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U.S. Rates Update September 2019

MICHAEL Y. PAK, CFA | 10 OCTOBER 2019

September saw a partial unwind of the immense August Treasury rally primarily on the back of mixed but mostly firm economic data and the U.S./China agreement to resume trade talks in mid-October. The ISM non-manufacturing index for August registered at a strong 56.4 vs 54 which was the highest reading in three months. On the other hand, the ISM manufacturing data for August fell into contractionary territory printing below 50 at 49.1 indicating that the manufacturing sector is still being weighed down by trade uncertainty. However, the market chose to focus on the strong headline ISM non-manufacturing index (as well as housing and ADP payroll data that beat expectations) which continues to point to a resilient consumer in the face of on-going geopolitical uncertainty. By month-end, the 2s10s Treasury curve bear-steepened +6bps and every point on the curve closed +11 to +17bps higher. The sell-off in domestic rates also spilled over into global markets with the notional amount of negative yielding global debt decreasing by over $2.5trln to $14.8trln.

The aforementioned economic data, trade talk developments and even Trump impeachment talk aside, the real fireworks in domestic rates in September occurred in the oft-overlooked repurchase agreement (repo) market where an estimated $2.7trln in securities is financed on a daily basis. Broadly speaking, the repo market is where a diverse set of participants lend or borrow cash typically collateralized on an overnight basis by Treasuries, Agencies or Agency MBS. It is often referred to as the plumbing of the financial markets. Going into mid-September the market was aware of a handful of technical, calendar-based events which were likely to elevate repo rates given that they would drain cash from the system. On 9/16, a net $32bln in newly auctioned Treasuries settled and quarterly corporate tax payments ($50bln between 9/13-9/16) were paid. The resultant use of cash to pay for the Treasuries and taxes as well as outflows from money market funds leading up to that date temporarily caused an imbalance between the supply and demand of *lendable* cash in the repo market. Against a backdrop of dealers who are still financing over $200bln of Treasuries on their balance sheets in the repo markets and a rumored liquidity hoard from the Middle East due to the oil facility attacks, market participants with limited funding options were suddenly left scrambling for cash. Repo rates which were trading around 2.20% heading into mid-month soared on 9/17 to close at 6% after touching an *intra-day* high of 10%.

Michael Y. Pak, CFA
Senior Vice President
Fixed Income

Mr. Pak is a Senior Vice President in the Fixed Income group where he trades Money Markets, Treasuries, and Agencies. Prior to joining TCW in 2015, he was a Fixed Income Portfolio Manager at Columbia Threadneedle where he managed institutional separate accounts and mutual funds with a focus on the Investment Grade Credit and Rates sectors. Previously, he was a generalist Portfolio Manager at Western Asset focused on short duration strategies. Prior to Western Asset, he worked on the cash desk at PIMCO and the investment department at Teledyne, Inc. Mr. Pak holds a BA in Economics from UCLA and an MBA from the Marshall School of Business at USC. He is a CFA charterholder.

