

US Rates Watch

US funding: subtle repo ripple

Small shift in US funding reflects cash / collateral theme

Recent US repo dynamics represent a subtle but important shift in the lower cash / higher collateral theme. August month end saw (1) slightly higher repo rates (2) jump in repo volumes (3) decline in Fed ON RRP use. The month-end decline in ON RRP stands in contrast to recent month ends where dealers de-leverage & push MMF cash to Fed. These dynamics likely represent a build-up in street collateral financing needs & a small ripple of upward funding pressure. This funding ripple will gradually turn into smaller funding waves & eventual large waves that pressure SOFR higher. We elaborate below.

SOFR shifted slightly higher, esp on month ends

Over the past few month-ends, we have seen SOFR print above ON RRP and typically stick there for a couple of days. This is a shift from the trend over the previous 2 years where SOFR-ON RRP was either unchanged or even narrowed on most month-ends (Exhibit 1). To us, this is evidence we are moving away from a period of cash greatly outweighing collateral post COVID QE and entering a phase of lower cash in the system alongside significant collateral coming into the market.

Repo volumes higher & ON RRP use lower on month end

On August month-end we also saw the largest month-end increase in SOFR and sponsored repo volumes, as well as the largest month-end drop in ON RRP use in these data series (Exhibit 2, Exhibit 4, Exhibit 5). We suspect the higher repo volumes & ON RRP drop reflects a dealer community long collateral on month end & in need MMF funding. Fed primary dealer data on Aug 30 does not show a sharp increase in UST inventory but doesn't capture the \$77b coupon & bill settlements on Aug 31 (Exhibit 5).

Current repo dynamics similar to early '17 period

We were curious about the historic parallel of these small funding shifts vs the last QT period ('17-'19). Current funding dynamics seem most similar to early '17 before the Fed launched QT but when excess Fed liquidity was still quite high (Exhibit 6). In '17, SOFR spread to ON RRP averaged 5.5bps, shot up to nearly 19bps in '18 and peaked at an average of 20bps in '19. This historic comparison reminds the market is still in early stages of funding normalization but higher repo levels lie ahead.

Repo shift not alarming but don't overlook theme

The small repo ripple is not cause for concern today but the slow theme of lower cash & higher collateral financing need should not be overlooked. Our projections still expect SOFR to be well anchored near ON RRP until Fed facility falls towards zero in late '24 (Exhibit 7). We also continue to think SOFR/FF basis expects too much tightening too soon through spring '24. However, the repo ripple today likely suggests slightly tighter funding on month-ends going forward & into year-end. We suspect waves of repo funding pressure will be more clearly evidenced in mid- to late-'24.

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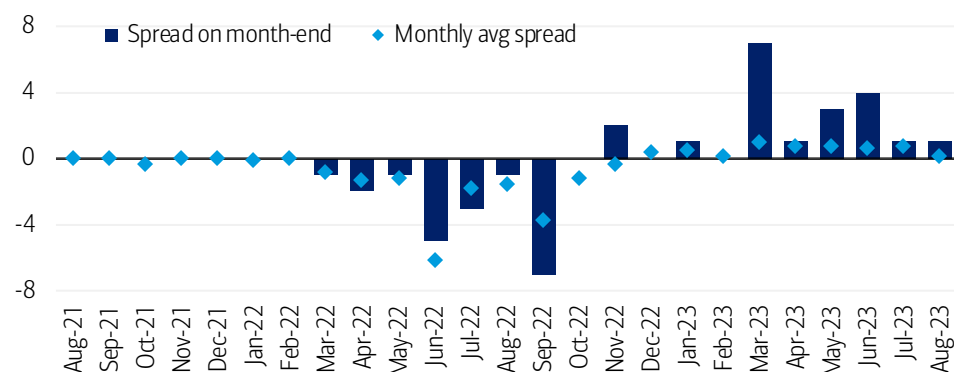
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Exhibit 1: SOFR-ON RRP spread (bps)

