

December 3, 2024

## RRP and Funding and Rates Volatility

### Expect It to Continue into 2025

- We expect the Fed to cut the RRP rate in December, but we think it will have little effect on money market rates
- iFlow shows the extent to which front-end volatility leads to large investor swings daily
- Monetary policy uncertainty and overall UST volatility are correlated

We expect the Fed to lower its policy rate by 25bp at the next meeting on December 18. Along with that we also expect to see the administered interest rate on reverse repo balances (RRP) lowered by 30bp, placing it at the bottom of the new target band for the federal funds rate, or 4.25%. We don't think this will have much of an effect on other money market rates, however.

In its minutes from the November 7 meeting, the FOMC telegraphed this likely change in the RRP rate. In the section on current conditions and the economic outlook, we were told that “some participants remarked that, at a future meeting, there would be value in the Committee considering a technical adjustment to the rate offered at the ON RRP facility to set the rate equal to the bottom of the target range for the federal funds rate...”

Earlier in the minutes, it was reported that the Fed staff briefed the Committee on the possibility of a technical adjustment to the RRP rate as part of its advice on balance sheet issues. It was asserted by the Staff that “lowering the ON RRP offering rate 5 basis points would align the ON RRP offering rate with the bottom of the target range for the federal funds rate and would probably put some downward pressure on other money market rates.”

We don't think this operation, although probably appropriate policy for other reasons, will actually lower rates across the money markets. The idea behind the assertion is that lower RRP rates would disincentivize money market mutual funds (MMFs) from parking cash in this facility at the Fed and would instead make them willing to lend it in repo, increasing the supply of cash and lowering its price (i.e., lowering the repo rate). We just don't think the arithmetic adds up.

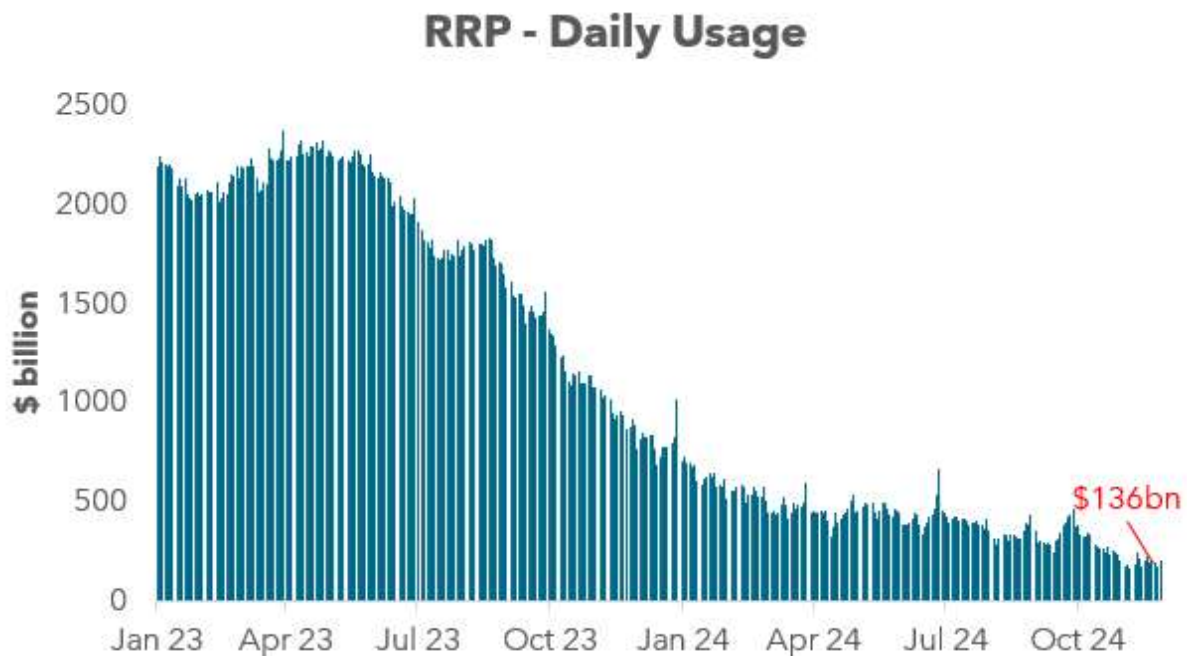
Currently volumes in the tri-party repo market are around \$4trn per day. On Monday, the New York Fed's RRP facility accepted just \$136bn (primarily) from MMFs. The latter quantity is just 3% of the former. If all the cash in RRP flowed into repo instead, it would be like a drop in the bucket. Back in early 2023, when RRP was in the trillions of dollars, such a move from the

Fed might have made a difference, but at that time repo rates were not especially elevated or volatile as they are now, and cash was in excess across the markets.

