



Daily Note

REPOCALYPSE II: THE PHONEY SEQUEL

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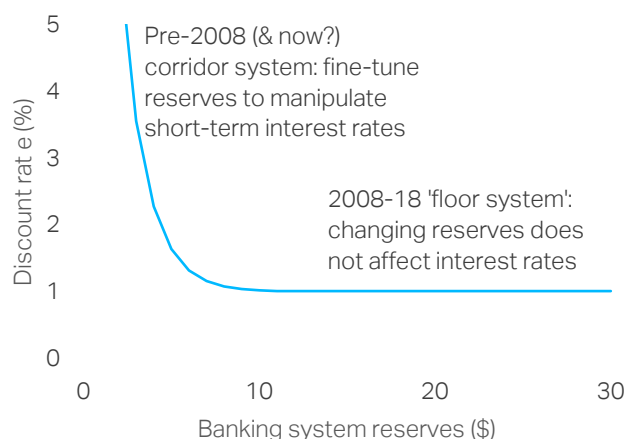
- **Tensions in money markets have unnerved some of our clients**
- **But similarities with the 2007-08 repo crisis are largely superficial**
- **Reserve scarcity looks genuine – but ‘real’ effects are preventable**

While policymakers were quick to downplay the significance of recent money-market tensions, the episode has still unnerved some of our clients. Investors remember what happened in 2007-08, when the authorities injected liquidity into the system while claiming the problems were ‘contained’. But the comparison with subprime is superficial, as we explain in brief Q&A format:

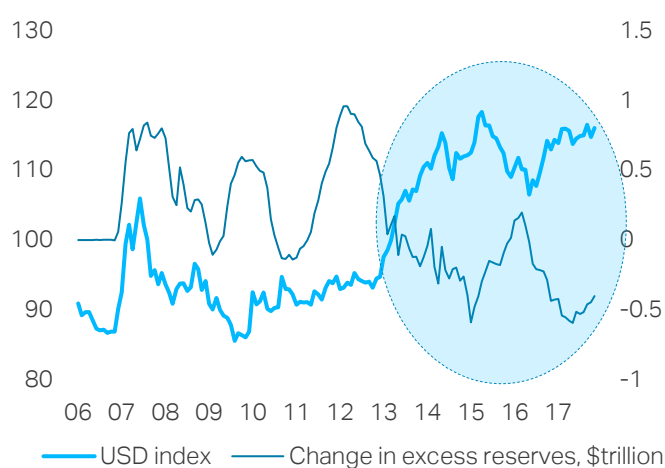
What happened? U.S. Treasury repo rates spiked higher, reaching levels not seen for decades. Tensions also appeared in adjacent markets. The fed funds rate traded far above IOER and outside its policy band. Highly rated overnight financial Commercial Paper rates increased, while less liquid asset-backed commercial paper and paper issued by non-financial firms jumped sharply. Reminiscent of 2007-08, the Fed has had to inject fresh liquidity into the system.

What were the triggers? Much of the commentary focused on specific short-term triggers, including corporate tax payments, the Treasury rebuilding its precautionary balance at the Fed and even the attacks on Saudi oil facilities. These forces may have created short-term funding pressures among US and global banks by reducing floating USD liquidity.

What about the underlying causes? More fundamentally, the tensions in money markets result from the combination of large UST issuance, regulations that limit the behaviour of global banks and a scarcity of reserves in the US banking system. To drill down; (i) The US Treasury has

Chart 1: Reserves and interest rates

Source: TS Lombard

Chart 2: Excess reserves and USD

Source: FRED, TS Lombard

stepped up its issuance in recent months, with much of this focused on short maturities. Even with strong underlying demand for fixed income (bond yields remain close to 700-year lows!), this can lead to indigestion in money markets. Primary dealers are obligated to bid in Treasury auctions, leaving them to hold whatever part of the auction was not sold to customers. While they will eventually place these securities in final hands, until then they finance their holdings in the repo market by borrowing the money and using Treasuries as collateral. If their inventories rise too quickly, repo rates will increase (i.e. there is a 'glut of collateral'). When yields slope upwards, primary dealers make money financing their position because coupon income on the bonds exceeds the funding costs. But when the curve is inverted, this can be more costly.

(ii) Scarcity of reserves in the US banking system means banks can't arbitrage away higher short-term funding costs to keep money market rates down. Basel III regulation is an important part of the story. Though the choice between reserves and USTs doesn't affect the Liquidity Coverage Ratio, it can influence other metrics including internal stress tests and resolution plans. This creates a strong regulatory preference for reserves rather than Treasuries. Similarly, banks can't borrow to lend in money markets because this will affect their capital/leverage ratios.

How can reserves be 'scarce' with \$1.4 trillion in 'excess'? The term 'excess reserves' is now meaningless because the new regulations mean nobody knows how many reserves the US banks need. The Fed has been operating on the theory that there is an inverse relationship between short-term interest rates and the amount of reserves, which is flat when there are ample reserves but gets steeper at lower levels. Before 2008, the Fed operated on the steep part of the curve, keeping reserves scarce and using open-market operations to fine-tune interest rates. This was the 'corridor system'. After QE massively increased the amount of reserves in the system, the Fed moved to the flat part of the curve, adopting a 'floor' system. It used the IOER to control rates and didn't need to 'fine tune'. Fed staff thought they would be able to reduce their balance sheet with QT while staying on the flat part of the curve and sticking to the floor system. Yet the evidence of the past few weeks suggest they have hit the steeper part of the curve sooner than they expected, stumbling back into a corridor system. If this is the case, recent liquidity operations (which were not large in size) will become the norm.

Does any of this matter? This is not a repeat of 2008. Though repo was at the epicentre of the subprime crash, back then banks were hoarding liquidity because they were worried about counterparty risk. There are no toxic securities that could cause a similar run today and banks are not dangerously overleveraged. **Regulation, not fear, has frozen the system.** Thinking beyond the phoney 2008 comparisons, the important question for the real economy is whether the Federal Reserve will be able to keep short-term borrowing costs in line with its target. We suspect it will, but it will likely require some sort of permanent liquidity provision (such as a standing repo facility) plus an expansion in the Fed's balance sheet. Some will call this QE4.

Unlike some commentary, we do not think the recent tensions suggest the market is unable to absorb US fiscal deficits, which would require higher bond yields. Despite current indigestion, there is still a powerful global bid for duration, even if yields have been volatile in 2019.

What about the US dollar? The implications for the USD is perhaps the most controversial part of the 'repo crisis'. Since 2015 there has been a correlation between the amount of excess reserves in the US banking system and the value of the currency. With regulation causing a structural Eurodollar shortage (global banks can't use their balance sheets the way they used to), large US banks such as JP Morgan arguably became the marginal source of global dollar funding. So any Fed attempt to add liquidity or expand its balance sheet could lower the exchange rate. This is important because the value of the dollar has a powerful impact on global trade, cross-border lending and risk appetite – with the Emerging Markets especially sensitive.