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RATES

US Money Markets: Value in extensions given the aggressive Fed discount

The Fed has hiked and the market is positioned for more. Moreover, the discount is there for maintaining an elevated funds rate for a prolonged period. We think this is overdone and presents value in longer tenors (nine months to two years). Pickups into credit remain mild, so an extension on the core product is good enough. Liquidity remains supportive



The Federal Reserve raised interest rates by 25bp in September. Markets are expecting more rate hikes, but we see rate cuts in 2027 and into 2028

The call on the Federal Reserve

Fed Chair Kevin Warsh delivered on the market discount, and did so after all the talk that this Federal Reserve would do things differently. It was still an eloquent performance. The 2yr was a tad spooked by the Committee's unanimity on the 25bp hike (Chair Warsh voted for it too) and the implied priming for another hike from the dot plot. Since then, the rate hike discount has hardened and intensified further. The carry spread (Fed funds rate to the 3yr) is back out to 100bp. Neutrality on that spread is about 30bp, so the remaining 70bp is a rate hike discount.

Ahead, we think there are enough rate hike fears discounted at this juncture. Remarkably, the current 10yr SOFR is priced as if the funds rate is heading to 5% and will average here for the coming 10 years. That seems to be quite an aggressive long-term discount, even if the Fed does overshoot to the upside as a theme for the remainder of 2026. More likely, in our opinion, is that the Fed ultimately turns tail and cuts rates in 2027 and 2028, where a return to the 3.5% area is anticipated.

The Fed balance sheet narrative

Since the Fed recommenced T-bill buying in mid-December 2025, it has bought a cumulative \$360bn. Overall, the Fed's holdings of all securities (including bills) are up \$235bn, to almost \$6.4tr.

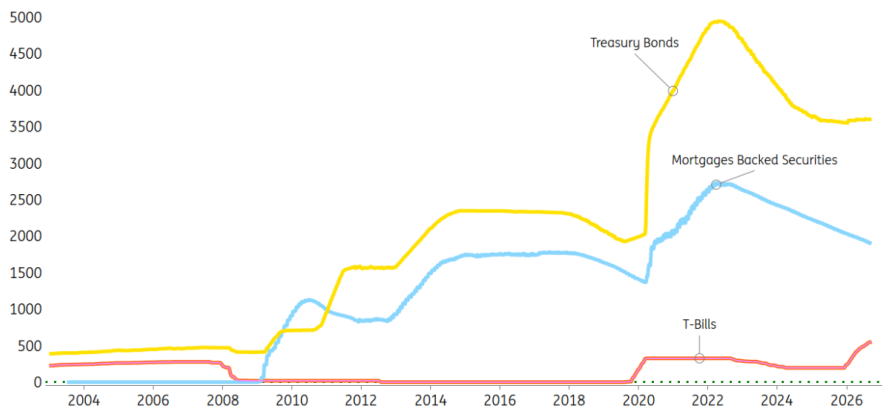
Chair Warsh came into the job in the wake of various suggestions that the Fed should reduce the size of its balance sheet. We covered the issue [here](#), and noted that at the end of 2005, the Fed's balance sheet was about 5.5% of GDP. Roll on 20 years, in and out of the global financial crisis (GFC) and pandemic, and it's now 21% of GDP (quadrupled). The driver was bond buying. Total bonds held by the Fed were around 5.5% of GDP 20 years ago. That now equates to 20% of GDP (almost quadruple). Bank reserves were purely regulatory in nature and a puny 0.1% of GDP 20 years ago. Today's bank reserves are closer to 10% of GDP (100-fold).

Warsh wants to 'fix it', it seems. The technicalities could require the sale of all mortgage-backed bonds (\$1.9tr) and at least half of the Treasury bonds (c.\$3.6tr). So that's some \$4.5tr in total, and would bring Fed bond holdings back down to around 5.5% of GDP (pre-GFC proportions). That in itself is big, and raises questions about a doable pace.

On the other side of the balance sheet there is the complication of transitioning from the current excess bank reserves environment back potentially towards a scarce regulatory bank reserves environment. On the former, a Congress-legislated special purpose vehicle tasked with taking the bonds off the Fed's balance sheet has been mooted (so they would not be 'sold'). On the latter, an easing in bank liquidity ratios would be required.

For now, it's all quite speculative. But what we do know is that Warsh can't simply sell bonds and stop there. He would need to address both sides of the balance sheet and make regulatory changes to bank liquidity requirements.

