municipal sector?

After several weeks of intense US congressional debate and negotiation, President Biden signed the USD1.85 trillion American Rescue Plan on March 11. Unlike prior rounds of federal stimulus, this plan includes USD350 billion of direct aid to state and local governments. Previous attempts to include direct aid in stimulus legislation failed, but January's change in congressional leadership turned the tide.

The USD350 billion of funds support state and local governments by reducing the need to plug budget deficits with additional borrowing. The aid also aims to keep more frontline workers and first responders employed during a time of budget pressure. Historically, local governments have used job cuts as a primary tool to counter the financial impact of economic downturns. Direct aid to states helps local governments, too, since a large portion of local budgets comes from state sources.

The funds will be available from the US Treasury within 60 days, but the pace of state and local spending will probably vary. Approximately 56% of the aid will be directed toward states, 37% toward local governments, and 7% toward tribal governments and US territories.[1] The USD350 billion in funds will be spread across the country, with more populous states receiving larger portions of the total aid.

The American Rescue Plan supports near-term municipal fundamentals
This second round of federal stimulus should further stabilize state finances, since USD195 billion is earmarked for states. According to Moody's, this amount is equivalent to nearly 16% of states' own revenue posted in fiscal 2019.[2] The US economy is also poised for a comeback, especially as vaccines become even more widespread. In addition to stimulus, it is important not to overlook the fact that states and localities can raise taxes, and we think we will see tax increases in 2021. We view the current period as a multi-year budget rebuild, the same way the first few years after the global financial crisis were a time of economic rebuilding.

To be sure, a one-time infusion of funds will not likely change the long-term trajectory of states or local governments with persistent pension funding problems or historically recurring budget deficits. We believe those governments will still need to remedy their budget problems with long-term, structural solutions. However, the stimulus is substantial. While cumulative state tax losses are forecast to reach USD31 billion in the current fiscal year, the federal stimulus being awarded to states is six times greater than this revenue loss.[3] State and local governments may use the stimulus money to reinstate funding where cuts had been made, replenish "rainy day" funds, or infuse momentum into their local economies.

Municipal credit fundamentals have fared better than expected during the pandemic
Although state and local government budgets were devastated by the pandemic, recent revenues have come in stronger than expected. State budget projections made early in the pandemic proved to be mostly pessimistic, and many key revenue drivers have outperformed estimates. Cumulative state revenues declined just 1.6% in the fiscal year ended June 30, 2020, and states estimate another 4.4% decline in fiscal year 2021.[4] The impact of the pandemic, has of course, not been felt equally across all states. States dependent on tourism, like Florida, Hawaii, and Nevada, have been especially hurt, but states with a large proportion of high-earning jobs, like California, Virginia, and Colorado, have seen stable or growing income tax collections.

States' rainy day funds are also at elevated levels. After the strain of the 2008 financial crisis, states spent the better part of the last decade building reserves in preparation for another economic contraction. The median rainy day fund balance was 8% of state expenditures at the start of fiscal year 2020, which is almost double the 2008 median.[5] This progress allowed most states to enter the pandemic with sufficient flexibility to withstand short-term revenue volatility.

The outlook for local governments is relatively sanguine since their primary revenue source is property taxes. Some communities with high exposure to commercial property could see declines in assessed values and tax revenues, but we do not anticipate a large negative hit to property tax revenues. Home prices have generally remained stable or, in many cases, increased during the pandemic.

Case study: Illinois
Illinois is a good example of a state that has faced budget strains in the past and is one of the larger recipients of new stimulus funds. At the height of the pandemic, the state was one of two issuers that borrowed under the Municipal Liquidity Facility. Prior to the pandemic, Illinois had recurring budget deficits, a large and growing bill backlog, and a poorly funded pension plan. Nevertheless, even this headline-grabbing credit has seen its fundamentals improve of late. On March 9, Standard and Poor's (S&P) upgraded the outlook on Illinois' BBB-minus credit rating to stable from negative. According to S&P, "The revised outlook reflects the waning of fiscal and economic uncertainty stemming from the COVID-19 pandemic and subsequent economic downturn."

