Repos

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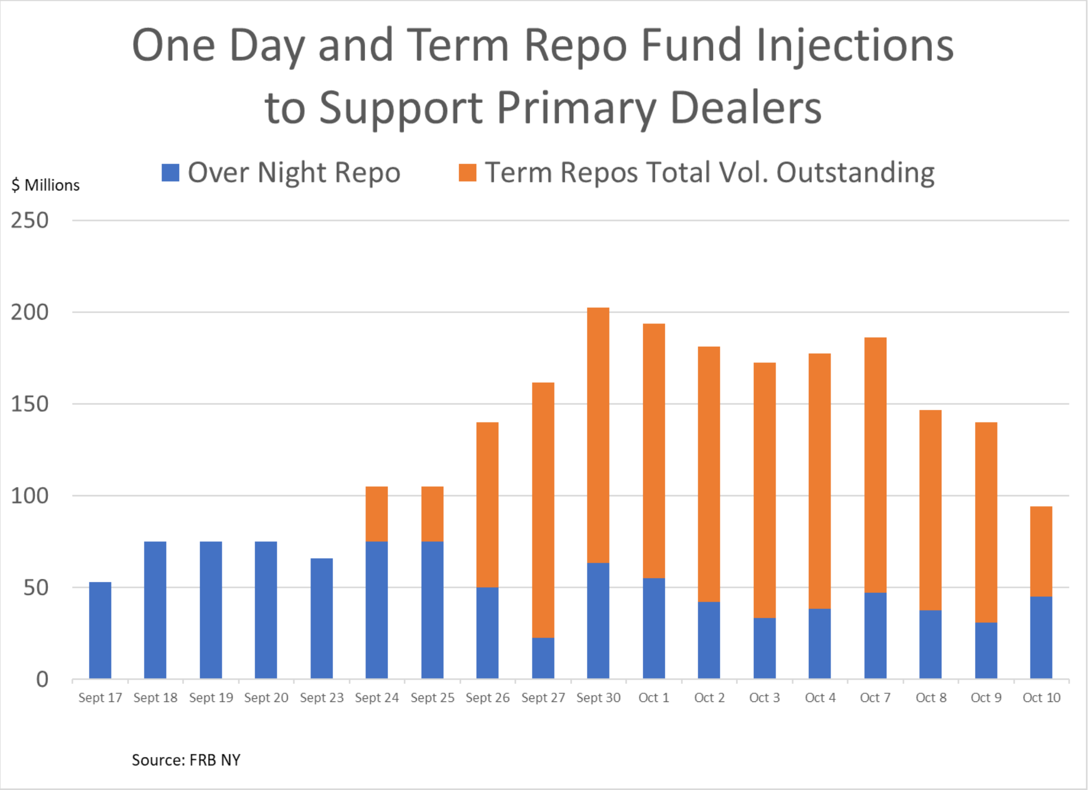
The Spike In Rates

- The Week of Sept 16 saw a spike in the Repo rate over 10%
  - Above the FOMC's target rate of 2.0-2.25% (now 1.75-2.0%)
- Result was a squeeze on primary dealers who finance their portfolios of Treasuries and MBS in the overnight Repo market



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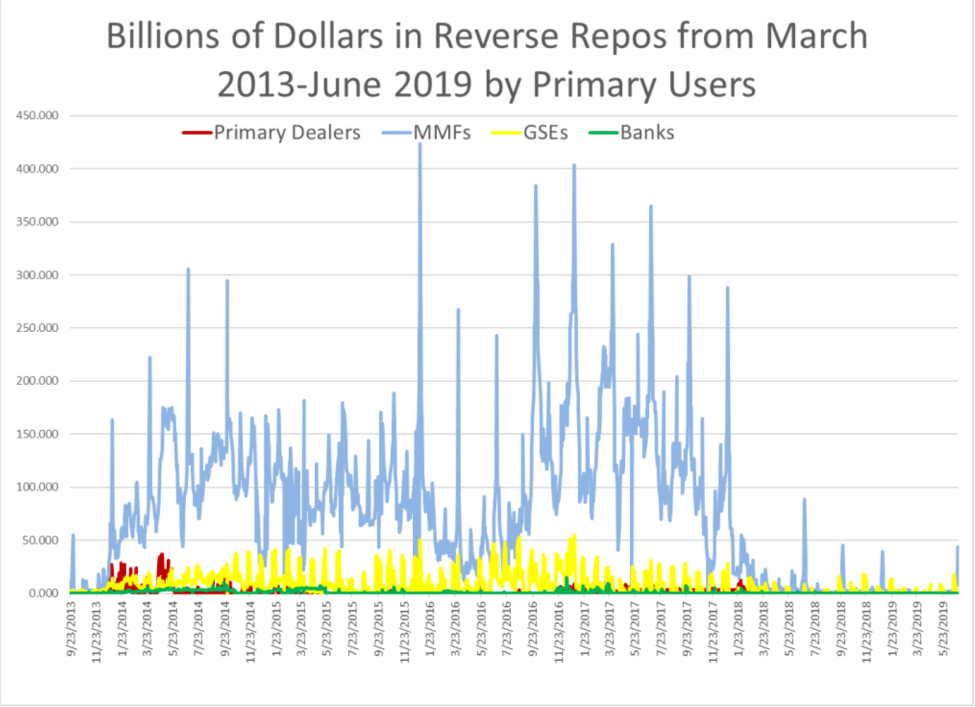
Background On Origins of the Market

- Current repo transactions are extension of Primary Dealer Credit Facility established during the financial crisis in March 2008 and closed in 2010
- Money Market Investor Finding Facility Oct 2008 and closed Oct 2009
- FOMC established Over Night Reserve Repos as temporary, supplementary too to control overnight interest rates.
  - Counterparties include banks over $30 billion, GSEs, primary dealers and money market funds. Of these neither primary dealers nor money market funds may hold deposits at the Fed.