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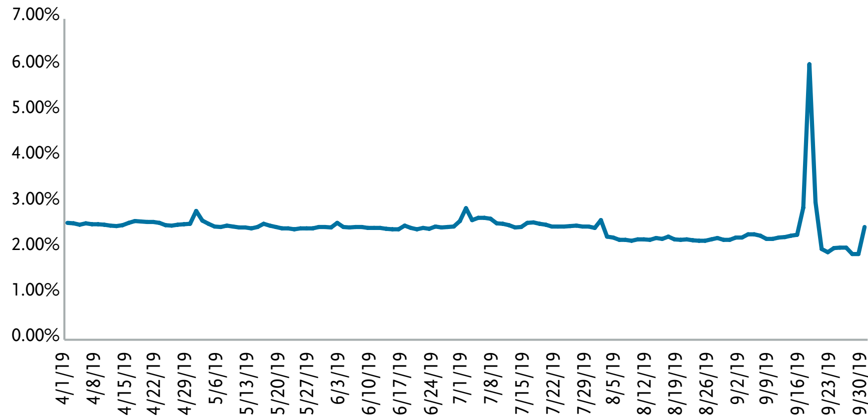
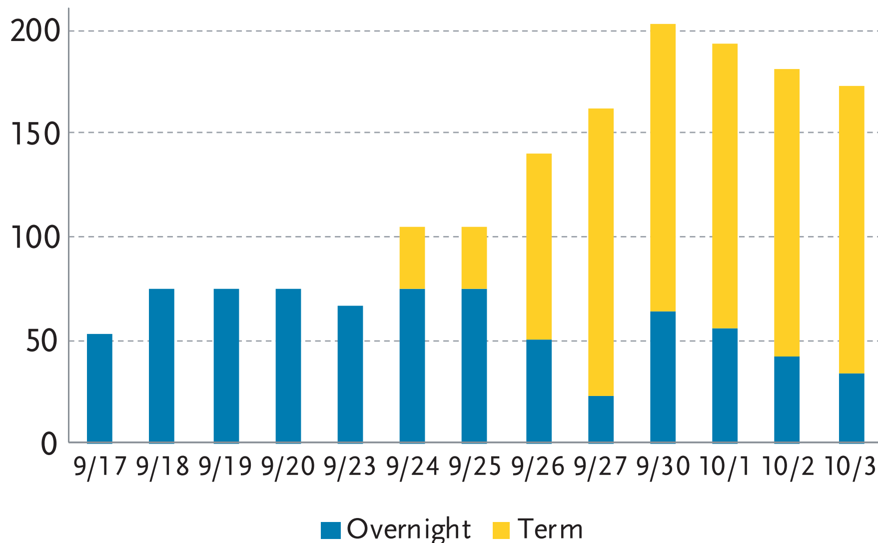
Treasury Repo Rate



Source: Bloomberg

Needless to say, the extent of the repo volatility left the market (and the Fed) stunned and searching for answers. Without the luxury of time on its hands to fully investigate the matter, the NY Fed stepped in on 9/17 to offer liquidity into the market in the form of Temporary Open Market Operations (TOMOs), something it had not done in size in over 10 years. The Fed initially announced rolling overnight TOMOs of $75bln in addition to three $30bln term TOMOs (2 weeks) whereby they would take in securities and lend out cash to primary dealers. When all was said and done, $213bln of Fed liquidity remained outstanding as of September quarter-end and funding markets eventually closed on a relatively quiet note.

NY Fed TOMOs Outstanding (blns)



Source: NY Fed, BAML Global Research

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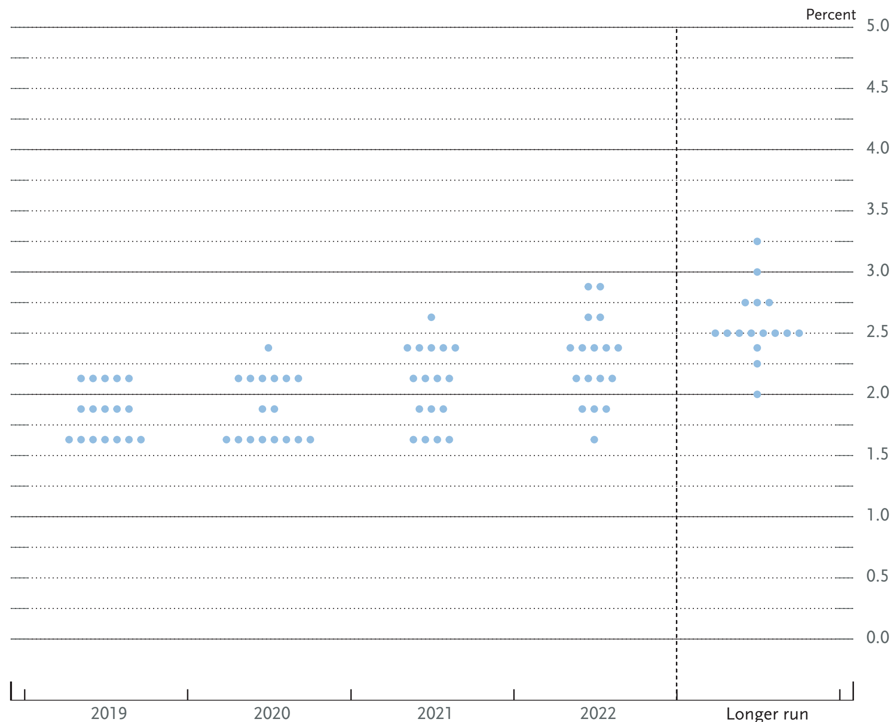
Although the Fed is likely to continue rolling these TOMOs to mitigate any repo volatility going into October, the market is clearly in need of a more permanent solution. Short of relaxing regulations to allow larger banks to hold lower reserves and/or more freely lend them into the market, it is likely the Fed will have to start re-expanding its balance sheet and outright buying securities in the open market. This would ensure that cash more efficiently permeates the system as reserves get created and at the same time gives relief to dealer balance sheets as Treasury supply is taken out of the market. Currently only primary dealers participate in the Fed's operations and although they have taken down varying amounts of liquidity during these Fed operations, there is no guarantee that this will continue given constraints on their balance sheets or that the liquidity will make its way down to those who truly need it. Said another way, regulation has essentially limited how much repo dealers can take on their balance sheets, locking up their reserves so they cannot readily intermediate in the repo markets as they have in the past. Therefore, simply rolling these TOMOs is not a long-term solution although the temporary increase in overall reserves and a Fed on high alert seem to have calmed markets for now.

