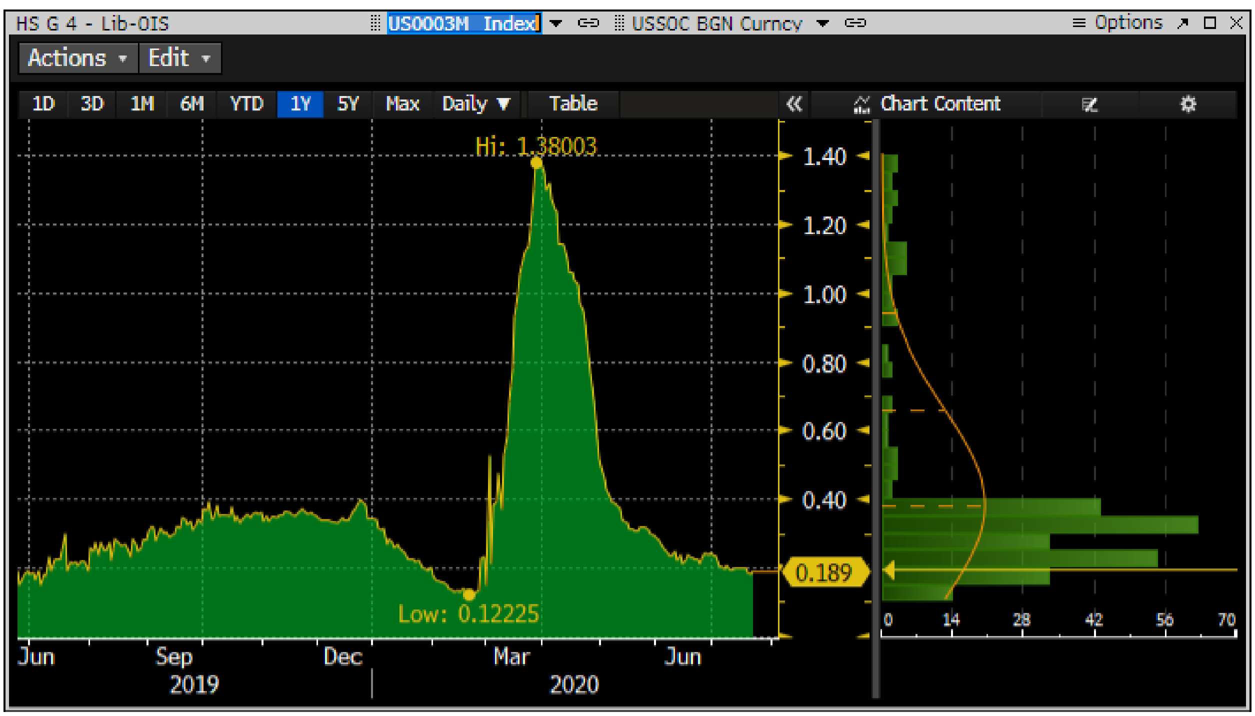
Note: This article was written exclusively for Pierpoint by Stephen Malekian, a recognised global repo market expert. As with all articles describing the "Current State …" of anything, conditions change and must be read in the context of the time of writing

What is the Current State of the US Repo Market?

I think it's safe to say that the US repo market has achieved a certain level of stasis. That has been both a double-edged sword for the funding markets and a relief for the NY Fed. The issues that plagued the market back in September and again last March have essentially been papered over by the Fed, both to provide liquidity and to reduce volatility, the latter having been the most disturbing, and most profitable, to many a repo practitioner. The fourth quarter of last year and the first quarter of '20 were some of the most profitable for repo desks on record. Since then…not so much.

In many ways, the repo market has been anaesthetized and given the forward guidance by the Fed that rates will be held at or near zero for the next two years minimum, while negative rates and yield curve control have essentially been taken off the table, it has engineered a certain calm over the markets. The Libor-OIS spread is perhaps the best indicator of less stress in the funding markets:



At the last FOMC meeting the Fed said that it would roll out a new framework in September defining their outright purchase plans, defining the future path of interest rates, the potential for negative rates and Yield Curve Control (YCC) which many think might result in the elimination of their weekly one-month term repo open market operation. That along with the Fed's daily o/n system repo operation (both sized at $500B) have garnered very little interest of late. In fact, there have been no submissions by the primary dealers to the overnight system repo since July 2nd while the term repo operations have been ignored dating back to June 8th! That's just another indication that the market is functioning on its own. That was not the case back in mid-March during the height of the volatility in markets that had the Fed inject a half a trillion dollars into the repo market. Looking ahead, net new cash flows over the next month will essentially be zero which will help keep funding rates in check. As cash management bills mature they are being replaced with coupon issuance out the curve with the former being marginally easier to finance than the latter, yet having no appreciable impact on funding levels.

