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PGIM FIXED INCOME

After the Storm: Next Steps for the Repo Market

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One of the striking features of the recent stress in the U.S. repurchase (repo) market is the culmination of factors—including developments in monetary policy, banking regulations, Treasury issuance, and corporate tax payments—that contributed to the pressure. While these factors may result in some continued bifurcation in short-term money market rates over the medium term, the mechanics of monetary policy will likely address and mitigate the recently emerged pressure in the near term.

The financial crisis launched an era of significant expansion of bank excess reserves held at the Federal Reserve, and any significant near-term adjustment to the level of reserves can have broad ramifications for the cash funding markets. Several years after the U.S. economy emerged from the financial crisis, the Fed began reducing the size of the assets on its balance sheet (namely U.S. Treasuries and Agency MBS), resulting in a similar reduction on the liability side of its balance sheet via excess reserves. Recent statistics show excess reserves falling to roughly $1.35 trillion, which is about $1 trillion less than the post-crisis peak (see Figure 1). Coincidentally, the reserves are also concentrated within the largest domestic bank organizations for regulatory purposes, namely liquidity coverage ratios (LCR) and net stable funding ratios (NSFR), and are not infinitely fungible with other money market alternatives, such as the repo market.

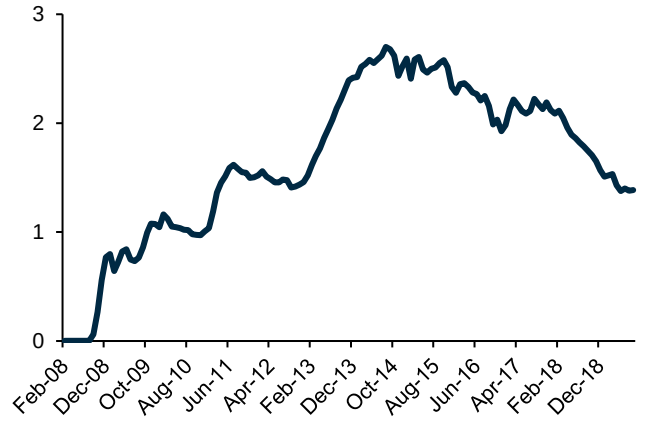
While the Fed was cognizant of the potential negative effects of fewer reserves in the system and stopped its balance sheet runoff in conjunction with a 25 bp rate cut in July 2019, the recent volatility in repo rates was undoubtedly unexpected. Recent "blips" of elevated funding pressures around month ends, quarter ends, and otherwise large settlements of U.S. Treasuries have passed quickly and relatively unnoticed. However, the system may have reached a point where the level of excess reserves has become inelastic, and any marginal demand for cash funding will have an increasingly large impact on repo funding. This will not go unnoticed by the Fed.

The Perfect Storm

Market participants had been anticipating some potential marginal increases in funding costs given the trifecta of large corporate tax payments, settlement of U.S. Treasury issuance as well as the resulting increase in the Treasury's general account balance and the drain on excess reserves held at the Fed. When these factors collided on September 16th, rather than another "blip," conditions quickly turned into the perfect storm. And the approximate reduction of $83 billion in reserves from the system—-representing 6% of the total—seemingly broke the levy.

The funding markets opened on Monday the 16th as expected at normal, albeit somewhat elevated, levels given the large cash drain due to the aforementioned factors. However, Tuesday's funding session opened with elevated rates of around 4% that quickly jumped to 6% and peaked near 9% with the median rate settling at 5.25% on the day (Figure 2 shows the recent spike in general collateral repo rates). At 2.30%, even the effective Federal funds rate settled outside of the Fed's explicit target range of 2.00%-2.25%. Clearly, a response from the Fed was warranted.

Figure 1: The Drop in Bank Excess Reserves Held by the Federal Reserve ($ in trillions)

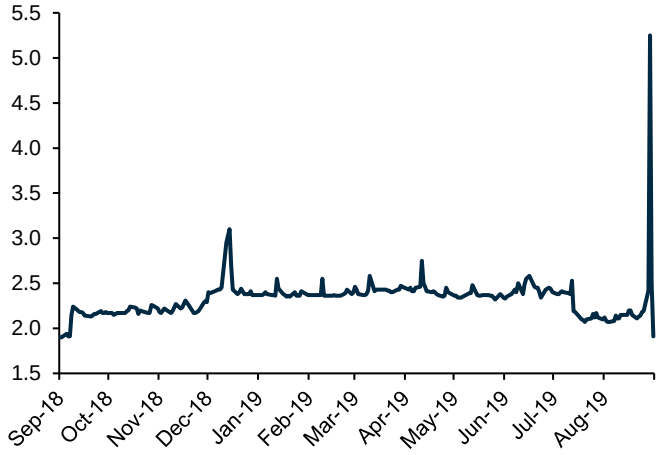


Source: St. Louis Federal Reserve as of September 20, 2019

The Reaction Function

Following Tuesday morning's spike in observed repo and effective Fed funds rates, the New York Federal Reserve's open markets desk reacted with its first open market operations since 2008. The New York Fed announced $75 billion of overnight cash in exchange for Treasury, agency, and agency MBS collateral (i.e., a Fed repo operation) to primary dealers through an auction process. This alleviated the funding pressure and repo rates consequently traded back into the 2.50% range. The New York Fed offered $75 billion each day last week and, on Friday, announced that it will also conduct a series of 14-day term-repo operations that will run through October 11th to help alleviate both overnight-repo and term-repo stresses given the frequent funding pressure at the end of quarters.

Figure 2: The Recent Spike in GC Repo Rates (%)



Source: Bloomberg as of September 20, 2019. Rates are as of the end of the day.

While the temporary open market operations (TOMOs) represent the first line of defense to alleviate the funding stress, there are likely further steps coming from the New York Fed and the FOMC. Fed Chair Powell mentioned the possibility of permanent market operations (POMOs) at his press conference following the FOMC meeting on September 18th. This would consist of outright purchases of Treasury bills, notes, and/or bonds that would once again begin increasing the level of excess reserves in the system to help alleviate future funding strains.

The other option under consideration by the Fed is a standing repo facility (SRF). Such a facility would serve two purposes: first, to provide primary dealers and smaller institutions with infinite, intraday access to cash versus collateral funding; and second, to allow large commercial banks with significant excess reserves balances to consider the fungibility of infinitely liquid reserves with now infinitely liquid Treasury repo, rather than mostly reserves. This would effectively serve as a cap on overnight repo rates and allow the Fed to control money market rates within a corridor system—i.e., the SRF would be at top end of the corridor and the reverse repo facility (which is already in place and where cash providers can invest excess cash with the Fed) would be at the lower end.

Implications for Monetary Policy

U.S. Treasury repo rates are one of the key factors of monetary policy implementation, and the Fed will not allow significant money market volatility to threaten an undesired tightening of financial conditions. Furthermore, in 2017, the Alternative Reference Rates Committee (ARRC), under the large influence of Powell (on the Federal Reserve Board of Governors at the time), commenced the transition away from LIBOR as the risk-free, short-term interest rate to SOFR (secured overnight funding rate), which is synonymous with Treasury repo. The Fed cannot risk the viability of SOFR as the penultimate risk-free, short-term reference rate, and after last week's volatility, it is likely to do "whatever it takes" to ensure smooth repo market functioning from this point forward.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of September 2019

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