September 2019 :
FROM REPO TO QE

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HOW THE FED FINALLY TOOK BACK CONTROL OF THEIR BENCHMARK INTEREST RATES!

It seems that during the week of the 16th of September, the Fed's tightening policy finally started to play through the US financial system.

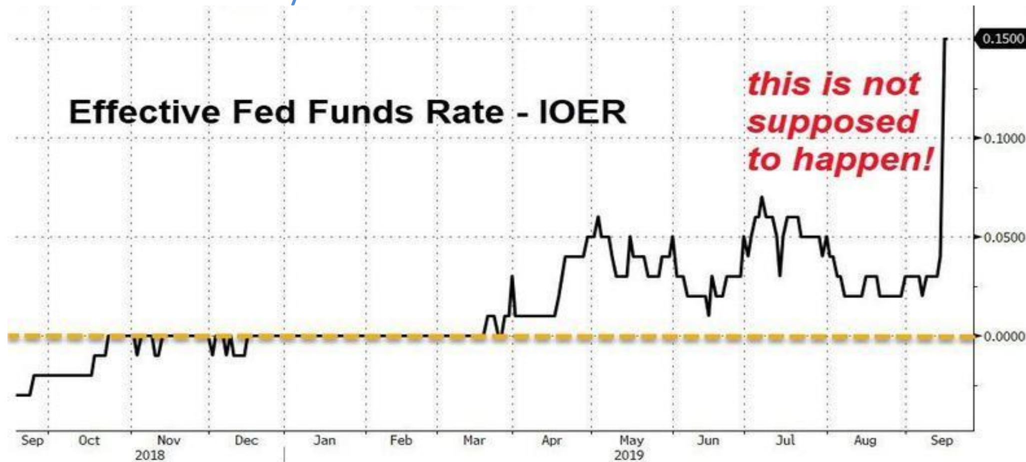

Chart 1 : source: Zero Hedge

The IOER is the Interest rate that the FED pay on Excess reserves that the banks have got on the Fed books.

In this article, we shall give you an account of what happened the week of the 16th of September, why it happened and what were the various responses of the Federal Reserve. And we shall look at how things should normalize going forward for this other liquidity problem to finally disappear.

• They've lost control

You may not know (or even care to know) the specifics, but most investors are probably aware by now of the fact that funding markets suffered something of a seizure around mid-September.

The squeeze, which saw the General Collateral Repo rate surge (visual below), was attributable to a number of various factors. Some structural (Fed balance sheet run-off, Treasury supply to finance the deficit and bloated dealer balance sheets), and some idiosyncratic (Corporate tax payments, coupon settlements and the first fortnight of September Bonds rout, the worst since the 2016 presidential election).

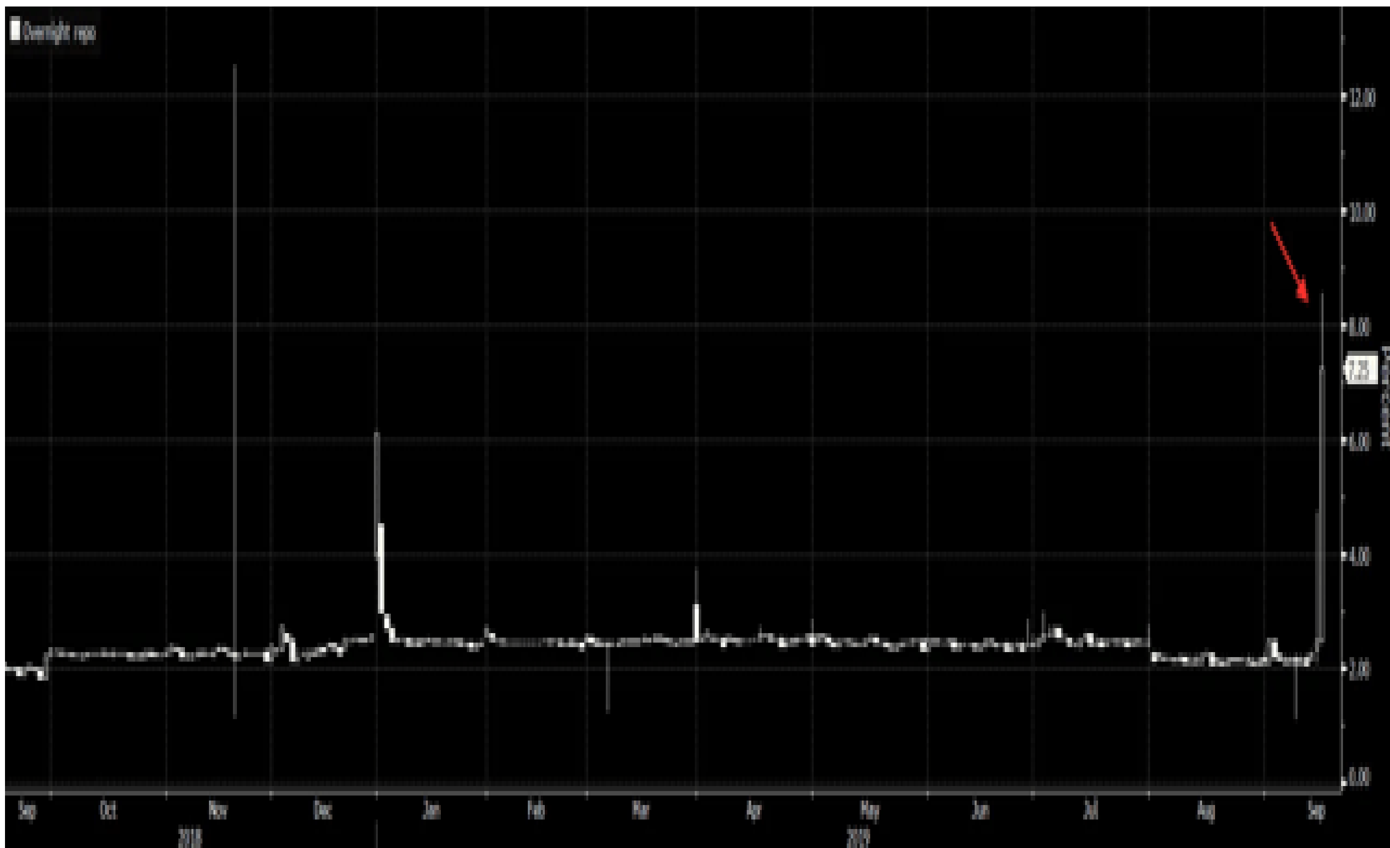

Chart 2 :source : Bloomberg

The New York Fed was forced to intervene on Tuesday the 17th of September for the first time in a decade, after the effective funds rate was dragged through the upper end of the target range. The Federal Reserve Bank of New York delivered major jolts of evidence that week that the Fed had, in fact, lost control over interest rates.