That's not to say that all is lost as far as financing opportunities are concerned, but for the foreseeable future, matched book activity will grind to a halt along with the need for clients and other financial institutions to term in their funding exposure, beyond all but the very short dates. The Fed has put a wall of cash just above prevailing GC rates and is happy to leave it there wringing out any chance of a spike in funding rates. But just because the funding markets happen to be in balance, I think it's safe to say that it's a delicate one. Factors driving supply and demand are varied and oftentimes in flux. When they move in directions that offset each other, it can give the appearance of stasis when in fact there are a lot of moving parts.

On the supply side we saw UST issuance in the form of large cash management bills (CMBs) drive Tbill rates higher which had the effect of bringing those yields temporarily above repo rates as well as the rate on interest on excess reserves (IOER). This became a competitive asset class to repo and sucked allocations out of the funding markets by bank treasurers searching for yield as well as money market funds (MMFs) apportioning larger cash balances to bills away from repo. On the demand side we saw a concurrent wave of deleveraging as hedge funds were shunned by the dealer community as the volatility in the market caught them wrong-footed. A look at the recent Sponsored Repo numbers and we can easily see that leverage has been wrung out of this market in a material way.

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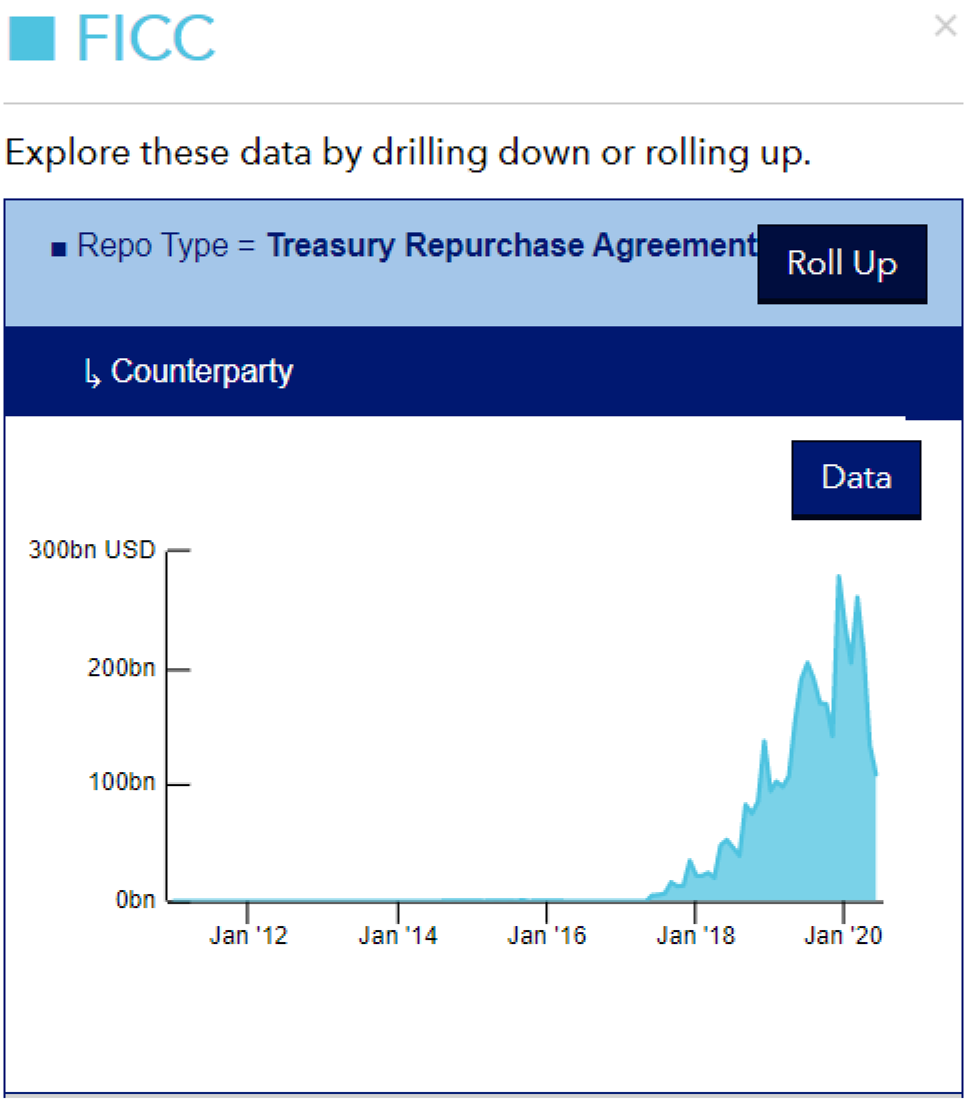