The RRP facility, of course was set up to help enforce the floor of the federal funds rate's target band. If there is an abundance of cash in the market, it could flow into the federal funds lower bound, unless there is an instrument that offers a competitive rate to the funds rate floor. Moving the RRP rate to the same level as the fed funds lower bound would still allow the facility to keep the effective funds rate within the band, and there is no need for the Fed to keep RRP above the floor for this purpose.

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### Exhibit #1: Little Left in RRP



Source: BNY Markets, Federal Reserve Bank of New York

Front-end rate volatilities have been picking up, and we've written about it a great deal. The September quarter-end period was especially challenging, and we wouldn't be surprised to see a reprise at the end of this month, coinciding of course with quarter- and year-end. Our client flows show that this volatility has been reflected in real money investing in short duration US Treasuries and cash and cash-like instruments.

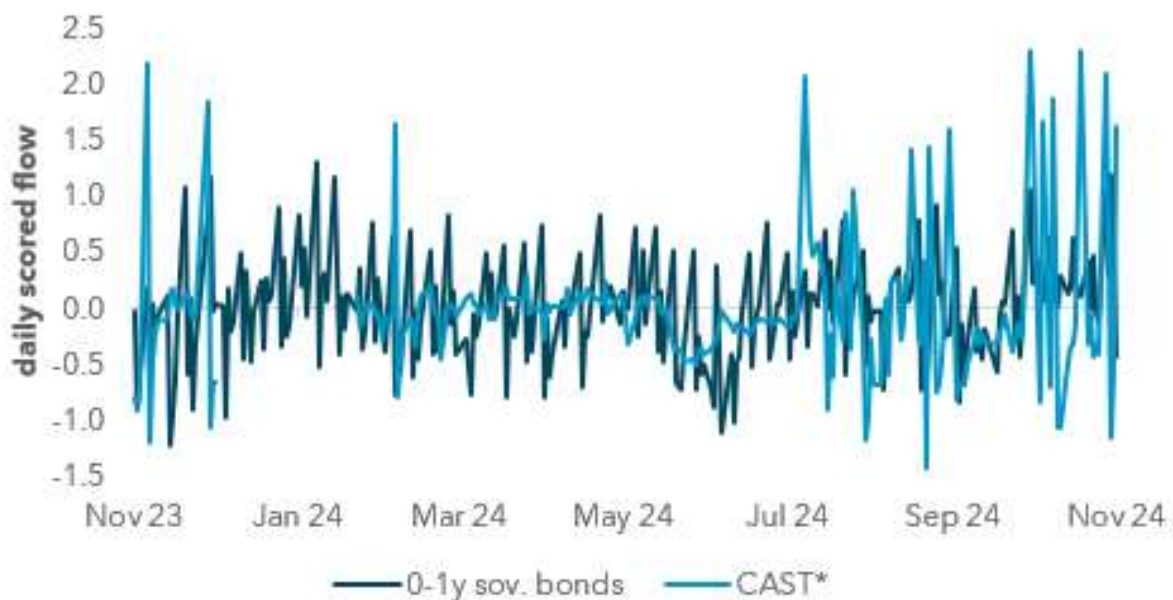
In Exhibit #2, we show the daily scored flow into both the 0-1y section of the UST curve as well as into a segment we call CAST – cash and short-term instruments. Particularly for the cash and cash-like grouping, we can see large daily swings in investor behavior, and these swings have been becoming more frequent and more intense since the end of July.

Given that we expect funding market volatility to pick up into the end of the year, we don't expect these gyrations to subside during the next month. Indeed, we would expect that such jumpy flow behavior will continue in the next year. Uncertainty about Fed rate policy, especially in the context of potential Trump administration policies and policy volatility, frictions in money markets (on which we have reported before – see [here](#), for example), and general balance sheet issues will keep the money markets volatile, and rates elevated.