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And the visual below, for those who still haven't come to terms with what happened, represents the Fed quite literally losing control of rates - albeit temporarily.

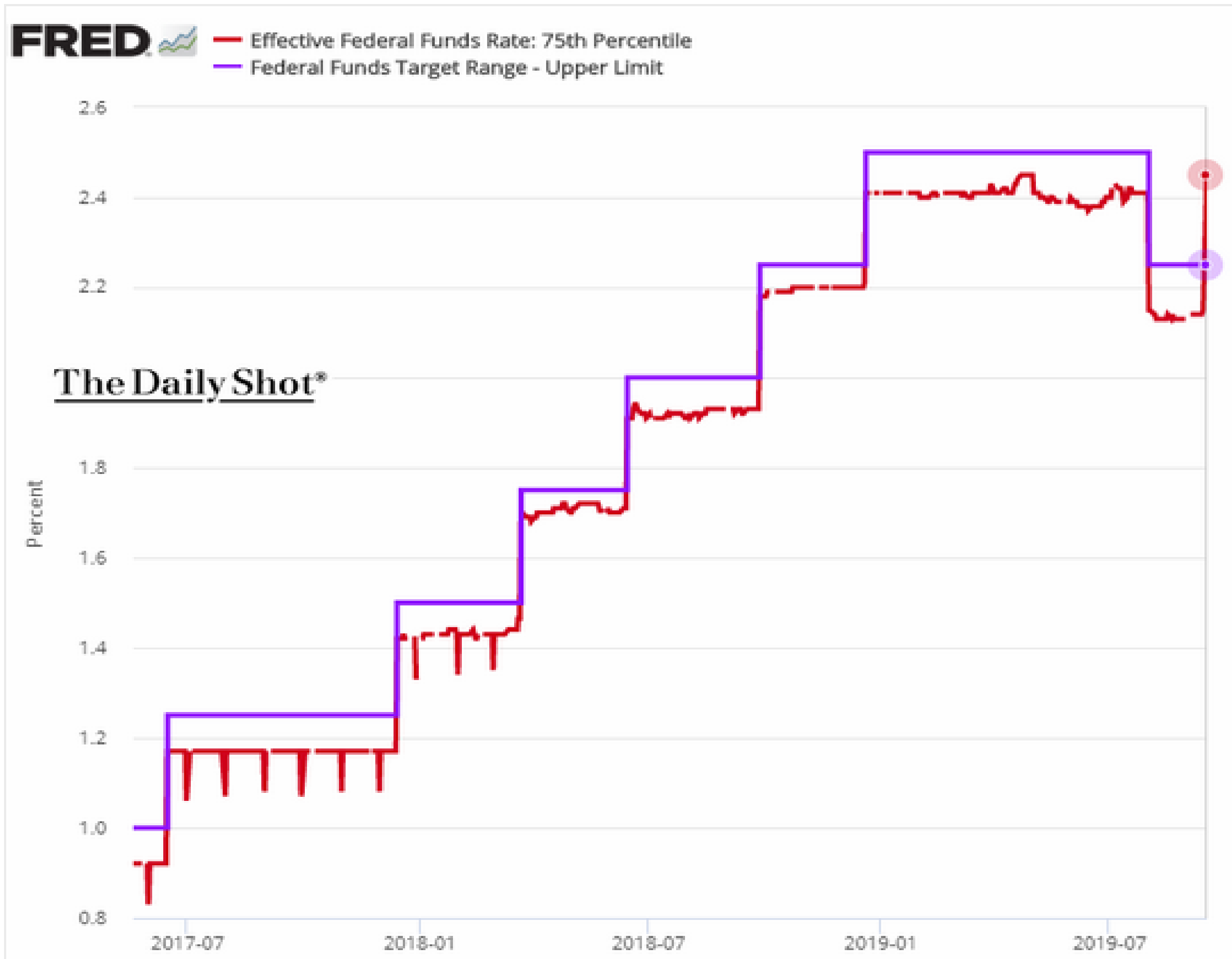

Chart 3: Source WSJ The Daily Shot

So, tell me the Fed has control of this when it has been clearly struggling with control to an increasingly greater degree for much of the year as you can see on chart 1, page 1. Which clearly indicates that the problem has been brewing since March 2019 when the effective rate (black curve on chart 1) started to diverge from the horizontal yellow line, it's official target….

You can see in the following graph that the intraday high in the overnight funding rate was truly historic:

