The Fed's Role in Rescuing Short Yields

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The bond market focus over the last month has been squarely on the sharp selloff on the long end of the yield curve, but short yields are threatening to sink into negative territory if the Fed doesn't step in. The short end has been anchored near zero for the last 12 months by the Fed's overnight rate target, but downward pressure is threatening to increase significantly in the coming months as the demand for treasuries overwhelms the fast dwindling Treasury-bill supply.

The extreme demand reflects a 25% year-over-year surge in the M2 money supply resulting from massive government pandemic relief spending. The expected passage of the $1.9 trillion "American Rescue Plan" will immediately add another $450 billion to household coffers. *All this cash has to go somewhere.* At the same time, the Treasury is required by congress to reduce its inflated cash position at the Fed by almost $1.5 trillion by August 1st in preparation for what's likely to be a heated debt ceiling debate this summer, and has announced it will *issue significantly fewer T-bills in the coming months.*

The U.S. government isn't permitted to sell debt at a negative yield, but that doesn't mean yields can't trade significantly below zero in the secondary market.

Since T-bills and money market funds act as safe harbors during periods of financial stress, the fraying of this essential safety net would likely exacerbate future market problems.

Money market funds have slashed management fees for months to keep rates positive. According to the *Office of Financial Research*, balances in U.S. money market funds totaled over $4.5 trillion at the end of January, with about 75% of these deposits held in government funds. If short yields turned negative for any length of time, money market funds would be hard-pressed to survive. Since T-bills and money market funds act as safe harbors during periods of financial stress, the fraying of this essential safety net would likely exacerbate future market problems.

The Fed's policy-making Federal Open Market Committee (FOMC) meets next Tuesday and Wednesday. Committee members have made it clear they don't intend to make changes in QE asset purchases, or to the overnight fed funds target. However, they could make a couple of technical adjustments to address supply imbalances.

The easiest and least disruptive patch would be to increase the rate known as interest on excess reserves (IOER), or *the interest rate paid to banks on cash balances held with the Fed*. By raising this rate by even 5 bps, banks would have greater incentive to park excess dollars with the Fed rather than buying short Treasuries. This response would free up supply and in turn allow a slight boost in market yields.

The fact that Treasury debt issuance has increased by over $4 trillion since the pandemic began, while Fed officials debate solutions to keep short rates from dropping below zero, indicates an impaired market.

Another remedy would be to reinitiate the "operation twist" program last used by the Fed in 2011-2012, whereby short securities are sold from the Fed's asset portfolio while longer securities are purchased. This reallocation accomplishes two key objectives: lowering long yields and boosting short yields.

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Market Indications as of 11:00 A.M. Central Time

DOW	UP 400 to 32,233 (NEW HIGH)
NASDAQ	UP 76 to 13,150 (HIGH: 14,095)
S&P 500	UP 33 to 3,908 (HIGH: 3,934)
1-Yr T-bill	current yield 0.08%; opening yield 0.08%
2-Yr T-note	current yield 0.16%; opening yield 0.16%
5-Yr T-note	current yield 0.80%; opening yield 0.81%
10-Yr T-note	current yield 1.52%; opening yield 1.53%
30-Yr T-bond	current yield 2.25%; opening yield 2.23%