US Rates Strategy

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Investor immobilization

Unlike in other markets, the Iran conflict has so far hardly created a ripple in short-term funding markets. Outside of the shift in policy expectations, there has been no defensive 'dash for cash.' But traditional measures of liquidity flight are distorted by the mid-April tax payment deadline. Could stablecoins provide more information?

- **Short-term funding markets show little to no signs of liquidity hoarding or defensive behavior**. Repo rates have fallen since the start of the conflict and CCPs are not shifting balances onto the Fed's balance sheet.

- Ahead of the mid-April tax payment deadline, institutional gov-only money funds balances typically fall and the Treasury trims bill issuance in anticipation of heavy cash inflows. This makes looking for signs of defensive behavior in the front-end difficult.

- **As stablecoins are not used to pay taxes they *might* provide a cleaner perspective on investor flight-to-liquidity behavior**. Stablecoins outstandings are unchanged this quarter at $275bn. **But transactions volumes have fallen sharply in March and there has been a decline in active addresses**.

- **We believe this behavior is consistent with investor 'immobilization'**. Broadly, investors appear to be waiting for clearer direction in all markets before they consider retreating to cash.

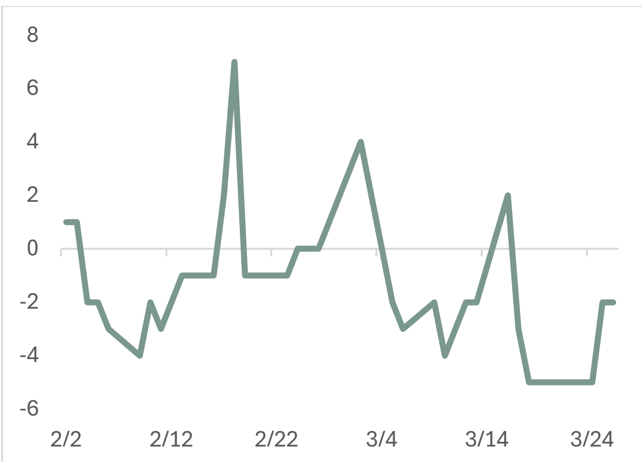
What flight?

In past shocks like COVID, investors have moved into cash instruments for safety and liquidity. Demand for bills increased and balances flowed into deposits at large banks and gov-only money funds. At the same time, lenders stepped back from lending in the repo market and held onto their cash. Our expectation was that investor behavior would show similar patterns after the start of the Iran conflict.

Instead, short-term markets have been calm and there are few signs of cash hoarding. Since the end of February, overnight repo rates have fallen about 3bp (Figure 1) and trading volumes – in both cleared bilateral and overnight tri-party repo have slipped. Bill yields are only 2bp lower. Meanwhile balances in gov-only institutional money funds have fallen nearly $80bn (2.9%). Balances at large domestic banks have increased just $23bn or 0.2% through mid-March. CCPs do not appear to be behaving defensively. Since the start of the conflict, CCP balances at the Fed have held steady around $240bn (Figure 2).

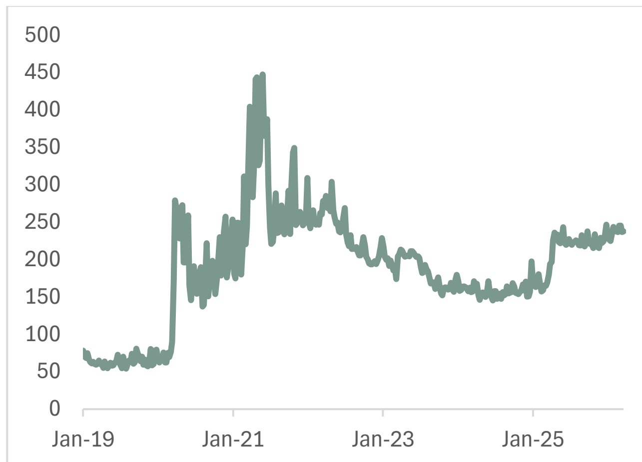
However, it is possible that any evidence of a flight to cash is being obscured by seasonal flows related to the mid-April tax date. Ahead of the payment deadline, businesses typically start withdrawing money from their gov-only money fund accounts to remit to the Treasury. This year's money fund outflows are running about $60bn more than last year's pace suggesting that corporate tax receipts could be strong this quarter (Figure 3). That said, receipts to date have been a bit lighter than last year. We do not think these heavier-than-normal redemptions reflect an investor shift from gov-only funds directly into bills as both are highly liquid. Since the IEEPA reversal, tariff revenues have fallen, although it remains to be seen how much revenue will be recovered from the temporary Section 122 duties. Bulk receipts paid into the Customs Bureau were $17bn in March compared to a Q4 average of just over $20bn.

