Key Questions

What is a Repo and Why Should Investors Care?

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Repo rates spiked last week in response to quarterly corporate tax payments.

Repo rates — critical to well-functioning money markets but little understood by most investors — spiked in response to a normal and typically uneventful situation: quarterly corporate tax payments sent to the US Treasury, which were due on September 15. ICAP, a major player in the repo market, quoted overnight money as high as 8.75% on Tuesday. This was 650 basis points (6.5%!) greater than the upper band of the Fed Funds target range, highlighting how truly anomalous current price moves are. What happened?

Let's start with a definition of repos. A repo (short for repurchase agreement) usually takes the form of a security sale with a simultaneous commitment by the seller to repurchase the security from the buyer at a future date at a predetermined price. Since the repo transaction allows the seller to obtain financing from the buyer, it is essentially a collateralized loan to the repo seller. Typical repo market participants consist of large institutional players, e.g., commercial banks, broker dealers, and money market funds.

Why should investors care about what's going on in this rather esoteric ~$2.0 trillion portion of financial market plumbing? The answer lies in just how dramatic the recent repo rate increase was.

As noted, last week's repo activity was driven by quarterly corporate tax payments, a typically routine event. Market participants know that corporate clients must withdraw cash from money markets to pay tax on a known calendar date each quarter. Given this, one would not expect a sharp move in funding rates.

Understandably, then, the spike in short-term financing rates of 650 basis points last week sent a chill throughout the investment community. In fact, our Taxable Fixed Income team observed that the movement was something that they had last seen in the teeth of the global financial crisis in 2009. That such a relatively small (~$50 billion) and commonplace occurrence would cause overnight funding market rates to skyrocket indicates how delicate these markets currently are.

We believe that this turmoil is happening now because of Treasury funding activity. The US Treasury is set to issue over $800 billion in net new debt into the end of the calendar year as a result of the earlier-than-expected resolution of the debt ceiling. Treasury supply this large will lead to funding stresses, as the market has never had to absorb this much issuance in both such a compressed time period and into an inverted yield curve (short-term rates are higher than long-term rates).

In fact, the supply could not come at a worse time for market participants. Foreign carry traders attempt to make money by investing in longer-term securities with funding sourced by cheaper short-term borrowing. However, with an inverted yield curve, foreign carry-traders are unable to profit from buying Treasuries because their short-term borrowing costs are too high. As a result, the yield curve inversion removes a very important source of Treasury demand.

What does this mean for Fed policy? One way to help rectify the situation is for the Fed to alter the slope of the yield curve by cutting short-term interest rates, which could entice participants looking for positive carry to buy long-term Treasuries as this supply hits the market. This would also help dealer inventories clear and ease funding pressures on the front-end. If the Fed does not cut interest rates, we believe that money markets will suffer and overnight rates will move outside the Fed's target band. This would have the same impact as a rate hike and begin to call into question the Fed's ability to control short-term rates.

It is unclear to us at this time how long these elevated levels in short-term funding markets will persist. The New York Fed has stepped in to provide liquidity, at least temporarily calming the situation. However, any prolonged pressure could signal unruly year-end funding markets. At the very least, the spike in short-term rates suggests that the next few months could be volatile given the unexpected increase in Treasury supply, bloated dealer balance sheets, regulatory issues, and a banking system where reserves are scarce.

This restiveness in short-term rates continues to be a mostly technical issue for money markets that are confronting an imbalance between supply and demand. In our view, this should result in little economic or market impact. However, the situation is well worth monitoring. If things fail to normalize, market participants will need to adjust quickly to an investment landscape where the Fed has trouble controlling monetary policy via traditional levers such as short-term rates.

For more information, please contact your Key Private Bank Advisor.

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