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.

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**US Treasuries - Deterioration in Liquidity**

**Treasury Supply Up, Fed Purchases Down**

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Sources: Bloomberg, Haver, SMBC
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