Figure 1: Tri-party less IORB (bp)



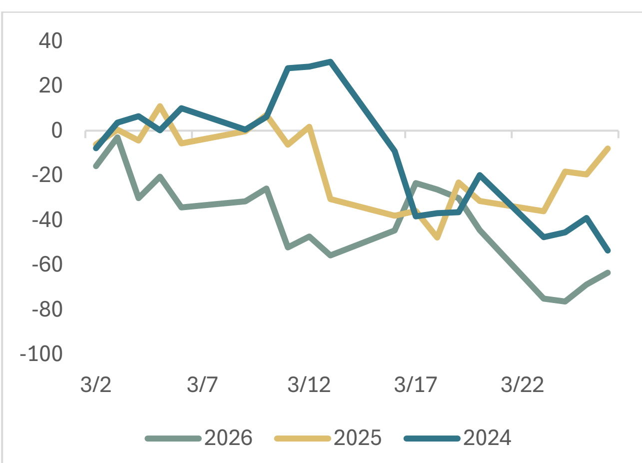
Source: Federal Reserve, SMBC Nikko

Figure 2: CCP deposits ($bn)



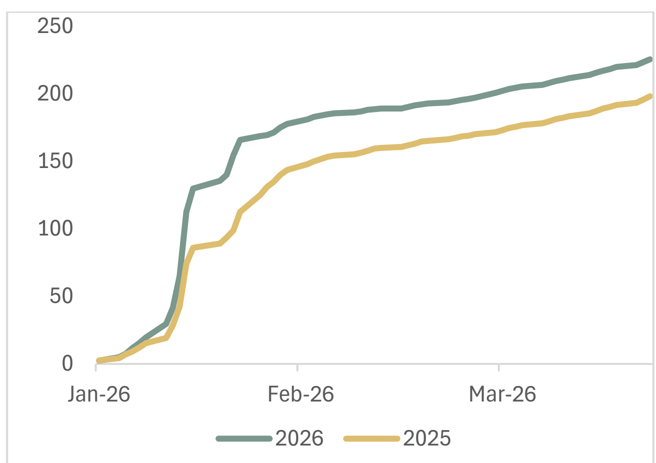
Source: Federal Reserve, SMBC Nikko

Figure 3: Gov-only outflows ($bn)



Note: Institutional balances only. Cumulative change from last day in February. Source: Crane's Data, SMBC Nikko

Figure 4: Non-withheld tax payments ($bn)



Note: Cumulative inflow since January 1. Source: US Treasury, SMBC Nikko

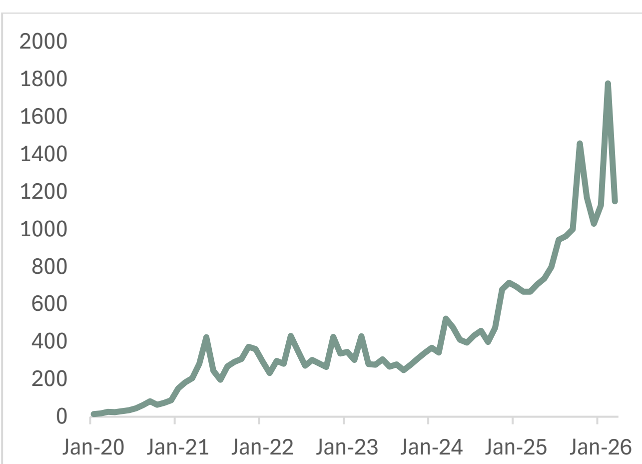
Household tax payment patterns are a little harder to discern in part because retail money fund balances do not have the same seasonality as institutional balances. Our sense is that retail payments for non-withheld taxes on capital gains are just as likely to come out of bank deposits. **That said, the Treasury is receiving heavy non-withheld tax inflows – balances are 12% above last year's pace** (Figure 4). With strong cash flows, the Treasury has already begun paring bill issuance. Since the conflict began, bill supply has shrunk ($23bn) with most of the reduced issuance coming in the last two weeks ($64bn). We believe this accounts for the roughly 2bp decline in bill yields. Given the Treasury's heavy reliance on shorter maturity bills rather than cash management bills, we expect supply to decline further in coming weeks. We expect the Treasury to eventually reduce bill supply by $300bn after April 15.