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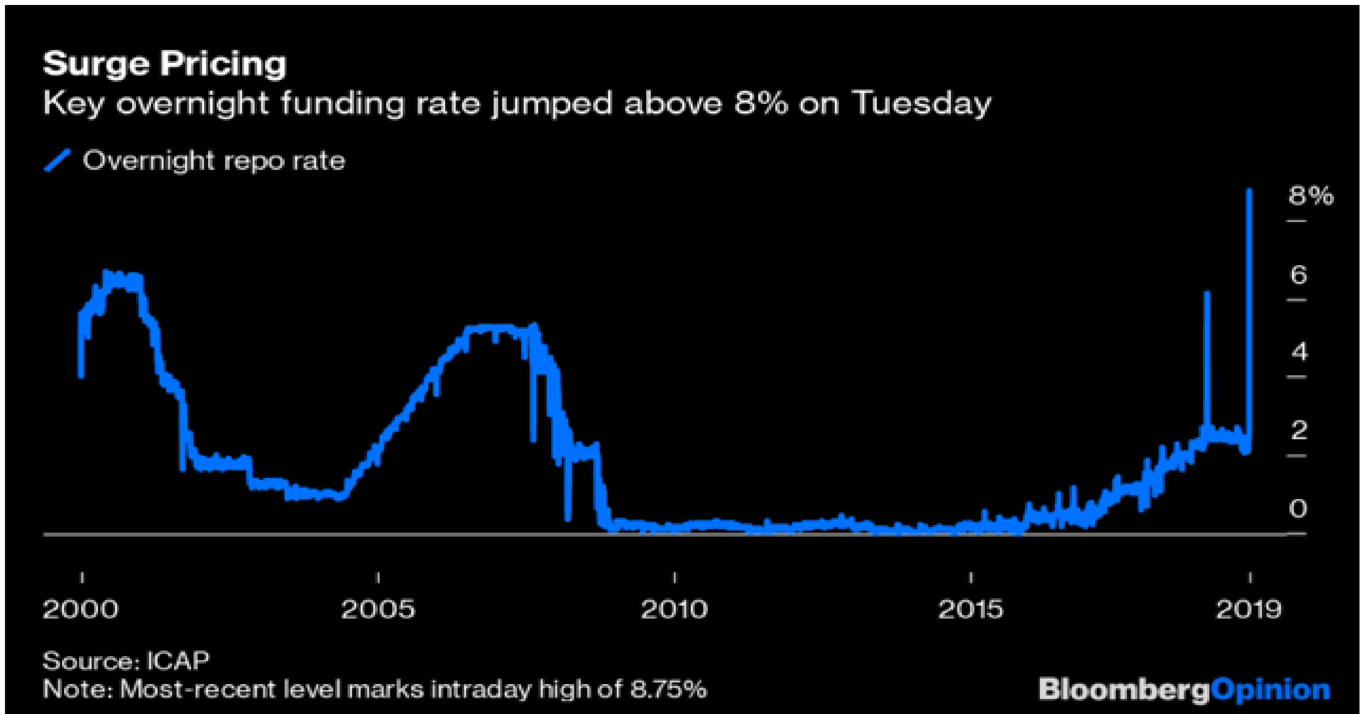

Chart 4 : source : ICAP and Bloomberg

As the Economist put it in an article appeared in the Finance and Economics section of the print edition under the headline “Hitting the Ceiling.” :
“That sent shivers down spines. A spiking repo rate was an early warning sign before the financial crisis. In 2007, as market participants began to doubt the quality of collateral backed by mortgage lending, repo rates jumped as lenders hoarded cash.
The latest jump was unlikely to have been caused by such doubts. Most collateral is now high-quality American Treasury bonds or bills. Even so, there are reasons to worry. America’s banks and companies seem to be short of cash.
And during the turmoil the repo rate stopped tracking the federal funds rate. This link is the main way monetary policy influences the economy. A gap opening between the two deprives the Fed of its most important policy tool.”
Fortunately, the Fed’s interventions seemed to work. As The repo rate returned to its usual level, close to the federal funds rate, which in turn is within the range targeted by the Fed.

. How bad was it?

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Well how to put it? I think there is only one way of truly describing it: really, really ugly!!

A kind of timed demolition went off on Monday the 16th of September: corporate tax day, meaning a huge amount of cash was withdrawn from the bank accounts to pay Federal taxes, an overseas holiday for one of the largest holders of USTs (Japan) and a large "unplanned expense"(??) … plus a massive settlement day for recently auctioned Treasury collateral. And massive in that case means massive. The Treasury issued more than $70 Bns of Bills the week before. Look at the following two charts: the amount of the securities on the banks balance sheets and then the deposit balances of the same banks…

