US Macroeconomics | SMBC Capital Markets

November 3, 2022

Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

Liquidity Is Drying Up. Will It Continue?

Bond market liquidity continues to deteriorate as measured by the Bloomberg US Government Liquidity Index and shown in the chart below. Declining liquidity is seen by a rising index and vice versa. Think of the index as measuring stress in the treasury market. Why does this matter?

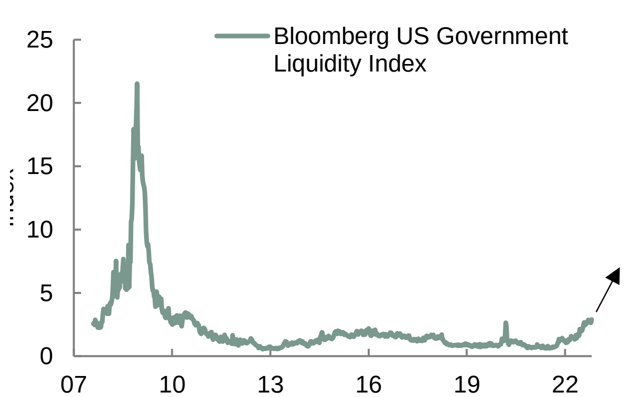
At approximately $24 trillion in size, the treasury market is the deepest and most liquid market in the world. Moreover, treasury securities are the benchmark for pricing all other fixed income instruments and are used in various ways to measure fair value among different asset classes such as stocks. **Worsening liquidity conditions could presage systemic financial market risks** as was the case during last decade's financial crisis in 2008 and 2009.

At present, **treasury liquidity is relatively tight with the Bloomberg metric at its highest reading since the height of the pandemic stress**. Thankfully, market liquidity is still more ample than what was the case in 2008 but the situation could change because of two factors: One is additional treasury supply, and the other is shrinkage of the Fed balance sheet.

The second chart below shows the Treasury Department's projected marketable borrowing needs for this quarter and next. They are estimated at $1.1 trillion, which is the third largest sum on record. **Current borrowing needs have only been eclipsed during the quarters immediately following the onset of the pandemic and the two quarters ending Q1 2022**.

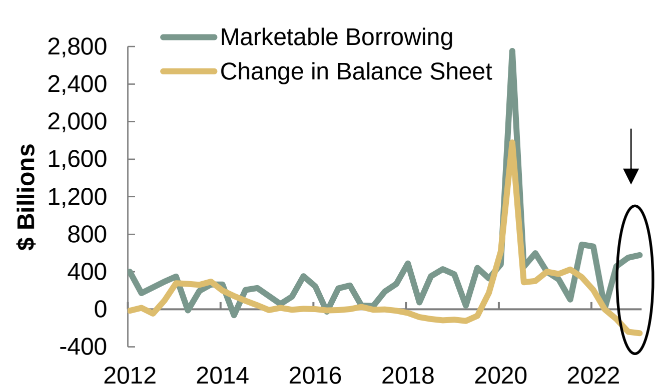
However, unlike the recent past, **the Fed is now shrinking its balance sheet and is doing so at nearly three times the pace as the 2017 to 2019 QT**. Last month, the Fed's portfolio of securities declined by $83 billion. The fact the Treasury's borrowing needs are rapidly rising at the same time the Fed is dialing back its purchases could put further stress on the bond market. This would be evident from a further deterioration in liquidity and hence concurrent rise in systemic financial risks.

US Treasuries - Deterioration in Liquidity



Sources: Bloomberg

Treasury Supply Up, Fed Purchases Down



Sources: Bloomberg, Haver, SMBC

Disclaimer

This presentation is for discussion purposes only and is not intended to be an offer to sell or the solicitation of an offer to buy any securities, or any commitment to underwrite, subscribe for or place any securities, is not an offer or commitment to provide any financing or extension of credit or service, and does not contain any tax or legal advice. This presentation has been prepared by SMBC Group (which may include, collectively or individually, any of the following entities in the Americas Division: Sumitomo Mitsui Banking Corporation ("SMBC"), SMBC Nikko Securities America, Inc. ("SMBC Nikko"), SMBC Nikko Securities Canada, Ltd. ("Nikko Canada"), SMBC Capital Markets, Inc. ("SMBC-CM"), SMBC Leasing and Finance, Inc., JRI America, Inc., and SMBC Rail Services LLC) and is being furnished by SMBC Group solely for use by the client or potential client to whom such materials are directly addressed and delivered. This presentation is confidential and is the property of SMBC Group subject to copyright. Any reproduction of this presentation, in whole or in part, is prohibited, and you may not release these materials to any person, except to your advisors and professionals to assist you in evaluating these materials, provided that they are obligated, by law or agreement, to keep the presentation confidential. These materials do not constitute research, a recommendation or an offer or solicitation to any person to enter into any transaction or adopt any hedging, trading, or investment strategy. Prior to participating in any such transaction, you should consult your own independent, competent, legal, tax, accounting, and other professional advisors.

In preparing this presentation, SMBC Group has relied upon information available from third parties, including public sources, and we have assumed, without independent verification, the accuracy and completeness of such information. Specific prices, indices, or measures, including ranges, listed in this document were prepared at the time the document was prepared, and are subject to change without notice. SMBC Group makes no representations to and does not warrant this presentation's accuracy or completeness. SMBC Group expressly disclaims any liability for any use of the information set forth herein, including, without limitation, any use of the information set forth herein in the preparation of financial statements or accounting material.

These materials may contain forward-looking statements, which may include projections, forecasts, income estimates, yield or return, future performance targets or similar analysis. These forward-looking statements are based upon certain assumptions. All forward-looking statements are based upon currently available information and SMBC Group is not obligated to provide an update. Actual events may differ from those assumptions. Opinions, projections, price/yield information and estimates are subject to change without notice. There can be no assurance that estimated returns or projections will be realized, that forward-looking statements will materialize or that actual results will not be materially lower than those presented. Past performance is not necessarily indicative of future results. Any transactions or strategies addressed may not be suitable for all parties. The value, price or income from transactions or strategies may fall as well as rise. SMBC Group or an affiliate may have a position in any of the underlying instruments, assets, indices, or rates mentioned in this document. You should make your own independent judgment or seek independent financial and tax advice with respect to any matter contained herein.

SMBC is subject to Japanese firewall regulations and therefore absent client consent, non-public client information may not be shared with SMBC Nikko Securities Inc.

SMBC Nikko is a U.S. registered broker-dealer of SMBC Group. Nikko Canada is a U.S. and Canadian registered broker-dealer of SMBC Group. SMBC-CM is provisionally registered as a U.S. swap dealer with the CFTC. Capital markets and other investment banking activities for SMBC Group are performed by a combination of SMBC Nikko, Nikko Canada, SMBC Nikko Securities Inc. and SMBC-CM. Lending and other commercial banking activities are performed by SMBC and its banking affiliates. Derivative activities may be performed by SMBC-CM or SMBC. SMBC Group deal team members may also be employees of any of the foregoing entities. SMBC Group does not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with SMBC Group or for the purpose of avoiding U.S. tax-related penalties.