

TREASURY ROAD TRIP



At \$30 trillion outstanding, on its way to \$52 trillion over the next decade,¹ the U.S. Treasury market is the deepest, most liquid government bond market in the world. However, the interaction of fiscal and monetary policy, regulatory changes and evolving market infrastructure is reshaping market dynamics and straining Treasury market liquidity. BNY highlighted these trends last year in our report *The Importance of Safety and Liquidity in the U.S. Treasury Market*. We share a summary of these driving forces, plus the signals that investors should watch for.

A CHANGING ROAD

As you would expect, the U.S. Department of the Treasury plays a significant role in affecting liquidity in the Treasury market through its issuance and cash management policies. To fund increased government spending and restore its cash buffers after the debt ceiling was suspended in June 2023, the Treasury Department significantly ramped up Treasury bill (T-bill) issuance in recent months.

Since July 2025, when the debt ceiling was raised, net bill issuance has exceeded \$600 billion, which permitted the Treasury Department to rebuild its cash holdings with its fiscal agent, the Federal Reserve (Fed). Increases in the Treasury General Account (TGA) cash balance, which is used to help ensure the Treasury has sufficient cash to make payments in the event it loses access to funding markets, have grown to nearly \$900 billion. Increases in the TGA, a liability on the Fed's balance sheet, are offset by reductions from the Fed's other main liability, bank reserves, which are effectively bank deposits at the Fed. Consequently, as reserves decline, liquidity is drained from the banking system.

Although the Treasury Department can influence market liquidity temporarily through changes in the TGA cash balance, the Fed ultimately manages the overall level of banking system reserves and liquidity in short-term funding markets through its balance sheet and monetary policy tools. Since June 2022, the Fed has been reducing its

holdings of Treasury and agency securities by letting maturing securities roll off without reinvestment, a process known as quantitative tightening (QT). As assets on the balance sheet decline so do reserves, on the liability side. The shrinking balance sheet has been gradually pulling reserves and liquidity out of the banking system, tightening short-term funding conditions.

Under its operating framework, the Fed aims to maintain an "ample" level of banking system reserves. To manage overnight interest rates, the Fed pays interest on reserve balances (IORB) and uses other tools like the Standing Repo Facility (SRF) with the objective of keeping short-term interest rates trading near the level of interest paid on reserves.

Due to the growth in the TGA and ongoing QT, reserves recently dipped below \$3 trillion for the first time since early 2023, off roughly 14.5% from their April 2025 peak.² As reserves have fallen, repo and other funding rates have begun to climb relative to IORB and market participants have begun to tap the SRF more frequently to satisfy their need for overnight liquidity. In response, at the October Federal Open Market Committee (FOMC) meeting, the Fed announced it would be stopping QT at the start of December, a move that will help stabilize the level of reserves and avoid a funding market contraction like that seen in September of 2019.

¹ Source: Congressional Budget Office accessed at <https://www.cbo.gov/data/budget-economic-data#3>.

² BNY Markets, Federal Reserve Board of Governors, U.S. Treasury.

Although the supply of liquidity may be more stable, the demand for it has increased. Post-financial crisis regulatory reforms have focused on making the financial system safer by imposing capital and liquidity requirements, such as the supplementary leverage ratio (SLR) and liquidity coverage ratio (LCR) for banks and dealers. While effective in reducing risk by requiring banks to hold capital against Treasury positions, the impact of these regulations can inadvertently constrain dealer balance sheet capacity, limiting their ability to intermediate large Treasury volumes and absorb shocks.

Market structure change is adding to the demand for liquidity. The SEC's new mandate for central clearing of Treasury market transactions will improve counterparty risk management but will increase liquidity demand because market participants must post margin, which fluctuates with market volatility. The additional daily clearing volume is large, estimated at \$4 trillion. The associated margin could raise baseline liquidity needs in normal times and could amplify demand during stressed episodes, converting what was credit risk into liquidity risk and cost.

CURVES AHEAD

With the supply of liquidity in the market having declined and the demand growing, funding markets could be subject to unexpected shocks. We think economic expansion has some road ahead, but potential potholes are possible. Given we are late cycle, the economy is more vulnerable to volatility, like that seen on Liberation Day. Such shocks could have an outsize impact on market liquidity — simultaneously impairing return expectations and increasing volatility (functionally driving Sharpe ratios to zero).

In gauging what's ahead, we believe investors should keep an eye out for some key signs.

1 Fed Balance Sheet

We think investors should begin watching Fed purchases. As announced, starting in December, the Fed will stop shrinking its balance sheet through QT and reinvest principal paydowns from its holdings of agency securities into Treasury bills. Those reinvestments will hold the overall size of the Fed's balance sheet steady. But over time, the Fed will also have to conduct outright purchases in order to offset structural growth in the currency in circulation and other liabilities on its balance sheet. The tenor of these purchases could affect prices of government bonds, T-bills and agency debt, along with the shape of the yield curve. Some Fed policymakers have also suggested that the Fed could pursue sales of its agency mortgage-backed securities (MBS) portfolio, even while growing the balance sheet.

2 Funding Market Stability

A sudden shortfall in funding market liquidity, like that seen in 2019, could reverberate through financial markets. Volatility in funding markets could spill over into asset prices, as positions become more costly to fund or if leverage is unwound, affecting everything from corporate funding to basis trading. Although the Fed has announced it will be stopping QT, we think investors should continue to watch funding markets for early indicators of strain and develop funding and liquidity management strategies that can be deployed in the event of market stress.

3 Management of Duration

With bill issuance higher and Fed reinvestments favoring the purchase of T-bills, the fulcrum of demand for duration could shift shorter. Further, more price-sensitive investors with shorter-duration liabilities, such as hedge funds and money market funds, are now driving U.S. Treasury demand alongside longer-term investors, like pension funds and insurance plans. If demand for longer-dated Treasury bonds weakens, driven by rising federal deficits or persistent inflation, we could see more volatility in longer tenors. In our view, investors should manage duration thoughtfully given this confluence of factors.

Potential Signs of Liquidity Stress

- Elevated repo and overnight funding rates, especially if persistently above the Fed's IORB rate
- Widening bid-ask spreads and reduced market depth in Treasury securities trading
- Sharply increased use of the Fed's Standing Repo Facility, signaling a sudden need for sourcing liquidity from the Fed given the cost of funding in private markets
- Volatility or declines in Treasury auction coverage ratios, including bills, signaling challenges absorbing new issuance

There may be twists and turns ahead on this Treasury market road trip. The Treasury market is being reshaped through structural and market factors, and given it is the epicenter of financial markets, those changes could impact asset prices and volatility broadly. We think investors may be able to better navigate bumps along the way by understanding these forces and looking out for these signs.



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Treasury General Account (TGA) is the U.S. Department of the Treasury's main operating account held at the Federal Reserve. It serves as the government's "checking account," into which tax receipts flow and from which spending, debt service and other federal payments are made.

Quantitative tightening (QT) is a central-bank monetary policy in which the bank shrinks its balance sheet — by letting bonds mature without reinvesting the proceeds or by actively selling assets — thereby withdrawing liquidity from the financial system and tightening financial conditions.

Sharpe Ratio is a financial metric that measures the performance of an investment compared to its risk. It is defined as the ratio of the excess return of the investment (the return above the risk-free rate) to its standard deviation (a measure of risk).

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