

US Rates Watch

Higher SOFR & funding outlook

SOFR pressure over recent weeks

SOFR increased vs ON RRP after bank stress & into quarter end (Exhibit 1). SOFR has subsequently declined & repo volumes have come off peak (Exhibit 2). We discuss possible drivers of the recent SOFR rate & volume increase + outlook going forward.

SOFR pressure drivers: cash raise & de-leveraging

SOFR rate & volume increase post bank stress may be due to: (1) bank UST selling (2) hedge fund de-leveraging (3) bank UST funding via repo. We offer thoughts on each.

Bank UST sales: banks may have sold USTs to raise cash / liquidity. These USTs would be held by dealers & repo financed. Banks were likely selling some USTs to raise liquidity but not enough to see increase in total dealer UST holdings. Indeed, dealer UST holdings are lower since bank stress but higher in the 3-6Y bucket (Exhibit 5, Exhibit 6). USTs of 3-6Y are usually thought to align well with average bank deposit life.

Hedge fund de-leveraging: bank stress & market vol may have also resulted in the closing of hedge fund cash-futures basis trades. Closing of these trades would have then seen more USTs on dealer balance sheets that need repo funding. We believe some activity has occurred consistent with higher dealer holdings of >11Y USTs (Exhibit 6).

Bank funding via repo: surge in SOFR volumes lines up with bank stress & domestic bank H.8 borrowings. Increased bank repo financing would be consistent with the limited increase in dealer UST holdings, esp ahead of quarter end. Bank repo borrowing may also be consistent with sharp increase in bi-lateral repo & sponsored repo activity (Exhibit 7, Exhibit 8). For more detail on the repo market see note ([US Treasury repo primer-25 July 2022](#)).

Repo outlook: lower pressure if lower stress

We expect repo rates & volumes to be a function of bank stress. Near term, repo rates & volumes should moderate after quarter end assuming limited new bank stress.

Repo rates vs ON RRP & volumes should trend back to early March levels by late April or early May. Repo activity may time to normalize if banks prefer to be more liquid ahead of the April tax date (April 18) & bank earnings, which may rekindle stability concern.

... see page 2 for more detail on repo pressure outlook ...

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SOFR: Secured overnight financing rate

ON RRP: Overnight reverse repo facility

GC: general collateral

GCF: general collateral financing

EFFR: effective federal funds rate

PD: primary dealer

FICC: Fixed Income Clearing Corp

UST: US Treasury

FHLB: Federal Home Loan Bank

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Timestamp: 07 April 2023 06:00AM EDT

Any increase in bank stress could sustain higher repo rates & volumes as banks prefer to hold a larger liquidity buffer. Some banks might also be forced to liquidate USTs or other securities if unable to fund via FHLBs or Fed. A more acute increase in banking system stress could also see increased concerns over counterparty credit risk which could make it more difficult for certain repo funders to raise cash. We see these risks as low.

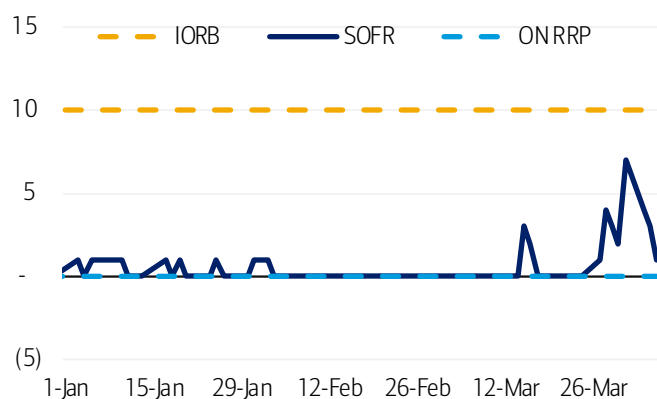
Overall, we continue to think that term SOFR rates are pricing too much expected repo pressure too soon. Tri-party repo will likely continue to be well anchored around the ON RRP rate until there is a material decline in ON RRP utilization (i.e. ON RRP at \$500b or so). We also expect a richening of short-dated USTs & repo with upcoming bill paydowns following the April tax date / debt limit supply adjustments.

Bi-lateral repo funding need could potentially push SOFR to tri-party repo spread wider. However, we would be surprised to see SOFR exceed fed funds by 1-2 bps in late '23, as currently priced by SOFR/FF basis. For more detail see note([SOFR/FF basis: biased wider](#)).