The Fed's bond and bills holdings



Source: Macrobond, ING estimates

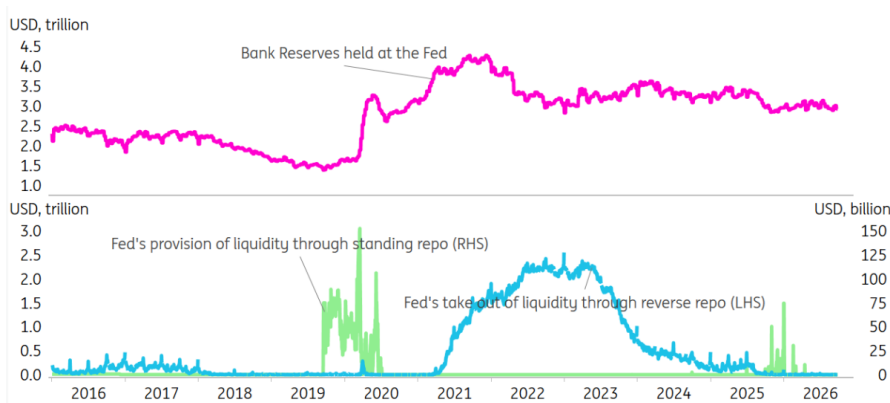
Then there is the complication of a transition from the current excess reserves environment, potentially back towards a 'scarce reserves' environment, as indicated by Warsh (but without specifics). Selling the bonds is relatively straightforward; far less straightforward is how to get back to the prior regime for reserves management and how the funds rate is set, along the way, and in the future.

One aspect that can help here is the revision to the leverage ratio requirements as of 1 April 2026. The fact that the larger banks now have more capacity to buy Treasuries and/or engage in repo is a benefit. The weak link in the current structure has been the capacity for tightness in repo to bully the effective funds rate higher, primarily on a relative-value play. Larger banks in the game act to tame the tendency for repo to over-tighten at times.

There is a link here with reserves, too, as the Federal Reserve has reverse-engineered a logic that repo tightness was associated with the fall in excess reserves to a level that exacerbated repo tightness. While a clear link between the two is not necessarily obvious, one does exist. We saw the same when the Fed went through its first quantitative tightening exercise in 2019, which culminated in a brief but severe repo tantrum. It was calmed through the Fed's decision to buy bills from December 2026, and that policy continues as we head through the remainder of 2026.

Bank reserves at the Federal Reserve

Alongside the Fed's repo (adding liquidity) and reverse repo facilities (taking out liquidity)



Source: Macrobond, ING estimates

The effective funds rate used to trade just 8bp above the funds rate floor. The ratchet higher to 14bp in September/October 2025 prompted the policy of renewed T-bill buying. The back story saw bank reserves dip below US\$3tr, and repo had shown a marked tendency to tighten, with bank reserves at sub-\$3tr. That repo tightness, in a relative value sense, was the genesis of the relative rise in the effective funds rate.

It is currently (3.88%), just 2bp below the rate paid on reserves (3.90%). It's actually tough to get to 3.90%, as then eligible counterparties have a choice between two windows (reserves vs funds rate). It should not go above, though.

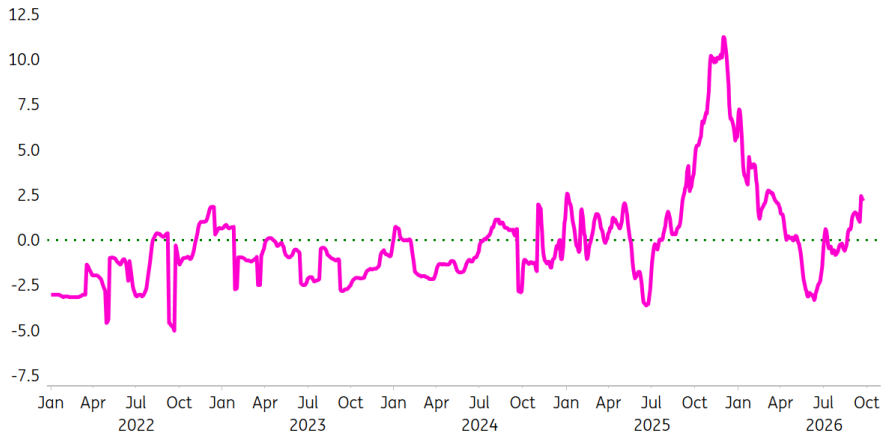
The other competition for avenues for market liquidity is repo, as encapsulated by the SOFR rate (basically an amalgamation of repo rates). Different players in the market with varying rights in the reserves bucket or the reverse repo bucket will see SOFR as an alternative rate that gets deployed from a relative value perspective. This is important for framing where the effective funds rate actually sits. SOFR should, in theory, trade below the effective funds rate, as it is a collateralised rate.

And in the funds market, we also need to account for the Federal Home Loan Banks (FHLBs). They typically provide funds to smaller banks. The FHLBs cannot post in the Fed's reserves bucket, but they can post at the Fed funds rate. In fact, they tend to be dominant players in the current funds rate market, especially as the commercial banks will prefer to post at the higher excess reserves rate. Bottom line, they are effective funds rate influencers.

SOFR, in consequence, has shown a tendency to trade through the effective funds rate, but more recently it has tightened up in line with a build in Treasury deposits at the Federal Reserve. That said, there has been better stability in money markets, apart from month-end (but even then there has been only tame volatility). We expect more of the same ahead based on the current policy of maintaining reserves at or about \$3tr, alongside ongoing buying of T-bills, as an offset to the roll-off of mortgage-backed securities (while the Fed's holdings of Treasuries remain unchanged).