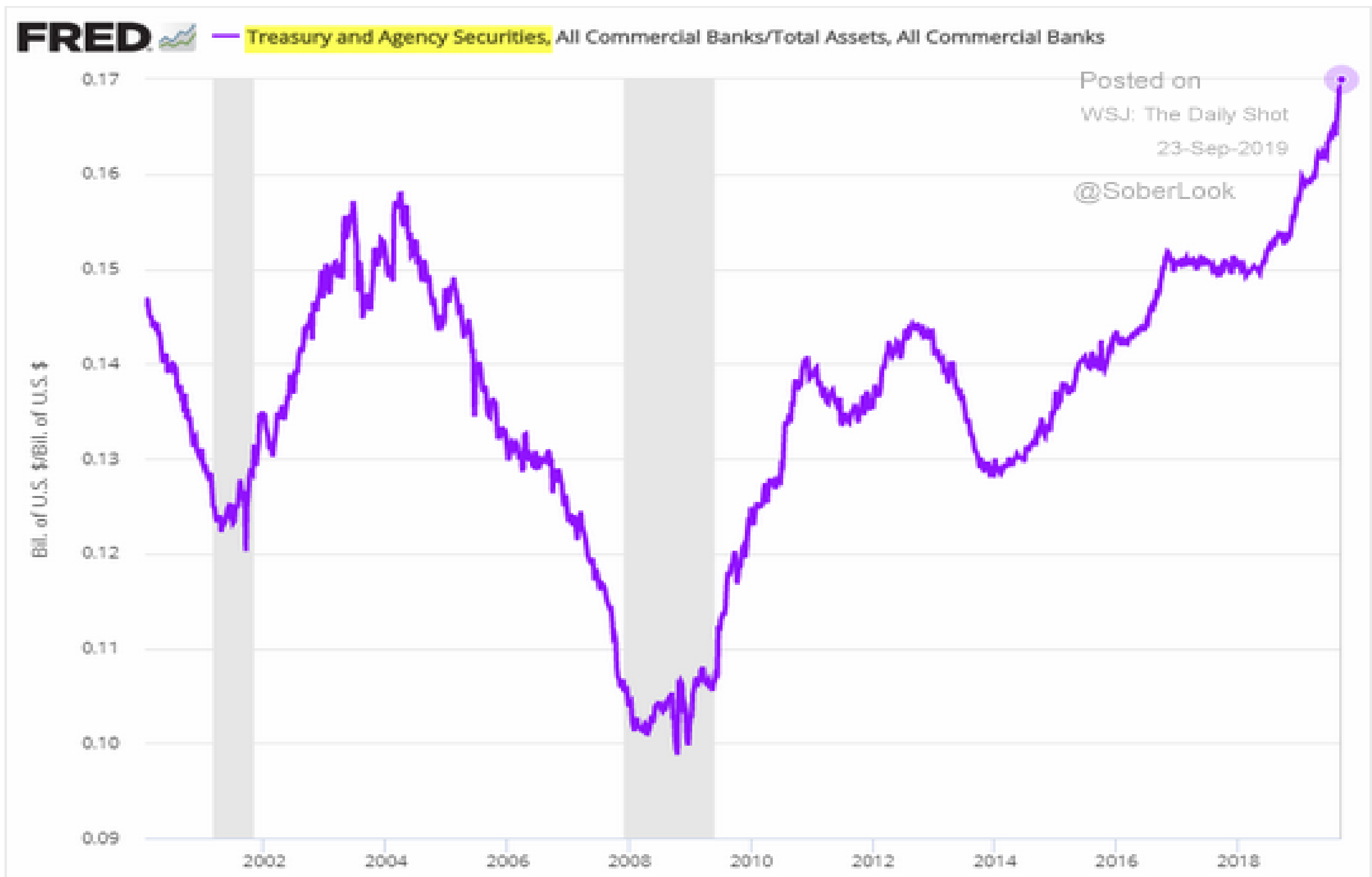

Chart 5 : source: Fed of St Louis

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Chart 6 : source : Fed of St Louis

The percentage of total assets held as treasuries at large U.S. banks is now over 20%, which is the highest on record. On the other hand, Cash, as a percentage of assets at those institutions, is now down to 8%, which is right at post-Dodd Frank and post-Basel 3 lows.

They're pretty much at the bedrock; they can no longer continue drawing down cash and using it to buy treasuries. But who is gonna finance the massive budget deficit then? Cash levels can't (and shouldn't) go lower like they did in the 2000's because that's the type of leverage that led to the financial crisis back then and current regulations require banks to have more cash.

Any one of the above mentioned factors could push overnight repo rates higher on their own, even during "normal" conditions. Given the circumstances, all of these factors together generated the explosive power of a hydrogen bomb in funding markets.

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Although, according to Deutsche Bank the main issue behind this funding squeeze IS **the demand on banks to finance increasing amounts of Treasury paper amid falling deposit balances (which shifted from private accounts to the Treasury account at the Fed)**. As shown by the following graph:

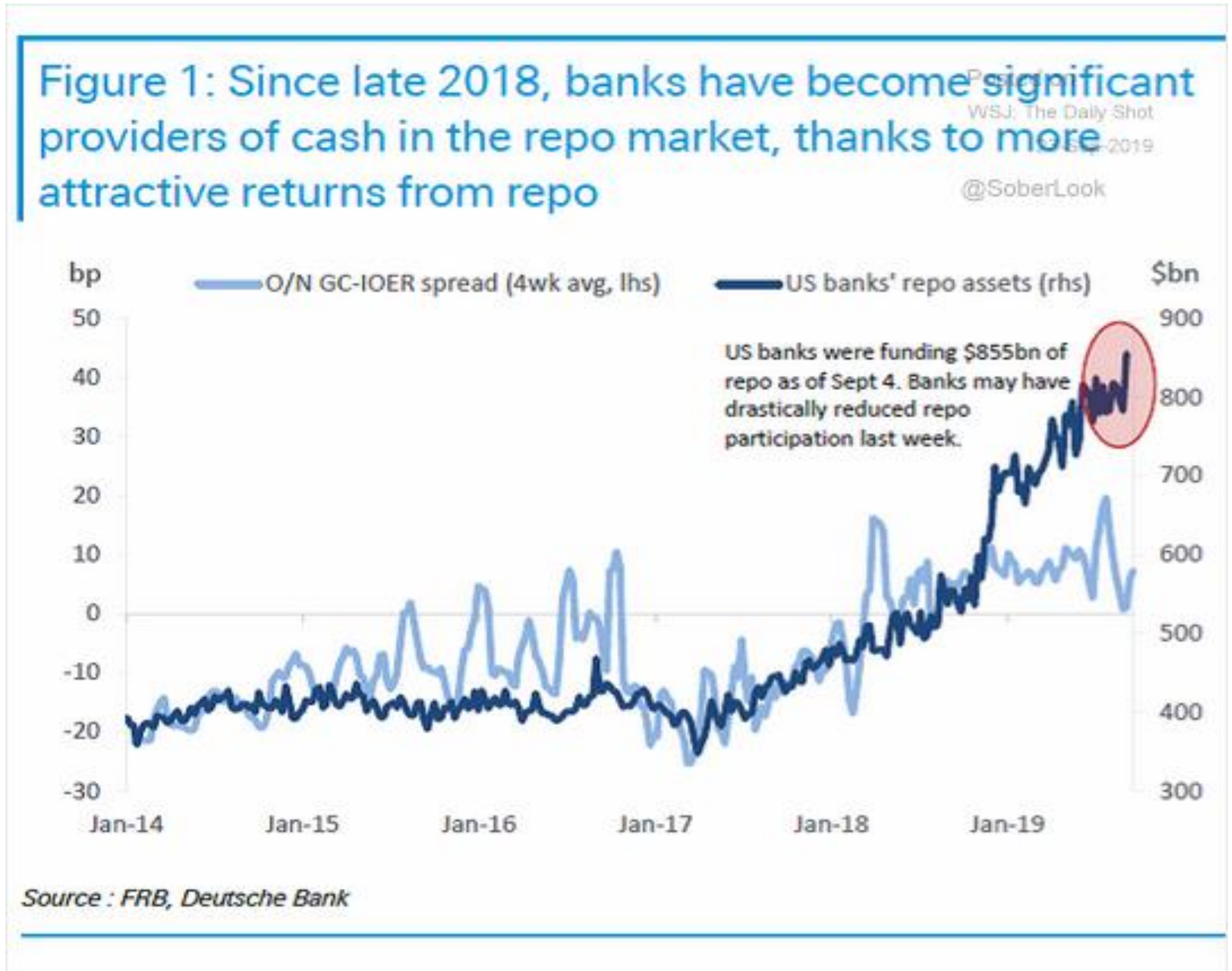

Chart 7 : source: Deutsche Bank

Stripping out year-end turns [such as the similar massive spike seen at the end of last December], this was easily the largest 1-day move on record - exceeding the previous highs that were set during the darkest hours of the financial crisis.

