Northern Trust | Repercussions of the Repo Scare

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In mid-September, there was significant attention focusing on one major corner of the short term funding markets for repurchase agreements. Commonly referred to as repo, and is also indicative of liquidity in the financial system. The dislocation in the repo market not only caught the attention of market participants, it prompted market intervention by the New York Federal Reserve. Let's take a closer look.

Beginning on September 16th, repo rates underwent significant volatility, spiking as high as 8%. This caught investors' attention, as repo rates are generally set based on the Federal Reserve's target range, which was 2% to 2.25% at the start of the week.

While repo rates are normally very well-behaved, there are instances where they can trade outside the target range on major reporting dates, such as a quarter end or a year end. But it's rare to see this type of volatility outside of those periods and of this significant magnitude. While repo rates climbed sharply, other traditional credit indicators remained stable and did not suggest credit distress.

A confluence of factors contributed to this dislocation and liquidity squeeze. First, September 16th was corporate tax day, which tends to take $75 to $100 billion out of the market around this time every month. Coincidentally, approximately $54 billion in US treasuries also settled that day, which also took liquidity out of the market. And after the recent years of balance sheet reduction by the Fed, the impact of the draining of reserves has now implied the market needs more liquidity.

In response to the liquidity squeeze, the Federal Reserve Bank in New York re-established a primary dealer liquidity facility that had been left unused for over a decade. The liquidity intervention by the Fed, through its open market operations, was taken as a strong statement to support further liquidity, and as a result, repo rates normalized by midweek. Since then, the Fed has committed its overnight liquidity facility up to $75 billion each day to primary dealers until October 10th, as well as introduced a short two-week term facility.

While we believe this was not a credit driven dislocation, it has prompted questions on how much excess liquidity the market requires to smooth out dislocations. The recent volatility has been eye opening for investors. We think this may prompt further assessment from the Fed to better understand the amount of excess reserves and market liquidity to support a $21 trillion US economy.

We also believe the Fed will need to increase its monthly asset purchases in order to rebuild the amount of excess reserves for banks to buffer against erratic surges in funding rates. Increased asset purchases will be one more factor that will stabilize money market rates, but also push 10-year US treasury yields lower through the rest of 2019.

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