The USD7.55 billion earmarked for Illinois under the American Rescue Plan cannot address all of Illinois' budgetary issues on its own. But Illinois has taken steps in the right direction by proposing a balanced fiscal year 2022 budget that contains some structural, recurring revenue sources and expenditure reductions. Illinois, like other states and local governments with long-term budget strains, will likely need to implement structural remedies to address future financial needs, but new stimulus supports its ongoing credit improvement.

Conclusion

We expect the Biden administration's latest legislative initiatives to benefit the municipal bond market in 2021 and beyond. It has been a tumultuous year for municipal bond issuers, but, in our view, the impact of COVID-19 has not dramatically changed fundamentals. On the one hand, state and local governments were hit hard by pandemic-related lockdowns, but on the other hand, stimulus packages have provided critical relief. Municipal credits that were on a weaker footing before the outbreak will likely have a harder time navigating the environment, but we expect governments in a stronger financial position to continue to weather the storm well.

1 Source: Preliminary Congressional estimates based on CRS, Census Bureau, HUD data, and Hilltop Securities.
2 Source: Citi, Municipal Weekly, "Will stimulus stimulate performance?", March 15, 2021.
3 Source: https://www.wsj.com/articles/covid-19s-hit-to-state-and-local-revenues-is-smaller-than-many-feared-11612706030 .
4 Source: https://www.wsj.com/articles/covid-19s-hit-to-state-and-local-revenues-is-smaller-than-many-feared-11612706030.
5 Source: https://taxfoundation.org/state-rainy-day-funds-covid-19/.

The bottom line

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What does the US Treasury's cash drawdown mean for the fixed income market?

In the past year, US broad money growth has reached historic highs, primarily driven by reserve growth and securities growth – both on the asset side of banks' balance sheets. Invesco Senior Economist Adam Burton argues that if the US Treasury General Account (TGA) is included, monetary growth was even stronger in 2020. The amount of cash in the TGA reached a historic high of USD1.8 trillion in July 2020 but has been declining recently.[1] As the TGA is drawn down, those funds are transferred to the private sector, boosting spending power. The regulatory requirements for high bank capital ratios may limit banks from expanding their balance sheets, meaning additional money from the TGA might flow into money market mutual funds and short-term securities. If demand for Treasury bills is excessive relative to supply, then it is feasible that Treasury bill rates might turn negative. Either way, the effect of the TGA drawdown is to increase the quantity of money held by the public. We speak with Adam and members of the Invesco Fixed Income team for their perspectives on the potential implications of the TGA drawdown for the fixed income market.

Q: What has happened to the US money supply in the last year, and why are we monitoring it?

Adam: In the last year, the growth rate of the US broad money supply (M2) has increased from 6%-7% year-over-year, pre-COVID-19, to now over 25%.[2] The reason it is important to monitor the money supply is that it drives the business cycle, and sustained periods of excessive growth in the money supply can lead to inflation. We agree with American economist Milton Friedman who famously said, "Inflation is always and everywhere a monetary phenomenon."

Q: What is the Treasury General Account (TGA), and why does its drawdown pose a potential concern for investors?

Adam: The TGA is the deposit account of the US Treasury at the Fed. Normally the US Treasury does not hold much cash (around USD300 to USD500 billion), but the demand for US Treasury bills (Treasury securities with maturities of less than one year) was so high between March and June of 2020 that the US Treasury ended up raising an historic amount of cash (USD1.8 trillion as of July 2020).[3] This cash is effectively waiting in reserve (not being used to purchase assets, goods, or services), and when it is spent in the private economy, it will boost the broad money supply (M2). Stimulus checks from President Biden's fiscal stimulus package, for example, will be funded via the TGA.

Q: What could the drawdown of the TGA mean for the US money market?

Marques: The drawdown of the TGA has already had a significant impact on the US money market. The US Treasury has reduced the TGA by reducing its Treasury bill offerings in its weekly auctions. This has decreased Treasury bill supply, putting downward pressure on short-term interest rates. This is happening at a time when demand for US Treasuries is high due to strong demand for short-term securities in general. We expect this supply-demand imbalance to grow, causing Treasury bills and overnight repurchase agreements to trade even closer to the Fed's lower bound of 0%.