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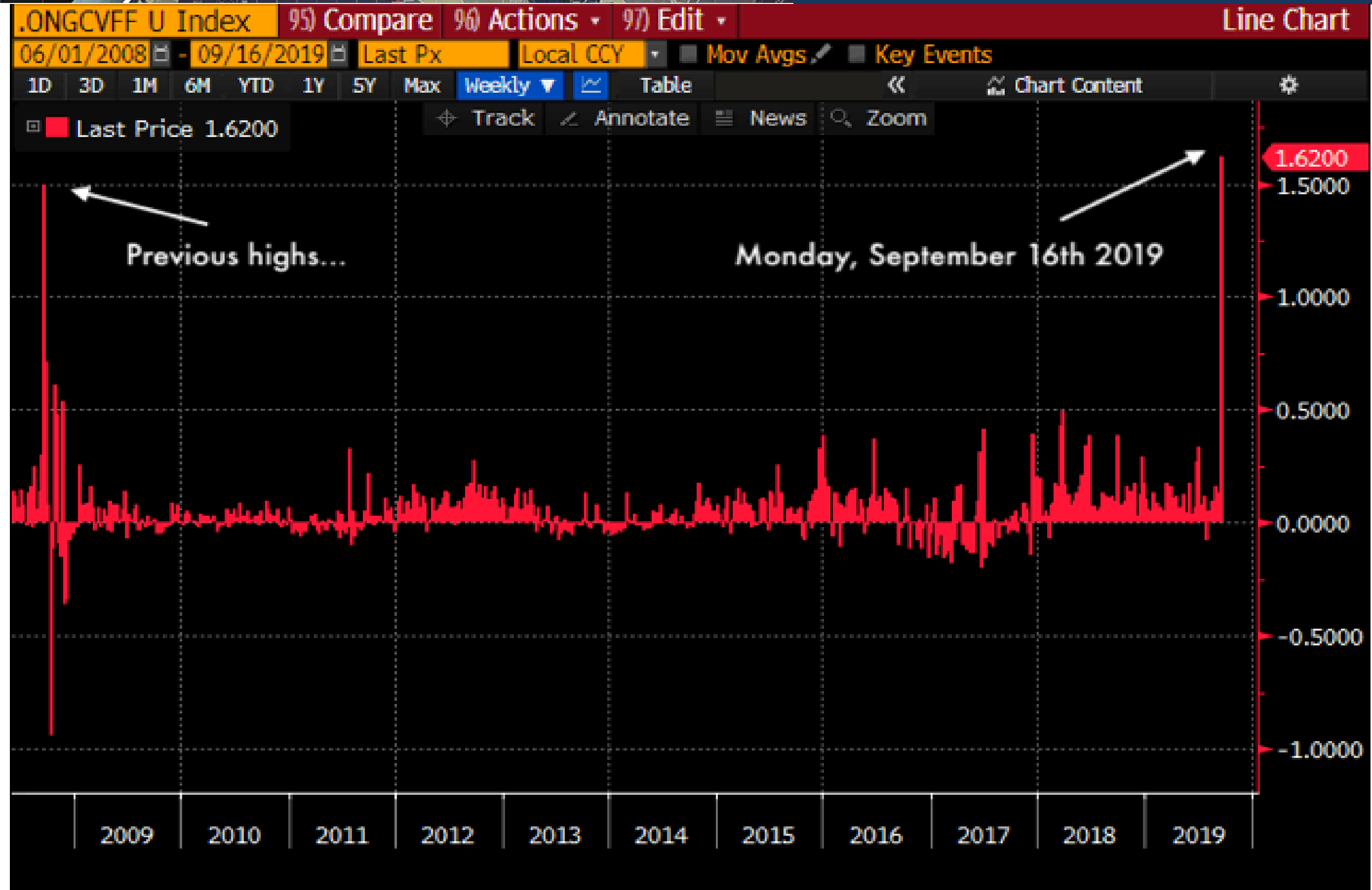

Chart 8 : source: Bloomberg

This is a customized index GC Repo Rate vs Fed Funds rate

Clearly, we are not talking a small problem. December's spike was a one-day problem on the final day of the year for all financial transactions to be cleared for the year. It was nothing compared to this. Firstly because these spikes are very common around year end, and secondly because this spike broke higher than December's, and it kept spiking all week with repeated massive attempts by the Fed to bring it under control. And bear in mind this is all in the one market the Fed manipulates most directly and most carefully!

. The response: Part I

Here is a chronological account of the events :

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On Tuesday, the NY Fed had to leap in with over $50 billion in overnight Repos, in which it injects money directly into the economy for a day by buying treasuries from banks with the agreement that banks buy them back the next day. That was the NY Fed's first major transaction like that in more than a decade! As interest shot up, the NY Reserve Bank punched it down by creating $50 billion in flash cash out of thin air. This is similar in size to quantitative easing. For an accurate sense of scale, it is the same amount the Fed was taking out each month during quantitative tightening, except the money created is just temporary. It goes into the system one night to relieve stress and is paid back and deleted the next.

Bloomberg described the drama of Tuesday's thrill ride this way:

“Up and down Wall Street, phones lit up Tuesday morning as a crucial market for billions in overnight borrowing suddenly started to dry up. What had begun on Friday, with tremors inside U.S. short-term funding markets, was escalating rapidly….”

