

US Rates Watch

SOFR/FF spread wider near-term

Softness in repo driving SOFR/FF spread wider

The SOFR/FF (FF-SOFR) spread has re-widened recently due to softening in repo rates. We expect the factors that have contributed to the recent softening in repo will likely stick around near-term. Recent revisions to our expectations for liquidity drain via QT, bill supply, and leverage demand all risk wider SOFR/FF spreads near-term.

Updated SOFR/FF model output: overweight high ON RRP

We forecast the SOFR/FF spread using a regression that looks at the relationship between SOFR and FF spreads to IORB vs liquidity (ON RRP + reserves) to GDP during 3 periods: (1) low ON RRP take-up period of Q3'20 to end Q1'21, (2) high ON RRP take-up period of Q2'21 to end Q3'23 and (3) current period of Q4'23 to today (Exhibit 1, Exhibit 2). Using the 3 regression outputs of our model, we revise our forecast to overweight the output from the high ON RRP take-up given expectations for ON RRP to remain elevated due to tweaks to our TGA forecast (see report: [Fed balance sheet: tax date tweaks](#)) and bill supply cuts in Q2 ([Bill supply report](#)). Our model output produces spreads to IORB that are tighter than we would agree with but we are content with the SOFR/FF spread forecast but acknowledge risks to wider levels (Exhibit 3).

Fed funds remains incredibly steady

Overall, the fed funds rate has been incredibly steady and despite lower liquidity via QT, pressure appears to largely be to the downside. Often when FHLBs have excess cash from a late date payment they'll lend it in the fed funds market and may need to accept a lower rate to find a borrower. Given the small size of the FF market, it can place downward pressure on the rate. Looking at the FF percentiles, the 75th percentile is equal to the 50th percentile, or effective fed funds rate, implying we're still seeing very limited upward pressure in fed funds. We will likely not see upward pressure in fed funds until small domestic banks are in need of reserves and have to pay up to borrow. Despite small banks being close to the trough seen in their 2019 cash to asset ratio, this upward pressure has not arrived. We expect FF to stay stable for longer and for any near term changes in SOFR/FF spread to come from fluctuations in SOFR.

Repo only ripples, no wave yet

We began to see upward pressure in SOFR last year on mid-month and end-of-month settlements. The driver was large collateral settlements chasing limited cash at the front-end. We saw this as a sign that the overall balance of cash in the system had become less abundant. Since then UST GC repo has been very stable even with sizeable UST supply. We attribute the recent funding stability to lack of leverage demand driven by fewer UST dislocations / UST cheapness. The reduction in leverage demand likely follows a reduction in UST asset manager long futures positions driven by lower confidence in swift Fed cuts. We will watch March & April tax date dynamics for further signs of USD funding pressure.

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facility

TGA: Treasury General Account

FF: Fed funds

FHLB: Federal Home Loan Banks

UST: US Treasury

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Timestamp: 01 March 2024 07:00AM EST

Few signs of upward pressure in repo returning

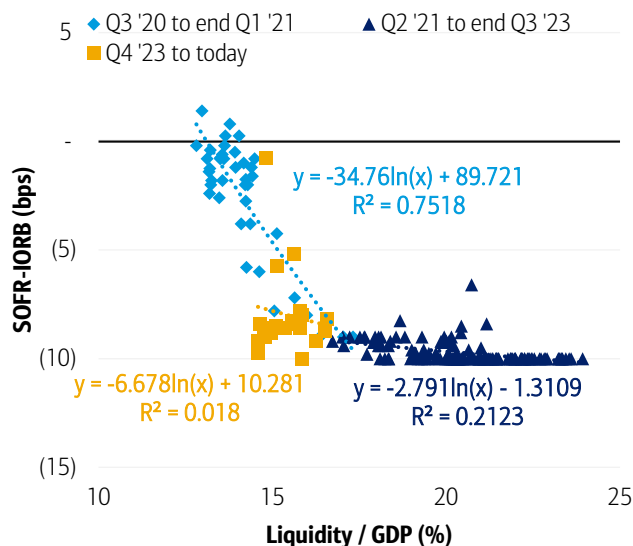
We expected to see a continuation of this upward pressure in SOFR to continue to tighten SOFR/FF spreads. Since Q4, however, bank lending in repo has declined while bilateral and GCF repo rates have actually softened. GC repo has largely been steady and appears it is still capped by the rate on ON RRP, outside of month-ends, as MMFs still have a lot of excess cash, which limits upward pressure in GC.

The decline in bilateral repo rates, which is the majority of transactions in SOFR, has been the primary driver of lower SOFR prints. We attribute the lower bilateral repo rates to lower leverage demand and higher specials activity (see report: [Stable repo: less leverage & more specials](#)). We expect these dynamics to stick around at least near term. Large UST settlements will likely continue to put upward pressure on repo but not as significant as levels seen in Q4'23. Upward pressure in repo is likely to be capped by more cash coming in via sponsored repo, cuts to bill supply in Q2, which also contributes to slower ON RRP drain, leaving MMFs with more excess cash.

Bottom line: repo is likely to remain soft near-term, risking wider SOFR/FF spreads. Higher ON RRP, lower bill supply starting in April, and lower leverage demand are likely to contribute to softness in repo for the foreseeable future. The softness in repo could push out a slowdown in QT as funding remains stable.

Exhibit 1: SOFR-IORB spread vs liquidity to GDP

Narrowing in SOFR-IORB spread has reversed in recent weeks

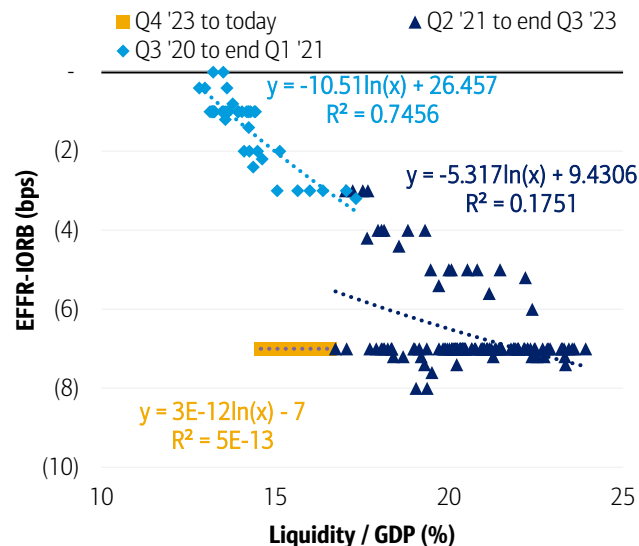


Source: BofA Global Research, Bloomberg, Haver Analytics

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Exhibit 2: EFFR-IORB spread vs liquidity to GDP

FF-IORB spread remains incredibly steady with few signs of upward pressure



Source: BofA Global Research, Bloomberg, Haver Analytics

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Exhibit 3: Regression outputs for FF-SOFR spread (bps)

In high ON RRP take-up period, FF-SOFR spread widens as FF lifts faster

Date	SOFR-IORB	EFFR-IORB	FF-SOFR
Dec-2023	-7	-4	2
Mar-2024	-7	-4	2
Jun-2024	-6	-4	2
Sep-2024	-5	-3	1
Dec-2024	-4	-3	1
Mar-2025	-5	-4	1
Jun-2025	-5	-4	1
Sep-2025	-2	-2	0
Dec-2025	-2	-2	0

Source: BofA Global Research, Bloomberg, Federal Reserve

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