CETERA® INVESTMENT MANAGEMENT

COMMENTARY

Repos and Rate Cuts; Busy Week for the Fed

Key Takeaways:

- The Federal Reserve cut the Fed Funds Rate by 0.25% and slightly raised their GDP forecast.
- Separately, the Fed began providing liquidity to cash markets.
- The liquidity operation is not like 2008, occurring for differing less-worrisome reasons.

The Fed's Busy Week

The Federal Reserve had a busy week after policymakers voted 7-3 on September 18 to cut interest rates a second time this year, yet the central bank remains deeply divided on future rate direction. The Fed Funds Rate, the key lending rate to banks, was lowered by 0.25% to 1.75%-2%, with the majority of members signaling a preference for no further reductions in 2019 unless economic conditions warrant it. Separately, the Fed raised its 2019 GDP outlook to 2.2% from 2.1%.

Before the rate cut on Tuesday, September 17, the Federal Reserve Bank of New York conducted an overnight "Repurchase Operation," its first in over a decade. Repeated daily through September 25, these Fed interventions collectively added over $491B in cash liquidity to address a dislocation in the overnight credit funding market. These actions were needed to relieve money-market stresses, and were commonplace in the pre-financial crisis era, by temporarily injecting cash with the Fed taking government securities as collateral. These repurchase "repo" operations are aimed to better align repurchase rates back to within the Fed Funds target range of 2%-2.25% before the recent interest rate cut to the new target range of 1.75%-2%. If you are confused by all this, you are not alone. Let's try to simplify.

What is the repurchase "repo" overnight market?

At the beginning of each day, banks that have excess cash can lend those reserves to another bank that needs cash for its daily operations. As part of the arrangement, the lending bank receives high-quality collateral in exchange. The collateral is typically U.S. Treasury, Agency, or Mortgage-backed Securities (MBS). The borrowing bank that pledges the collateral in exchange for cash also agrees to repurchase or buy back its securities at a negotiated price. The repurchase price is what determines the yield earned by the bank that lent the cash. Typically, the repurchase takes place the following day.

Why this is different from 2008?

During the global financial crisis, about 10% of the collateral represented in the market were subprime mortgages and other similarly risky assets. During that time, the repo market activity dramatically slowed as banks feared that the composition of collateral had become too risky. This past week, we had a different type of issue in the repo market. The Federal Reserve has been normalizing its balance sheet, allowing bonds to roll off its balance sheet as they mature. The net effect of this normalization is that the market has a higher supply of government bonds, which are less risky, and a lower supply of cash.

In addition, the government also agreed to raise the federal debt limit in March, setting the stage for even more Treasury issuance. As a result, the financial system now features more U.S. Treasuries and less liquid cash. Compounding the issue, we saw a convergence of several other events. First, the Treasury auction from the previous week settled on Tuesday, September 17, which impacted liquidity. On the same day, corporate tax payments were due, which further drained the system of liquidity as cash left the balance sheets of corporations when they made their tax payments. Both activities had the compounding effect of reducing short-term liquidity in the system, causing the demand for cash to rocket higher. Instead of borrowing cash for an interest rate that was supposed to be within the Fed Funds target range, the interest rates on certain repo deals, the rate agreed to between the overnight lender and borrower, were briefly as high as 9%.

What did the Fed do?

The New York Fed promptly entered the market on Tuesday, September 17 to collectively lend banks $75B (maximum daily limit) in liquid reserves. The support has continued through today and will continue through October 10 to help smooth end-of-quarter activity. It was an encouraging sign for markets on Monday, September 23 as the full $75B daily maximum was not required to support daily liquidity.

Summary

While the repo market has exhibited some unusual behavior, the risks that we saw a decade ago are not the same as we see today. At that time, the issue was a perception of risky securities being used as collateral that slowed repo activity. This time, it has been due to an oversupply of Treasuries and lack of liquid reserves. To ensure that liquidity is sufficient heading into quarter-end, the Fed will offer three special 14-day term repo operations this week for $30B on September 24, 26, and 27. Out of an abundance of caution, the New York Fed today announced that for its September 26 operations it has increased its maximum on overnight repo's from $75B to $100B and doubled the size of its special 14-day repo to $60B.

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