As a well known market analyst (David Haggith: the Great Recession Blog) put it:

“Not since the 2008 financial crisis has a spike in money-market rates caused such a stir - or prompted such a response….

From New York to Chicago to Los Angeles, major banks, corporations and investment firms struggled to get answers about what is usually a simple question: Where is the overnight repurchase rate, the grease that keeps the vast global financial system spinning? Rumors flew. Wall Street dealers scurried to protect their clients - and themselves……

By 10:10 a.m., after an initial, embarrassing misstep, the Fed was pumping $53.2 billion into the market to calm nerves and regain control over interest rates - its first intervention since the dark days of Bear Stearns, Lehman Brothers and the rest.

It was a big deal with ominous overtones, and the buffer the Fed created in response looked like this in terms of how the various transactions during that twenty-four hour period impacted the repo rate:

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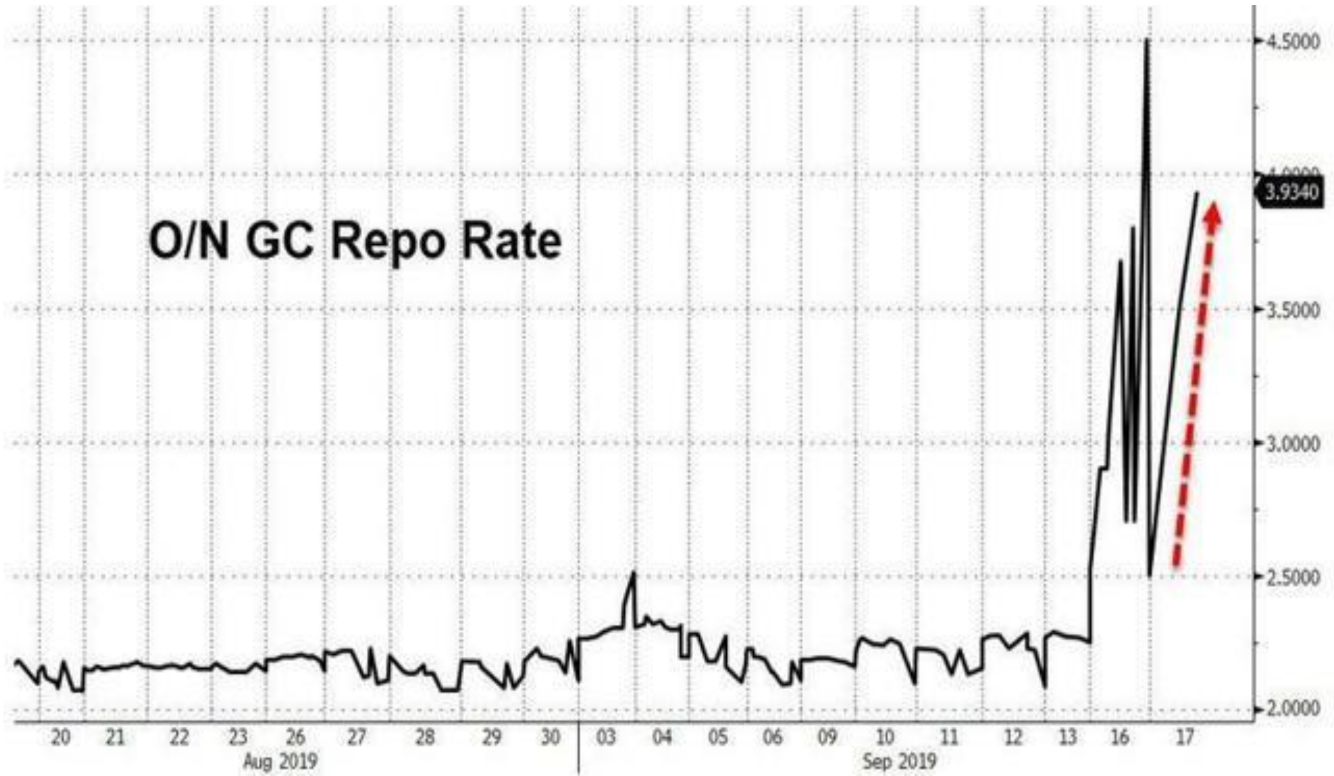

Chart 9 : source : Zero Hedge

Bouncing everywhere. Clearly, the NY Fed never did get interest rates down to its target range. The NY Fed kept slamming them down, but the next day they shot right back up."
So why did they shot up again?
The new money ran out! $50 billion simply wasn't enough to cover the day's demand!
Of course, as Bank of America's Mark Cabana purportedly said, one day is not a big deal; but if funding pressures persist, it implies a loss of control of funding markets.
Well, then, what happened on Wednesday?

Funding pressures did persist. Since the NY Fed's cash creation failed to meet demand, they had to jump and pump again - this time with 50% more new flash cash!
Wednesday the 18th presented solid evidence that the Fed was quite behind the curve, for this was the day when a NY Fed Repo operation the size of previously monthly Fed quantitative tightening didn't do the trick, so they amped up to a Repo operation nearly the size of the Fed's previous monthly quantitative easing - $75 billion! And that wasn't enough!

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Here is what you could read on Bloomberg that morning :”For a second straight day, the Open Market Trading Desk at the Federal Reserve Bank of New York will conduct an overnight repurchase agreement operation from 8:15 AM ET to 8:30 AM ET on Wednesday, Sept. 18, to help maintain the federal funds rate within the target range of 2.00%-2.25%. The repo operation will be conducted with Primary Dealers for up to an aggregate amount of $75B.”

On to Thursday the 19th:

Sure Wednesday was a failure again, but remember, "one day is not a big deal;" it's only a big deal "if funding pressures persist." In which case, "it implies a loss of control of funding markets."

Both days failed, because the NY Reserve Bank's operation, scaled as it was to the size of monthly QE3, fell short of funding needs, causing the Fed's overnight rate to remain far over the Fed's target.

And then Thursday failed….And so did Friday as well. So, depending on your definition of persist, you could have argued that things were very serious indeed!