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### Exhibit #2: Volatile Front-end Flows

## iFlow - Short Duration USTs and CAST\*



Source: BNY Markets, iFlow. \*Note: CAST = Cash and short-term instruments

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Front-end volatility is, not surprisingly, associated with broader interest rate and bond market volatility, but we would argue that currently elevated fixed income vol is being driven by uncertainty surrounding Federal Reserve rate policy. There is a clear relationship between central bank policy uncertainty and overall rate vol, as one would intuitively suspect.

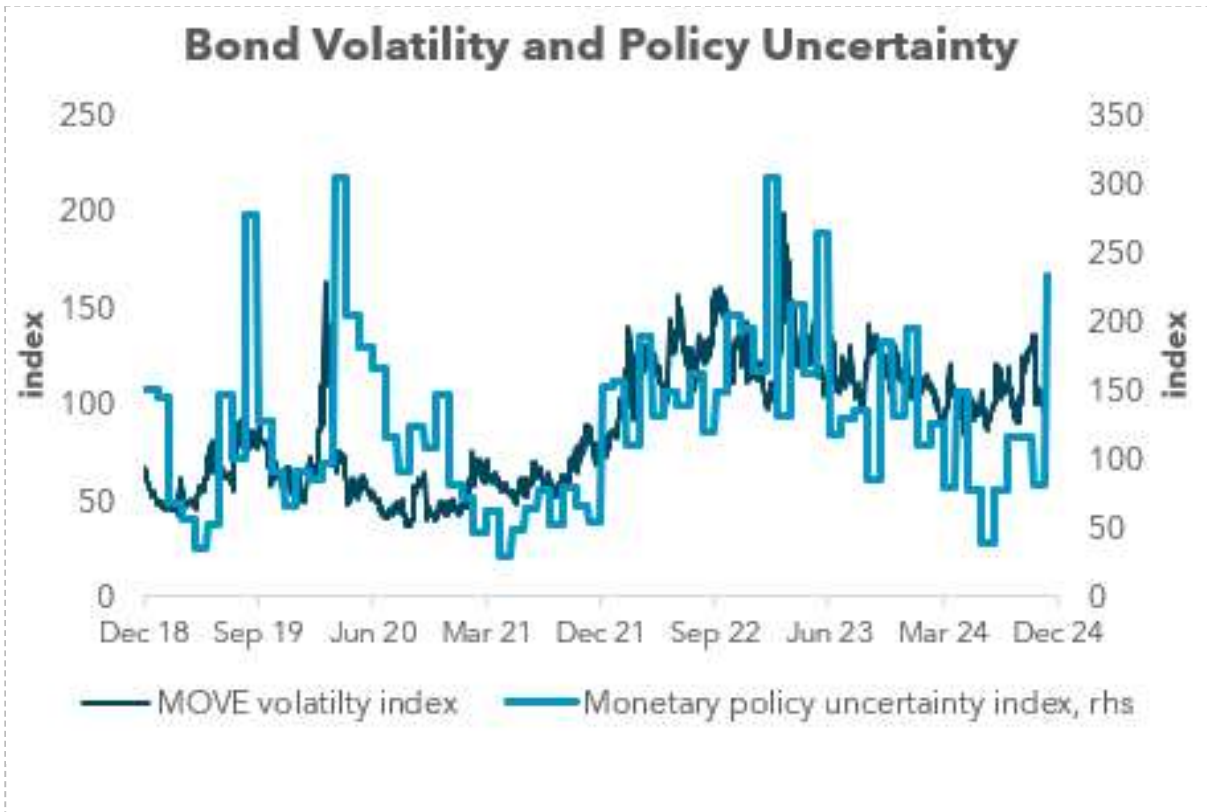
In Exhibits #3 and #4, we show the MOVE index of US bond volatility against an index of monetary policy uncertainty and fed funds futures trailing volatility, respectively. In the first case, we can see that over long periods of time, including before the pandemic, monetary policy uncertainty coincides with rate volatility. To measure this, we use the Baker, Bloom, Davis Monetary Policy Uncertainty Index (see [here](#)), which tracks the concept by scanning a number of news sources for keywords revealing uncertainty. Note that the most recent MPU reading for December is quite high, suggesting that the MOVE index will increase as well.

In the second exercise, shown in Exhibit #4, we calculate the realized volatility (measured by its 22-day standard deviation) in the generic 12th federal funds futures contract, a view on where policy rates would be expected to be in a year's time. When this short-end vol jumps, so does overall rate volatility, as revealed by the MOVE index.