We recommend clients fade late '23 repo pressure by positioning in Nov '23 SOFR/FF widenings at -1bp. We target a spread of 3bps & have a stop at -3.5bps. The trade will benefit from ongoing moderation in repo pressure over time & upcoming bill supply cuts. Risk to trade is any sustained increase in bank stress.

Exhibit 1: SOFR vs ON RRP (bps)

SOFR peaked at 7bps above ON RRP on quarter-end,

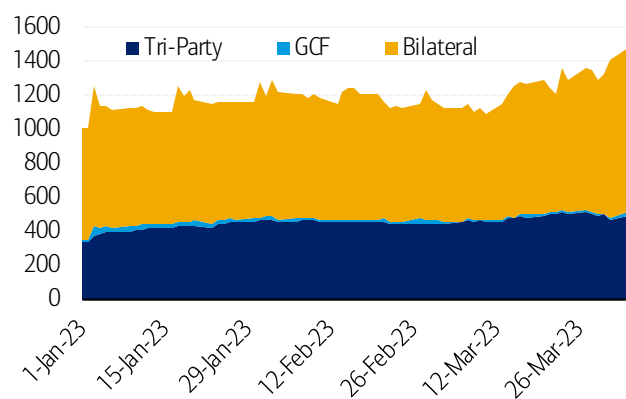


Source: Bloomberg

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Exhibit 2: Breakdown of SOFR volumes (\$bn)

Bilateral repo volumes make up a majority of SOFR

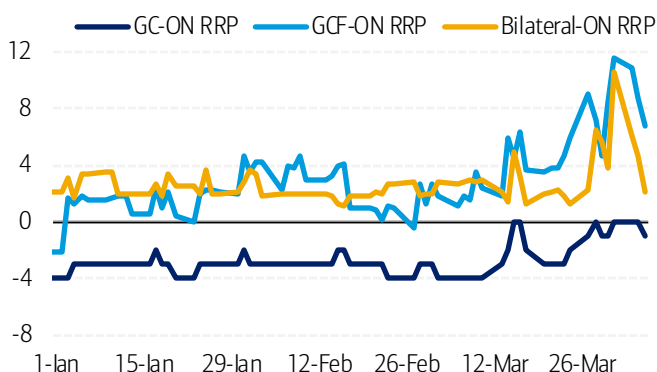


Source: Federal Reserve

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Exhibit 3: SOFR components vs ON RRP (bps)

All three components of SOFR rose

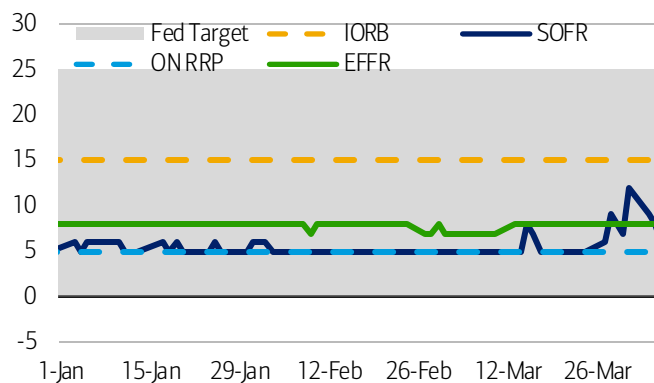


Source: BofA Global Research, Haver Analytics

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Exhibit 4: SOFR & EFR vs target range

SOFR rose, while EFR has been flat in past week

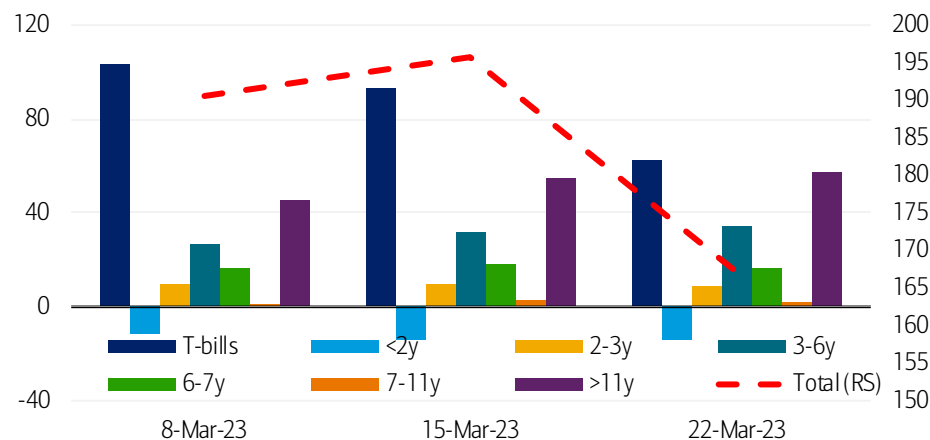


Source: Haver Analytics

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Exhibit 5: Primary dealer Treasury holdings (\$bn)