Stablecoins

Seasonal tax-related distortions make it difficult to get a clear sense of any investor flight into cash. **As stablecoins are less likely to be used to make tax payments, their behavior *might* provide some clues about investor defensiveness**. Like money funds, stablecoins maintain par by holding short-maturity assets like bills and repo. In theory, this property should attract defensive investors nervous or uncertain about the direction of markets. Admittedly, as crypto native instruments, their insights might be limited to assets like bitcoin which has proven to be less of a risk-hedge than other assets.

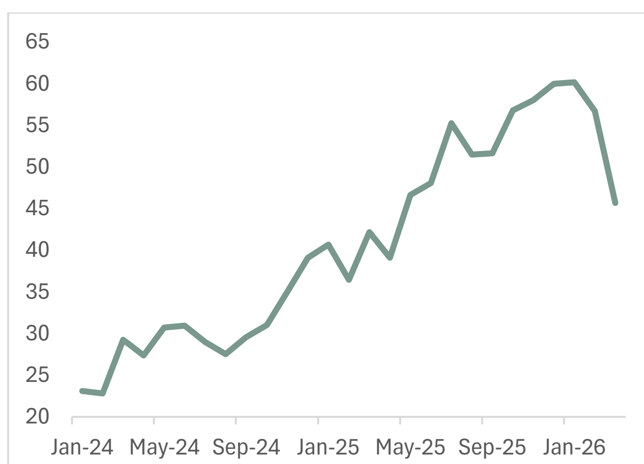
Since the conflict began, stablecoin balances have been steady. There has been no sign of inflows from investors leaving other crypto assets for the safety of par instruments. At the same time, investors are not shifting out of stablecoins or moving into more traditional forms of liquidity such as bank deposits. Balances have held steady at about $275bn since December. **Our sense is that unless the shock directly involves the crypto markets, money tends to stay invested in the sector – moving between cypto and stablecoins**. That said, there have been instances where balances shift from one stablecoin to another. After the collapse of SIVB briefly caused USDC to de-peg, stablecoin balances flowed into USDT. But even during the "crypto winter" from November 2021 to November 2022 where bitcoin prices fell 70% balances in the two largest stablecoins were largely steady at $120bn.

Figure 5: Stablecoin transaction volume ($bn)



Source: Visaonchainanalytics, SMBC Nikko

Figure 6: Average active addresses (m)



Note: USDC and USDT. Source: Visaonchainanalytics, SMBC Nikko

We also examined transactions volumes along with the number of active addresses. **In March, stablecoin transactions volumes fell sharply** (Figure 5). Likewise, the volume of active stablecoin wallets that were sending and receiving transactions on public blockchains fell in March (Figure 6). Because stablecoins are gateway assets for other crypto assets, their movement tends to be correlated with the price of bitcoin. As bitcoin prices fell steeply in January and February, it is possible that the heavy selling pushed stablecoin transactions volumes up sharply at a few wallets. Once prices stabilized, stablecoin transactions declined.

Our sense, however, is that the decline in trading volume and active wallets this month reflects a broader immobilization effect that can be seen in other markets. Investor uncertainty is keeping money locked into stablecoins until the direction of the broader crypto market becomes clearer. **Similar immobilization may account for last week's poor Treasury auctions following the volatile shifts in yields since the conflict started**. It is unclear if this is a prelude to a broad-based dash for cash.

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