The headlines around the repo market nearly overshadowed the September FOMC policy meeting as the initial TOMO operation actually took place on the first day of the FOMC's two-day meeting. At the meeting, the Fed cut its policy rate 25bps as widely expected and adjusted the target range for Fed Funds to 2% and 1.75%. Additionally, the Fed again made a technical adjustment to the Interest on Excess Reserves rate by 5bps which now sits at 1.80% or only 5bps above the bottom of their target range in an effort to keep its policy rate within that range. With respect to the Summary of Economic Projections (SEP), the longer-run projections were unchanged with only minor shifts to the projections. The median projection for real GDP growth and the unemployment rate were higher by 10bps with other data through 2021 unchanged. Additionally, the dots revealed that the median expectations for the Fed Funds rate was for no further cuts this year or next but the distribution showed a divided committee as seven officials expected another cut this year.

Mid-Point of Target Level for Fed Funds



Source: FOMC

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During the press conference, Fed Chair Powell was asked point blank about the repo market volatility and he flatly stated it was a technical issue and not something that would affect the broader economy. Chair Powell indicated that the Fed would continue to conduct temporary open market operations in an effort to keep repo rates stable in the near term. Powell also reiterated that the Fed is committed to conducting policy in an "ample reserves regime" and would be monitoring how the market operates and determine if and when it would be appropriate to return to "organic growth" of the balance sheet. This will be contemplated between now and the October meeting with the Fed particularly keen to see how markets react until then. Later in the month, NY Fed President Williams also remarked that the level of reserves needed to be higher to mitigate volatility in the repo markets but more importantly stated that "despite there being a lot of reserves in the system, they weren't moving around."

While the Fed is largely correct and the causes of repo volatility appeared mainly technical, they have been magnified by post-crisis banking regulation and the rising budget deficit/increases in Treasury supply. We do not know what the more medium-term repercussions could have been had the Fed not stepped in, but the spike in funding costs was already starting to seep into other markets. For one, we witnessed deleveraging from Treasury relative value strategies which caused cash Treasuries to cheapen vs. futures as the cost of financing those cash Treasuries sky-rocketed with little visibility into the future path of financing rates. The deleveraging could also have bled into spread products if funding costs remained high on a sustained basis and levered mandates were forced to unwind and sell into widening markets. However, the massive liquidity infusion by the NY Fed temporarily saved the day and a more permanent solution will likely be on the table by the October FOMC meeting. Until then the market will debate the optimal solution(s) that are likely to get deployed but at this point the primary open question appears to be not if the Fed will begin re-expanding its balance sheet but what the size and scope of that will look like once it does. ■

	8/30/19	9/30/19	Change
2yr Treasury	1.51	1.62	0.11
5yr Treasury	1.39	1.54	0.15
10yr Treasury	1.50	1.67	0.17
30yr Treasury	1.96	2.11	0.15
30yr TIPS Breakeven	1.60	1.59	(0.02)
3mo Treasury Bill	1.98	1.82	(0.17)
3mo LIBOR	2.14	2.09	(0.05)
Fed Funds	2.13	1.90	(0.23)
SOFR	2.16	2.35	0.19
U.S. Dollar Index	98.92	99.38	0.46
LIBOR/OIS	0.28	0.33	0.05

Source: Bloomberg

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