•The response: Part II

And this was acknowledged by the FED officials themselves who came out on Friday with an official statement announcing that :

•The Fed will continue to roll its repo financing operations through mid-October to contain the squeeze in the funding markets. The central bank will also offer some term financing (14 days).

And they provided the following schedule:

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Schedule of Overnight and Term Repurchase Agreement Operations

OPERATION DATE	OVERNIGHT	14-DAY TERM	TERM MATURITY DATE
Monday, 9/23/2019	$75 billion	No term operation	
Tuesday, 9/24/2019	At least $75 billion	At least $30 billion	Tuesday, 10/08/2019
Wednesday, 9/25/2019	At least $75 billion	No term operation	
Thursday, 9/26/2019	At least $75 billion	At least $30 billion	Thursday, 10/10/2019
Friday, 9/27/2019	At least $75 billion	At least $30 billion	Friday, 10/11/2019
Monday, 9/30/2019 – Thursday, 10/10/2019	At least $75 billion	No term operations	

Chat 10 : source : WSJ The Daily Shot

But the demand for the Fed's repo financing remains robust, suggesting that a more permanent solution will be necessary. As an example, just consider what you can see on the below chart: Tuesday the 24th of September: the $75 Billions offered were NOT enough they had to inject MORE, up to a bit more than $92 Billions!

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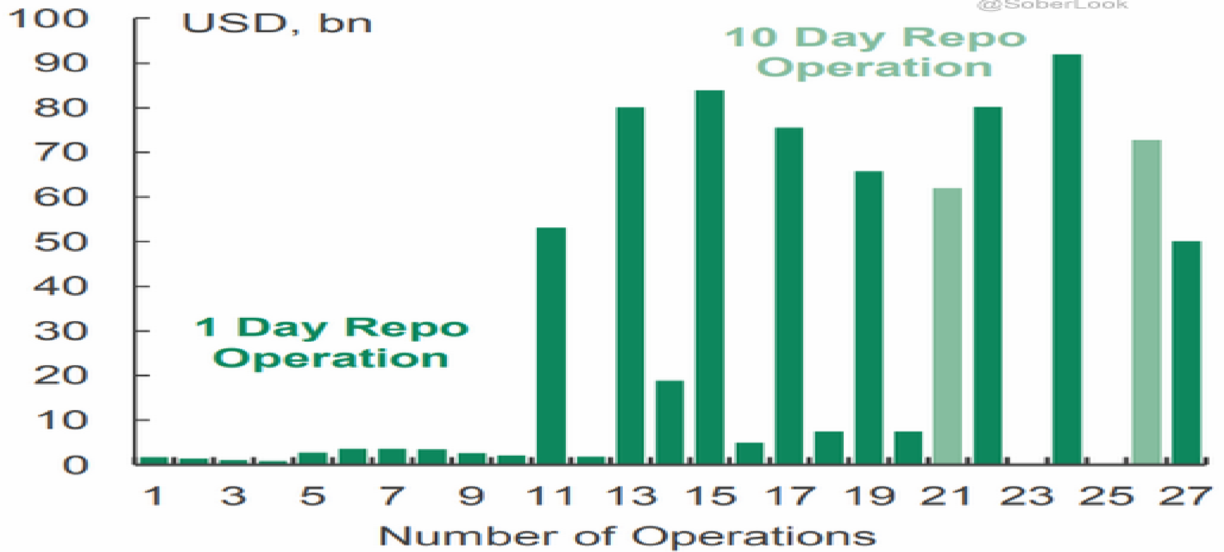

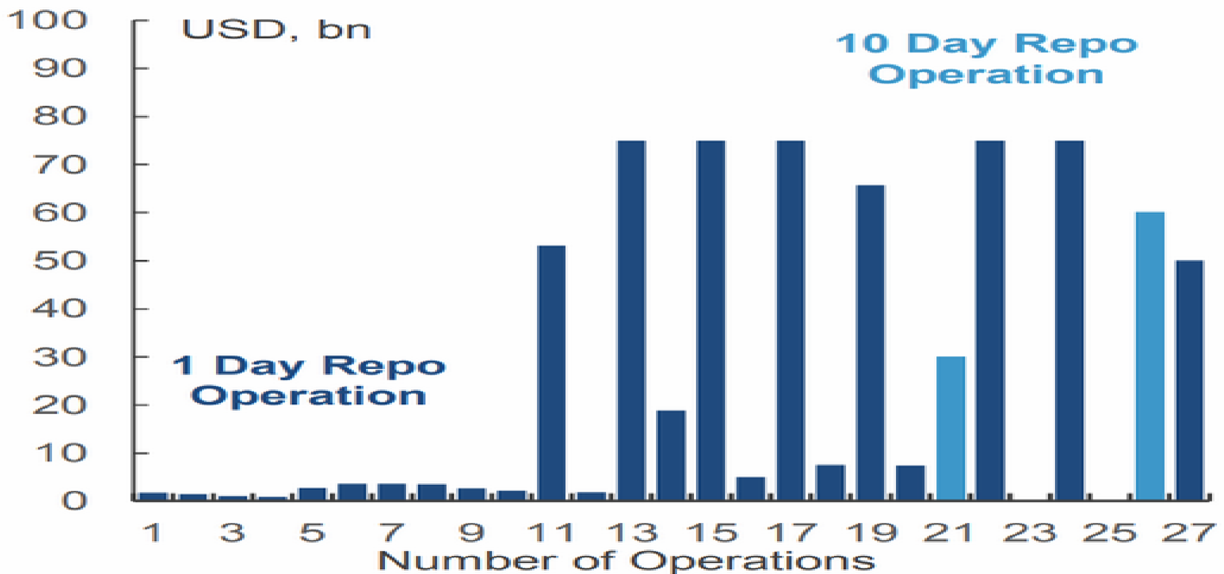

Chart 11 : source : Scotiabank with NYC Fed.