SOFR-ON RRP spread on month-end and avg over each month has moved to positive territory

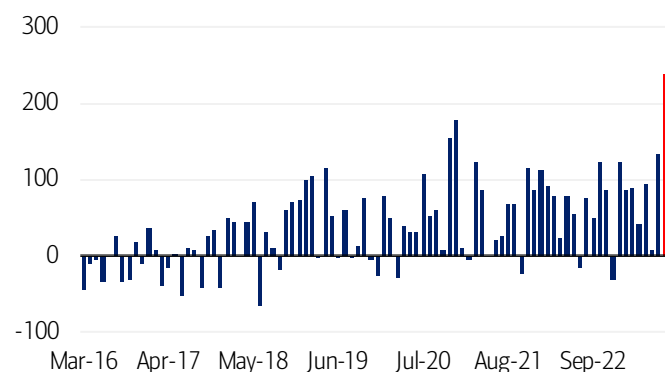


Source: BofA Global Research, Bloomberg

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Exhibit 2: 1-day change in month-end SOFR volumes (\$bn)

August month-end saw the largest increase in SOFR on a month-end

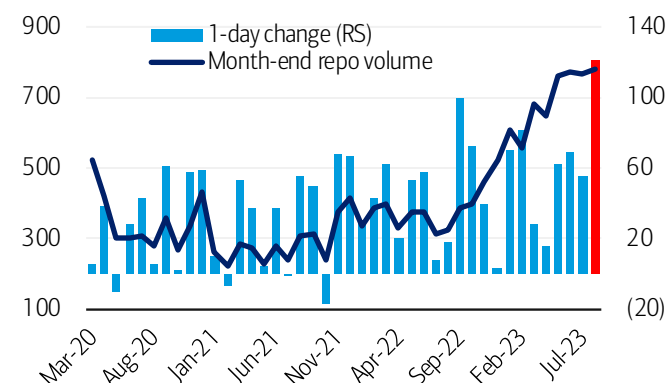


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Exhibit 3: Sponsored month-end repo volumes and 1-day change (\$b)

August month-end saw the largest increase in sponsored repo volumes

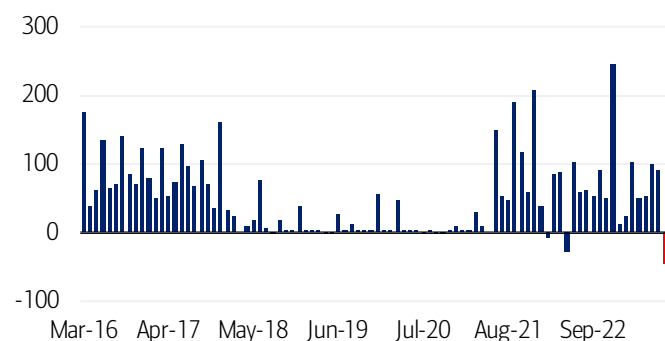


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Exhibit 4: 1-day change in month-end ON RRP take-up (\$bn)

August month-end saw the largest month-end drop in ON RRP take-up

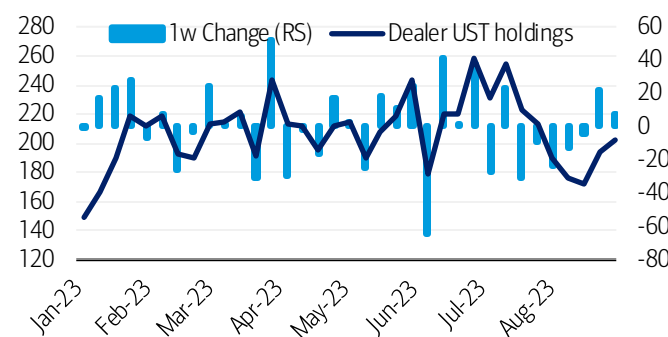


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Exhibit 5: Weekly primary dealer UST holdings (\$bn)

