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SHORT THOUGHTS

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US Financing Rates Edge Higher

Higher SOFR, Repo Rates Claim More Cash From RRP

Around the November month-end last week, US money market and repo rates inched above where they had been recently. For example, the secured overnight financing rate (SOFR), which had traded between 5.00% and 5.33% since the last time of the FOMC raised the federal-funds rate in late July, popped up to 5.39% on Dec. 1. It remained there to start this week. While a move like this isn't entirely unprecedented around month-end, it is not typical for such rates to stay elevated after the month is over. The general collateral (GC) repo rate, at 5.435% on Monday, is also higher than it has been in the recent past.

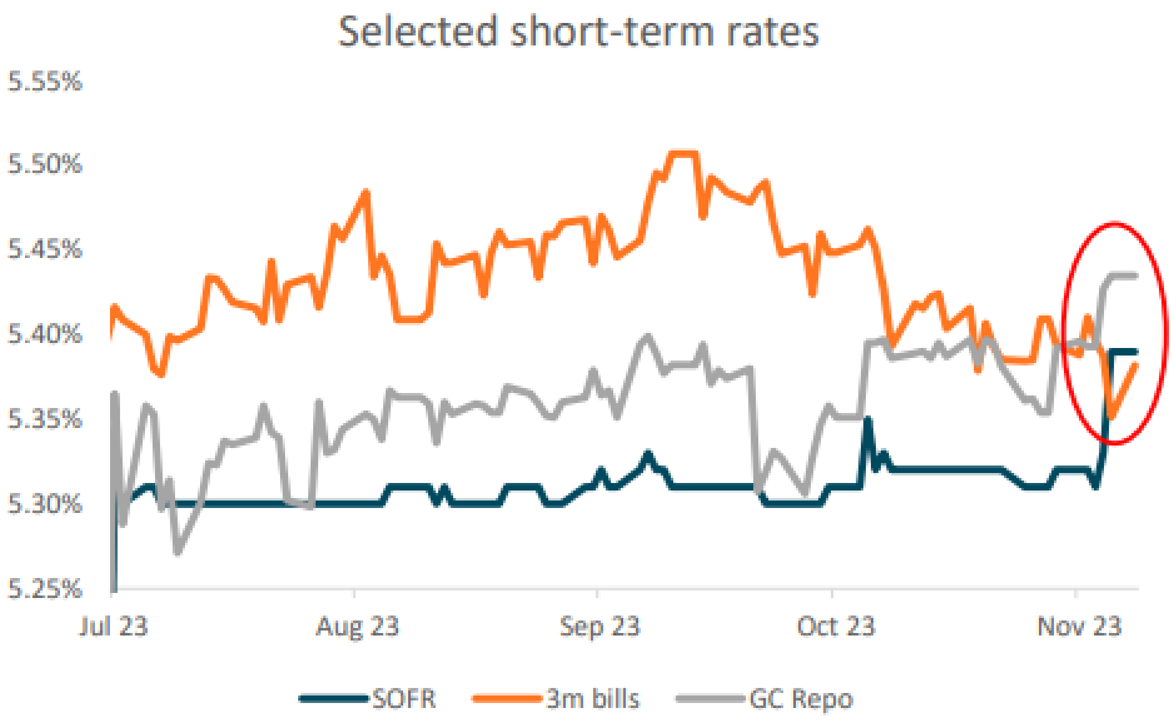
While this pressure on short-term rates is notable, we're not ready to say that there is a liquidity or funding squeeze at work. Instead, we think the upward pressure on rates could be a consequence of investors securing financing through year-end.

As the chart below illustrates, both SOFR and GC repo are trading above both the current 3m T-bill yield (3.38% currently) as well as the offering rate at the Fed's reverse repo facility (RRP, 5.3%). The latter, as we have noted, had been a popular place for money market mutual funds (MMFs) to park liquidity, although balances in RRP have been plummeting for a number of reasons (see here, for example, for more discussion of the RRP drain since early June). On Dec.1, however, the one-day decline in RRP balances was $119bn, the second largest drop since June 1, when the RRP drainage began in earnest.

In recent days, however, SOFR and GC have offered higher returns with just a one-day duration, taking more money out of RRP as a result. MMFs can earn more in these markets than in RRP, while avoiding longer-dated bills. This is especially true as the longer-dated bills are yielding less than the RRP's 5.3%, given expectations – mistaken, in our opinion (see here) – of potential Fed rate cuts as early as the FOMC meeting next March.

As we said above, our suspicions are that these secured financing rates are being squeezed higher due to year-end liquidity needs; investors are locking in funding through the year-end now. This means that if this funding wave abates in coming days and weeks, less RRP money will enter the markets as quickly.

Better Than Bills, Better Than RRP



Source: BNY Mellon, Bloomberg

MMFs Lending To The Basis Trade

Discussing the basis trade in this space in the past we noted that speculative investors (i.e., hedge funds) have been engaged in this strategy, which involves shorting Treasury futures and going long cash Treasuries, financing the trade via borrowing in repo. In the latest Bank for International Settlements *Quarterly Review*, there is a special feature examining the behavior of MMFs in this trade.