PD holdings declined on net, primarily in T-bills



Source: Bloomberg

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Exhibit 6: Change in PD holdings of US Treasuries (\$mn)

PD holdings of UST have declined since March 8, with most of the decline occurring since March 15

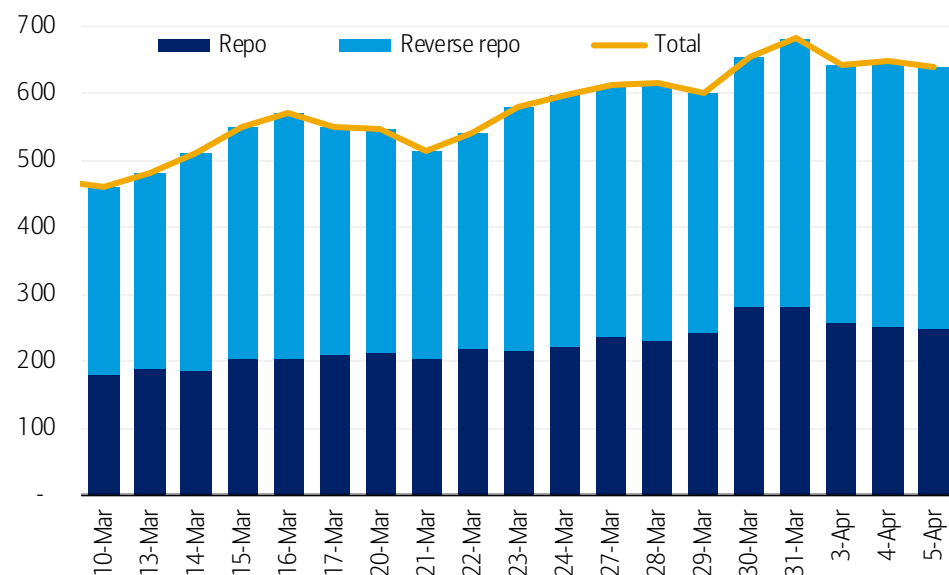
	Bills	<2y	2-3y	3-6y	6-7y	7-11y	>11y	Total
Level as of 22 Mar 23	62,342	-13,800	9,059	34,132	16,346	1,678	57,267	167,024
Change since 8 Mar 23	-40,754	-2,304	-1,004	7,497	61	1,126	11,886	-23,492
Change since 15 Mar 23	-30,748	720	-316	1,863	-1,673	-975	2,415	-28,714

Source: Bloomberg

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Exhibit 7: FICC Sponsored Repo volumes (\$bn)

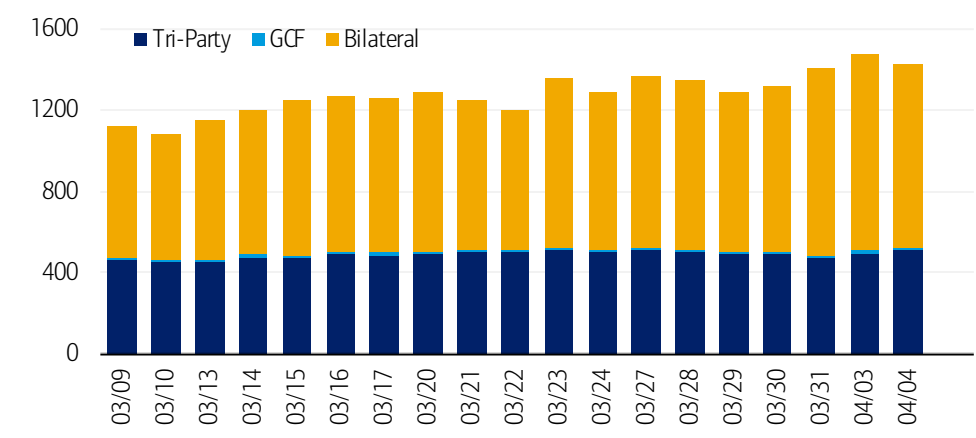
Sponsored repo volumes are elevated



Source: FICC DTCC

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Exhibit 8: SOFR repo volumes (\$bn)
Bilateral component of SOFR is elevated



Source: FRBNY

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