PD UST holdings have been increasing over the last 2 weeks

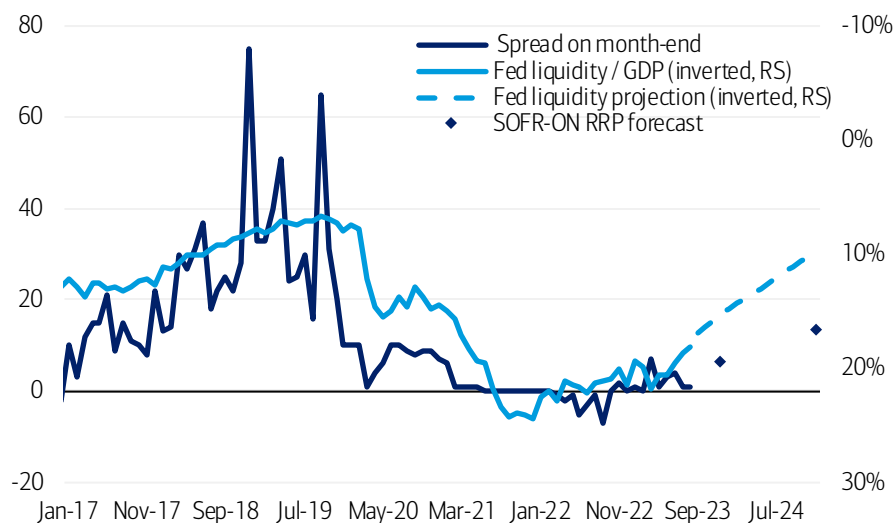


Source: BofA Global Research, Bloomberg

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Exhibit 6: Month-end SOFR-ON RRP spread (bp) vs Fed liquidity (%)

As Fed liquidity to GDP declines, SOFR-ON RRP spread typically widens

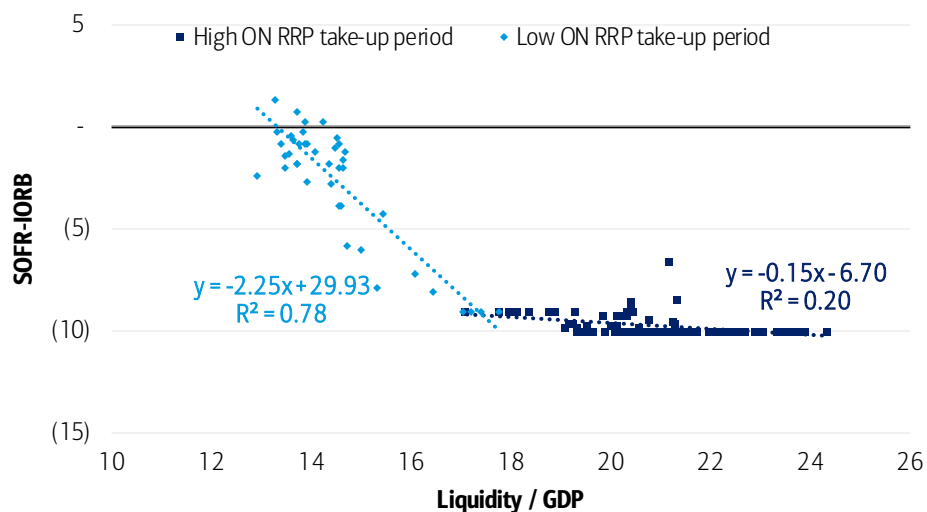


Source: BofA Global Research, Bloomberg, Haver Analytics

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Exhibit 7: SOFR-IORB spread (bp) vs liquidity to GDP (%)

SOFR tends to increase relative to IORB more quickly once liquidity to GDP is below 16%



Source: BofA Global Research, Bloomberg, Haver Analytics

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