A subscriber emailed us regarding our repurchase agreement (repo) analysis from Tuesday?s Daily Commentary. Her question is, ?***why should I care about a surge in repo rates?***? The commentary she refers to is at the end of this article.

Before answering her question, it is worth emphasizing that it is rare for overnight Fed Funds or Repo rates to spike, as happened this week, other than at quarter and year ends when bank balance sheets have little flexibility. Clearly, balance sheet constraints due to the end of a quarter or year are not causing the current situation. •Some say the current situation may be due to a lack of bank reserves which are used to make loans, but banks have almost $2 trillion in excess cash reserves. Although there may likely be an explanation related to general bank liquidity, there is also a chance the surge in funding costs is due to a credit or geopolitical event with a bank or other entity that has yet to be disclosed to the public.

Before moving ahead, let us take a moment to clarify our definitional terms.

Fed Funds are daily overnight loans between banks that are *unsecured*, or not collateralized. Overnight Repo funding are also daily overnight loans but unlike Fed Funds, are backed with assets, typically U.S. Treasuries or mortgage-backed securities. The Federal Reserve has the authority to conduct financing transactions to add or subtract liquidity to ensure overnight markets trade close to the Fed Funds target. These transactions are referred to as open market operations which involve the buying or selling of Treasury bonds to increase or decrease the amount of reserves (money) in the system. Reserves regulate how much money a bank can lend. When reserves are limited, short-term interest rates among and between banks rise and conversely when reserves are abundant, funding costs fall. QE, for instance, boosted reserves by nearly $3.5 trillion which enabled banks to provide liquidity to markets and make loans at low interest rates.

Our financial system and economy are highly leveraged. Currently, in the U.S., there is over $60 trillion in debt versus a monetary base of $3.3 trillion. Further, there is *at least* another $10-15 trillion of dollar-based debt owed outside of the U.S.

Banks frequently have daily liquidity shortfalls or overages as they facilitate the massive amount of cash moving through the banking system. To balance their books daily, they borrow from or lend to other banks in the overnight markets to satisfy these daily imbalances. When there is more demand than supply or vice versa for overnight funds, the Fed intervenes to ensure that the overnight markets trade at, or close to, the current Fed Funds rate.

If overnight funding remains volatile and costly, banks will increase the amount of cash on hand (liquidity) to avoid higher daily costs. To facilitate more short term cash on their books, funds must be conjured by liquidating other assets they hold. The easiest assets to sell are those in the financial markets such as U.S. Treasuries, investment-grade corporate bonds, stocks, currencies, and commodities.  We may be seeing this already. To wit the following is from Bloomberg:

> *?What started out as a funding shortage in a key U.S. money market is now making it more costly to get hold of dollars globally. After a sudden surge in the overnight rate on Treasury repurchase agreements, demand for the dollar is showing up in swap rates from euros, pounds, yen and even Australia?s currency. As an example, the cost to*

*borrow dollars for one week in FX markets while lending euros almost doubled.?*

A day or two of unruly behavior in the overnight markets is not likely to meaningfully affect banks? behaviors. However, if the banks think this will continue, they will take more aggressive actions to bolster their liquidity.

**To directly answer our reader?s question and reiterating an important point made, if banks bolster liquidity, the financial markets will probably be the first place from which banks draw funds. In turn, this means that banks and their counterparties will be forced to reduce leverage used in the financial markets. Stocks, bonds, currencies, and commodities are all highly leveraged by banks and their clientele. As such, all of these markets are susceptible to selling pressure if this occurs.**

We leave you with a couple of thoughts-

- If the repo rate is 3-4% above the Fed Funds rate, the borrower must either not be a bank or one that is seriously distressed. As such, is this repo event related to a hedge fund, bank or other entity that blew up when oil surged over 10% on Monday? Could it be a geopolitical related issue given events in the Middle East?
- The common explanation seems to blame the massive funding outlays due to the combination of Treasury debt funding and corporate tax remittances. While plausible, these cash flow were easy to predict and plan for weeks in advance. This does not seem like a valid excuse.

In case you missed it, here is Tuesday?s RIA repo commentary: *Yesterday afternoon, overnight borrowing costs for banks surged to 7%, well above the 2.25% Fed Funds rate. Typically the rate stays within 5-10 basis points of the Fed Funds rate. Larger variations are usually reserved for quarter and year ends when banks face balance sheet constraints. It is believed the settlement of new issue Treasury securities and the corporate tax date caused a funding shortage for banks. If that is the case, the situation should clear up in a day or two. Regardless of the cause, the condition points to a lack of liquidity in the banking sector. We will follow the situation closely as it may impact markets if it continues.*