Fed funds rates versus the SOFR rate

SOFR *minus* effective Fed funds rate



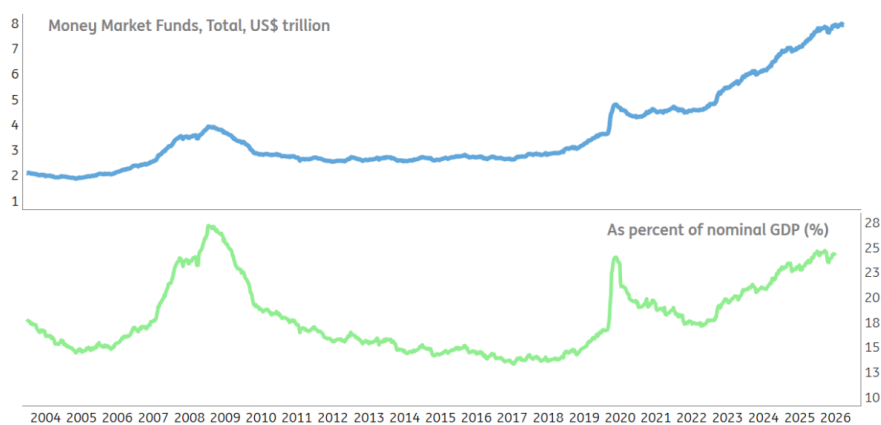
Source: Macrobond, ING estimates

Inflows to money market funds remain firm, although retail holdings have flatlined in recent months, while the pace of increase in institutional/corporate holdings has slowed.

As a percentage of GDP, total money market funds are now approaching 25%, not far off the previous high of 27% in 2009.

Money market funds remain on the rise

Also on the rise as a per cent of nominal GDP



Source: Macrobond, ING estimates

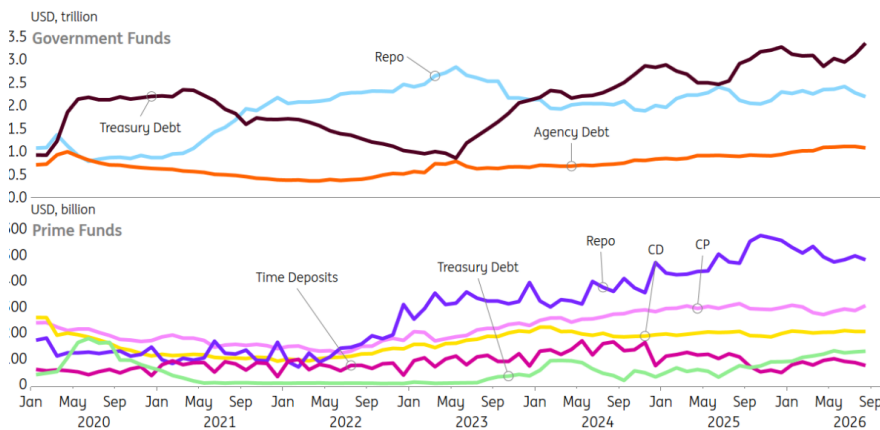
In terms of specific exposures, Government Funds have seen a renewed rise in holdings of Treasury Debt (effectively bills). Extra bills are being issued to take pressure off coupon issuance. This should help maintain a concession in bills. Repo has been downsized relative to

bills' holdings as a result.

In Prime Funds, repo (reflecting equity repo) exposures remain elevated, albeit off prior highs. Exposure to commercial paper (CP) has been gradually rising, while certificates of deposit (CD) and ordinary deposits have been steadier to a tad lower.

Money market fund holdings

Government Funds on top, and Prime Funds on the bottom



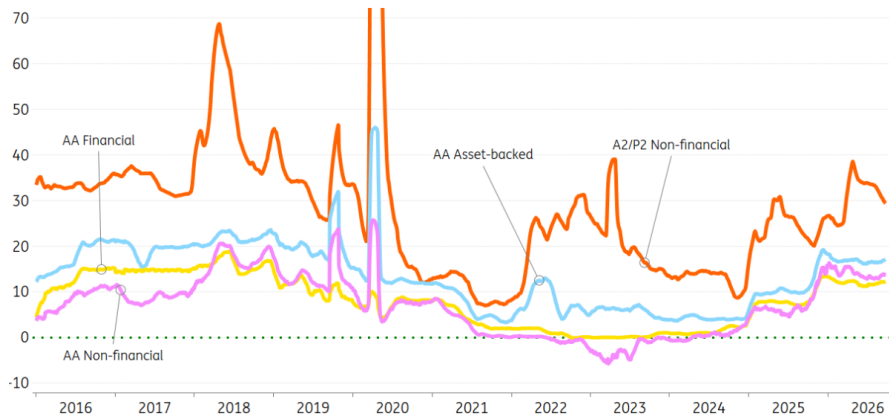
Source: Macrobond, ING estimates

In terms of attainable rates, the entire spectrum of overnight commercial paper rates remains comfortably above the Federal Reserve's reverse repo rate.

The market is discounting rate hikes, which has built concessions. Terming out in spread products at current levels takes advantage of this profile.

Commercial paper alternatives

As spreads above the Fed's reverse repo rate (bp)



Source: Macrobond, ING estimates

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