Those balances have come down by $170B since peaking at the beginning of the year taking some of the pressure off of funding levels. Clearly the relentless flattening of the market along with the rally across the entire term structure of interest rates has helped make that decision easier for the leveraged investment community. Given the reduced net interest margin (NIM) at banks, it coincided with repo desks being unable to meet the return hurdles on their bank's cost of long term capital and so balance sheet, once plentiful, is now also coming under pressure…just in time. Banks that tracked the S&P on the way down in February have lagged and lagged badly as the market recovered. The banks are clearly better capitalized today than they were at the time of the global financial crisis in '08, but there has been nowhere to go with that cash other than to their Federal Reserve account as a dearth of creditworthy borrowers combined with frequent stress tests keep that capital idle. The lagging of bank equity performance also coincides with the Fed's core facilities that have been rolled out both protecting the banks and the financial system, while removing the banks from their historical role of intermediator. Through June those facilities were being tapped for just shy of $300B…a fraction of their capacity.

Adding to the supply and demand dynamics has been a reduction in primary dealer holdings of US government bond and has coincided with cash moving out of MMFs in aggregate and back into equities as the Fed flashed the all clear sign with their alphabet soup of facilities. GC rates once again were not impacted. As bill yields declined, cash in Foreign Bank Operations (FBOs) which used to get a rate somewhere in the vicinity of the Fed's Secured Open Market Rate (SOFR) began funneling back into repo which coincided with the Fed's balance sheet beginning to shrink somewhat. These offsetting supply and demand dynamics has helped keep GC in a range. But the fragility remains…

Since the Fed's last meeting where it's minimum accepted repo rates were placed at IOER+5bps and IOER+10bps (effectively .15% and .20%) for their o/n and term offerings, respectively, rates have been pinned at 14bps for GC, while FFs, SOFR and the Bny Triparty rates have averaged 9-12bps. It's tough to argue for more balance sheet in that spread environment. Matched book traders could very well go by way of the buggy-whip makers at the turn of the century. Lest those whose jobs focus purely on funding, with the kind of stability we've seen in the market, it's not out of the realm of possibility that your average repo trader is in jeopardy of being replaced by some form of artificial intelligence (AI.)

With all the technology banks have sunk into their cost structure, they will be looking for a payoff very soon. What better time to roll that out then during a coma-induced marketplace engineered by the Fed during this crisis. Even a cursory look at the performance of equity price action for this group vis a vis the S&P500 is a stunning reminder that reducing costs in this environment will continue apace. Banks could be forced to make some very tough decisions going forward.

If you're looking for anything that could disrupt the quiet in the US Repo market, beyond a massive increase in issuance, I suggest it could be a disorderly decline in the US$. We are at a very significant support level in the dollar weighted index (see below) at 94.133 and should that level be breached a return to 88.593 is not out of the question. Anything that brings into question the creditworthiness of the dollar along with any threat to its reserve currency status and volatility will quickly return to the market. Rates could spike quite quickly from there. Libor-OIS spreads may very well be giving us the all-clear sign but with gold prices now at or close to all-time highs in almost every major currency and the trajectory of the dollar in free fall, it might well portend that quiet in the funding markets may not last.