And already as of the end of September 2019, here is what all the repo operations look like on the Fed's balance sheet:

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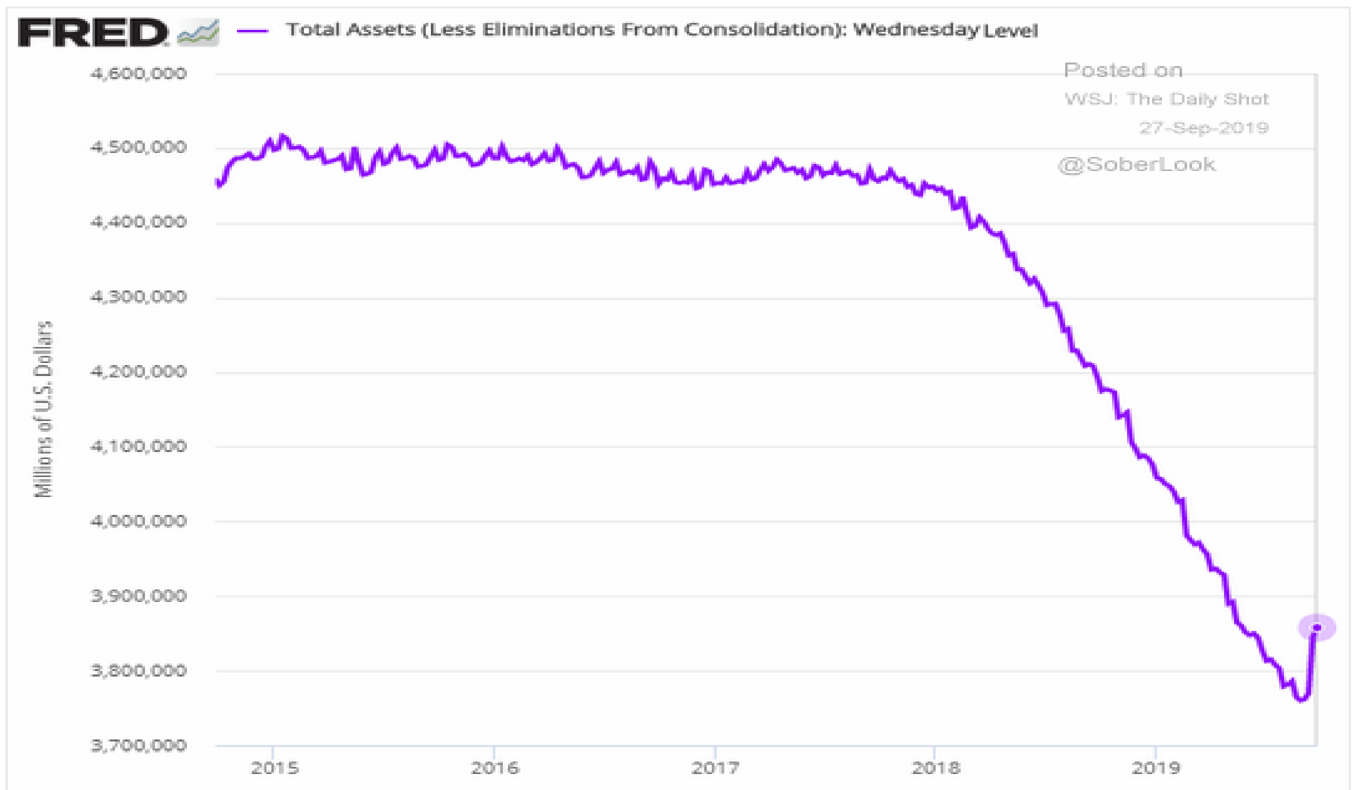

Chart 12 : source : Fed Reserve of St Louis

Another way to describe all these operations is, as A. Goodman wrote it in his blog: “The Fed Has Already Resumed 'QE' But Calls It Another Name”
And this other name is “Temporary Open market Operations” (TOMO). These TOMOs had already contributed to the net creation of $161.7 Billions at the end of September….
But as clearly indicated this second part of the Fed response IS temporary (until he 10th of October) .

.So what will come next?

For now, the Fed is going to plug the funding gap at the banks with these repo operations. But what if the problem is persisting or even escalating rapidly? It could be much bigger in aggregate globally than anyone can know, just like in 2008. In all probability, the Fed has no clue how big the potential problem is, and these repo operations will eventually morph into outright money printing. That is the view of more and more analysts and market commentators.

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On the other hand, a few others seem to think that this Repo Rate debacle will not trigger a real liquidity issue in the Credit market, therefore preventing the much feared contagion…..

The above mentioned Economist article concludes: “The Fed now faces a choice. It could return to conducting frequent open market operations to pin down interest rates, as before the crisis. Or it could keep the current system and avert future cash shortages by expanding its balance-sheet enough to keep the banking system permanently saturated with liquidity, even as demand for cash grows. On September 18th Mr. Powell suggested that the Fed would opt for the latter, saying it wanted reserves to be ample enough to avoid operations of the sort carried out in recent days. He also announced technical tweaks that will mean banks are compensated a little less handsomely for cash deposited at the Fed, which might encourage them to lend a little more in the repo market instead.

It is unclear how quickly balance-sheet expansion might be resumed. This week’s events suggest it may be soon. As Mr. Powell said after the Fed’s meeting, “I think we’ll learn quite a lot in the next six weeks.””

What we know is that as banks bought Treasuries, their cash piles fell**.** The surplus reserves banks hold in their deposit accounts at the Fed fell from $2.2trn in 2017 to $1.4trn now. And it’s actually when this level reached $1.34trn that the problem occurred. So we now know where the limit is: just under $1.35trn!

So in order to remain within an ample reserve system as Chairman Powell himself put it how much liquidity has the FED to inject and for how long? The average estimates seem to be around $250bns straight away (we’re nearly there by the way) and then at least $150bns every year.

Whatever the real numbers, what seems sure is that the FED balance sheet expansion has already resumed and WILL NOT STOP. It’s not a QE per se. Some even call it “QE -light” already, others say it’s the beginning of the POMO era where you replace the T(emporary) by a P(ermanent).

It will probably involve increasing bank reserves (via Treasury securities purchases) and even a (long talked (hoped?) standby repo facility. The bottom line is: The FED balance sheet is on the rise again!

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4/10/2019

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