As rates rise, as they did for most of this year, real money investors (such as asset managers) go long Treasury futures to hedge interest-rate risk. The difference between the price of the futures and the cash bonds is the "basis". To exploit these price differences, leveraged money shorts Treasury futures, financed by repo. During such periods, MMFs provide financing by lending in the sponsored repo market (with the Fixed Income Clearing Corporation, or FICC).

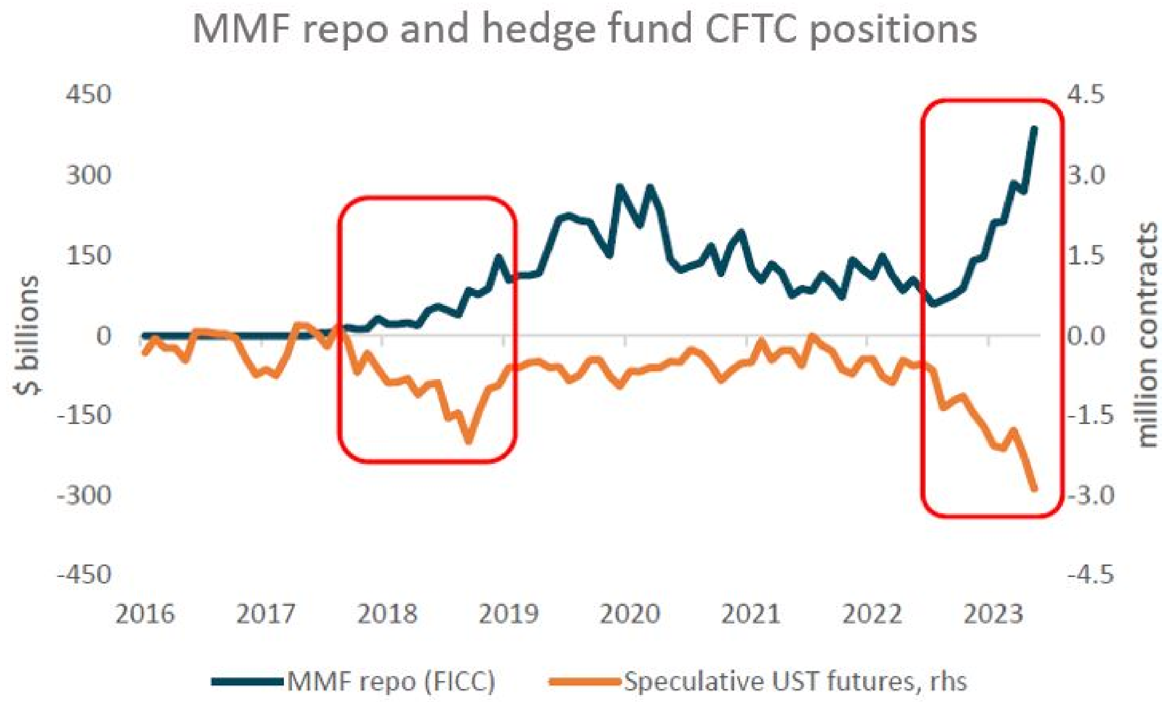
The chart below, which uses BIS-provided data through the end of May, illustrates this dynamic. The blue line captures monthly repo lending by MMFs via FICC. Note that during 2017 and 2018, while policy rates and 10y yields were rising, there was an increase in Treasury shorts by speculative accounts, while at the same time MMF lending through FICC was also rising, essentially financing the short futures trade.

The same behavior is going on currently. While the data in the chart only run through the end of May, we know that hedge funds' short futures positions are still increasing, while asset managers' long futures position is increasing. The financing provided by money funds in FICC repo is essential to keep the system in equilibrium.

Combined with the discussion in the opening section on the anomaly in short-term rates and the RRP drain, we think there are still legs to the basis trade, even though the broader market is beginning to price in cuts as early as the end of Q1. Does this spell the end of the basis trade? And what would this do to MMF behavior? We think that rates will stay higher than the market currently foresees, and also that supply pressures in the coupon market will keep 10y yields elevated. This should allow the basis trade to endure, with MMFs continuing to place cash in FICC repo, ultimately supporting this equilibrium. This means that RRP should continue to drain.

Our bigger, more long-term concern is what happens when – for whatever reason – RRP is close to fully drained. At that point, repo rates could stay elevated, in which case liquidity and funding concerns would become a real issue. When it initiated quantitative tightening, the Fed also established a special repurchase facility (SRF), which stands to provide liquidity if the market finds itself squeezed. We're not at that point yet, but the RRP drain, as well as the current elevated repo rates, do bear watching.

Financing The Shorts



Source: BNY Mellon Markets, Bank for International Settlements, CFTC

NOTE: See here for an explanation of the BIS data

Please direct questions or comments to: iFlow@BNYMellon.com

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