The recent passage of the USD1.9 trillion fiscal stimulus package by the US Congress should help to stabilize the supply of short-term Treasuries temporarily. Part of the stimulus will likely be funded by the TGA, but some will likely be funded by Treasury bills. So, the decrease in Treasury bill supply could be slower than expected, relieving some of the pressure on Treasury bill rates and decreasing the risk of negative Treasury bill rates for now.

Bryn: Another factor is banking sector regulation. The TGA is considered a liability on the Fed's balance sheet, and the drawdown of the TGA has the direct effect of increasing reserves in the US banking system. As US bank reserves increase, banks could turn away additional deposits and/or decrease their assets to stay in line with regulatory leverage ratios, such as the supplementary leverage ratio (SLR), which is a measure of a bank's capital adequacy (more on this below). If banks turn away deposits, cash from the TGA could end up in money market mutual funds, which would likely increase the demand for short-term securities. At the same time, if banks decrease their assets, there will likely be less collateral available for repurchase (repo) transactions. This combination could exacerbate the supply-demand dynamic in the repo market, creating additional downward pressure on short-term interest rates. The Fed has the ability to step in and help offset some of that extreme pressure by lifting the 0.0% floor on its overnight reverse repo program and raising the USD30 billion per counterparty limit (which it did in mid-March to USD80 billion).[4]

Nevertheless, we could see periods of market stress (at month and quarter-ends) that could cause Treasury bills to trade with negative yields in the secondary market and lead the secured overnight financing rate (SOFR) to stay close to the lower bound of 0%.

Q: How does the Fed's decision to let SLR relief expire impact this market dynamic?

Jay: In 2020, in response to the COVID-19 pandemic, the Fed relaxed the SLR calculation to allow banks to temporarily expand their balance sheets. Under current SLR relief, bank holdings of US Treasuries and cash reserves deposited with the Fed are excluded from the SLR calculation. Now that the Fed has announced it will let the relief exemption expire at the end of Q1, as originally planned, banks will have to include those holdings as part of their SLR calculation (equity/assets). Though the relief will expire, the regulatory minimum SLR should not be a limiting factor for those banks at most risk until Q2 or Q3, absent mitigating factors.

We would expect the end of SLR relief to cause a handful of larger banks' leverage ratios to decline and potentially breach regulatory minimums. If unaddressed, this would likely limit their ability to assume additional deposits. Exacerbating the limitations, some of the banks most affected have already announced they have no plans to pause or reduce share repurchases, which reduce equity that could otherwise be used to absorb at least a portion of the expected deposit growth.

We believe the broader effect of the drawdown of the TGA will probably be negligible for two reasons. First and foremost, the expected growth in the deposit base will likely be absorbed elsewhere in the banking system, e.g., by trust banks or larger regional banks that currently have more balance sheet capacity above their regulatory leverage minimums. Second, the affected banks have a few levers they could pull to manage their balance sheet capacity and continue to take deposits if they would like, although there are trade-offs to those options as well.

I believe the main concern of the TGA drawdown, as it relates to the expiration of SLR relief, lies more within the short-term overnight repo funding markets and whether banks would step back from those transactions to preserve balance sheet capacity for more profitable business, especially around quarter-end dates.

Q: What are the implications of the TGA drawdown for the broader markets and the economy?

Adam: Overall, the effect on markets and the economy is a roughly USD815 billion boost in the broad money supply (as estimated by the Quarterly Refinancing Statement from the US Treasury), which could continue to boost asset prices across the board (equities, real estate, commodities) and could place further pressure on inflation expectations and the US dollar.[5]

1 Source: US Federal Reserve. Data as of July 31, 2020.
2 Source: US Federal Reserve. Data as of February 28, 2020 and February 28, 2021.
3 Source: US Federal Reserve. Data as of July 31, 2020.
4 Source: US Federal Reserve, March 18, 2021.
5 Source: US Department of the Treasury. Quarterly Refunding Statement as of February 3, 2021, for Q1 2021.

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