We are fairly highly convicted on the next FOMC action, a 25bp cut on December 18. Thereafter, it gets less clear to us. Fed expectations have gyrated greatly since the end of the summer, and the outlook for the new administration's policy specifics is also unclear. Under a "steady state" scenario, without large policy shocks from the new administration and Congress, we see a gradual reduction in rates throughout next year, with the likeliest path showing four cuts throughout the year occurring at every meeting which features a Summary of Economic Projections (i.e., March, June, September and December). However, this is highly uncertain, to coin a phrase. Like the FOMC, which didn't mention the election or its policy implications in the minutes, we will have to see what is proposed and implemented over time. Tariffs, fiscal expansion and immigration policy are biased to produce higher inflation not lower and could very well – and indeed likely will – induce the Fed to be more cautious and deliberate. This uncertainty is translating into bond market volatility, which is likely to persist well into 2025.

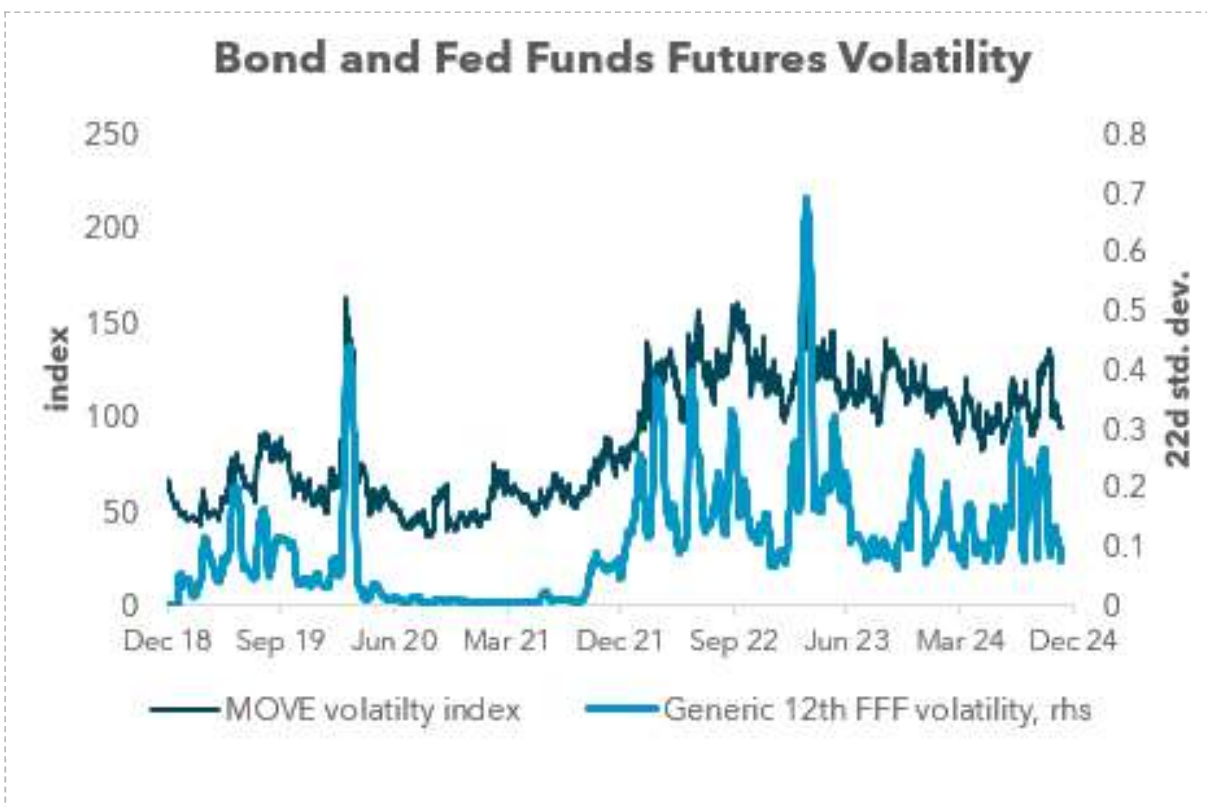
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### Exhibit #3: Monetary Policy Uncertainty Is Elevated...



Source: BNY, Markets [policyuncertainty.com](https://policyuncertainty.com), Bloomberg

### Exhibit #4: ... While Fed Funds Futures Vol Has Settled Down, for Now



Source: BNY Markets, Bloomberg

Please direct questions or comments to: [iFlow@bny.com](mailto:iFlow@bny.com)

### Disclaimer & Disclosures



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