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Simple Supply and Demand Issues May Explain Why Rates Spiked

- The supply of Treasuries that need to be financed on the books of the primary dealers has increased significantly since the Fed started to normalize its balance sheet
- Treasury is on track to issue more than $800 billion by the end of 2019 and increase its balances at the Fed by $200 billion
- Non-dealer demand for securities has declined
  - Corporate offshore holding of securities has declined
  - Curve inversion has made less desirable investments
  - Foreign central bank usage of Fed's foreign reverse repo facility has added volume to the over night market and reduces reserves since central banks transact through primary dealers sterilizing about $290 billion of reserves
- Overall, Pozsar estimates that dealer inventories have increased by $300 billion from $75 billion, demand for Treasuries has shrunk by about $800 billion and supply is up by over $1 trillion

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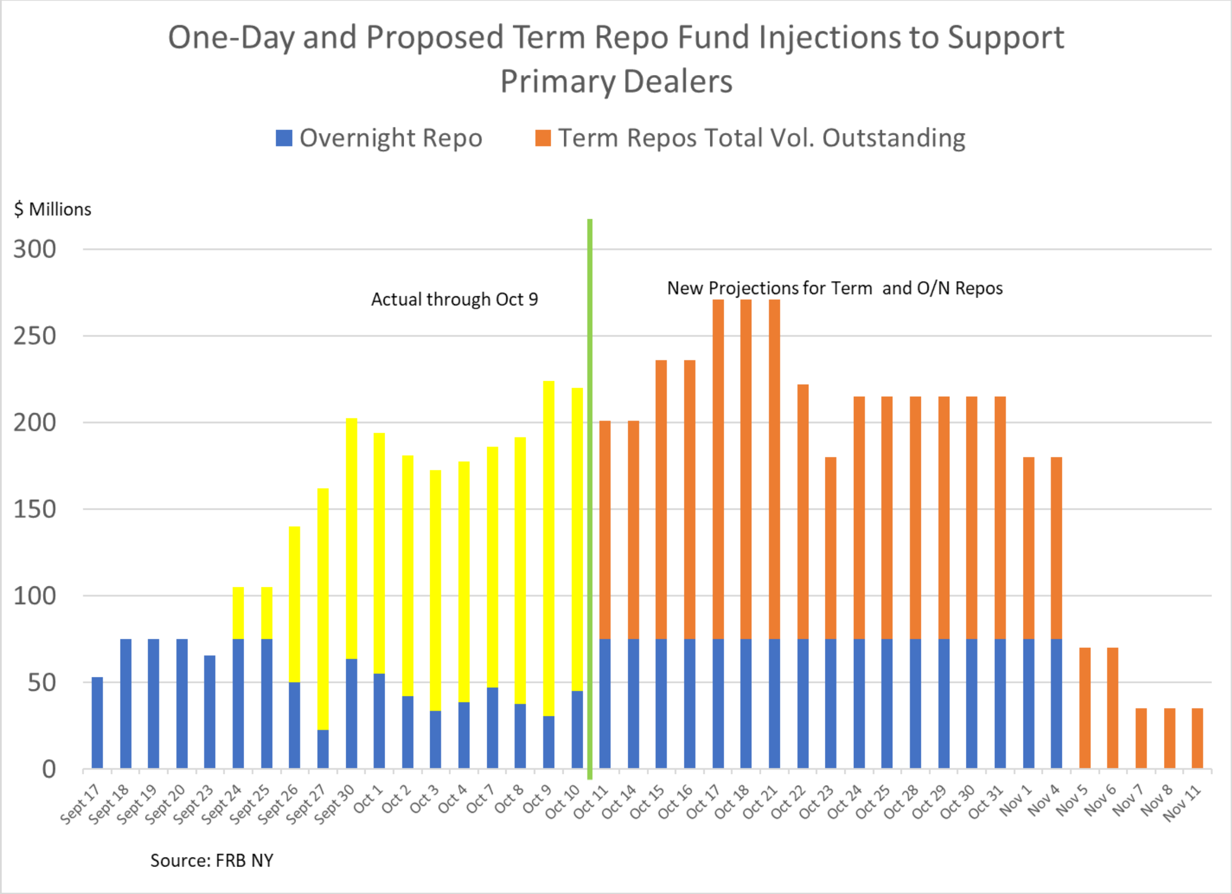
So What Has the Fed Done?

- The NY Fed announced a plan to inject overnight and term funding as a way of letting the market sort out how much of an expansion of the balance sheet is enough



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