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SHORT THOUGHTS

November 19, 2024

Quarter-end Funding Pressures May Be with Us to Stay – Can SRF Help?

Quarter- and Month-end Funding Strains and the SRF

- Repo market volatility at quarter- and month-end is a feature, not a bug
- The Fed's SRF is intended to offer funding at economically attractive rates and avoid federal funds market strains
- Stigma may be associated with the SRF, limiting its use, although the Fed is unconvinced
- Cross-border flows have not returned to the long end of the US curve, even with a rising term premium

Funding at quarter-end could remain volatile; SRF use remains limited

Since it was established in 2021, the Federal Reserve's standing repo facility (SRF) has barely been tapped in meaningful size. In a recent speech (see here), the New York Fed's System Open Market Account (SOMA) manager, Roberto Perli, described the role of the SRF, which is "to support the effective implementation of monetary policy and smooth market functioning by putting a ceiling on the effective federal funds rate." Should upward pressure on repo rates spill over into the federal funds market, the presence of the SRF as an alternative funding source should keep the effective federal funds rate (EFFR) between the upper and lower bounds of the federal funds target range.

At the end of September, repo rates rose significantly through a combination of what Fed officials identify as "frictions" in the repo markets, large settlements of Treasury securities which temporarily removed cash from the system, and quarter-end demand for cash for balance sheet reporting purposes. On September 30, the SRF was indeed tapped for a

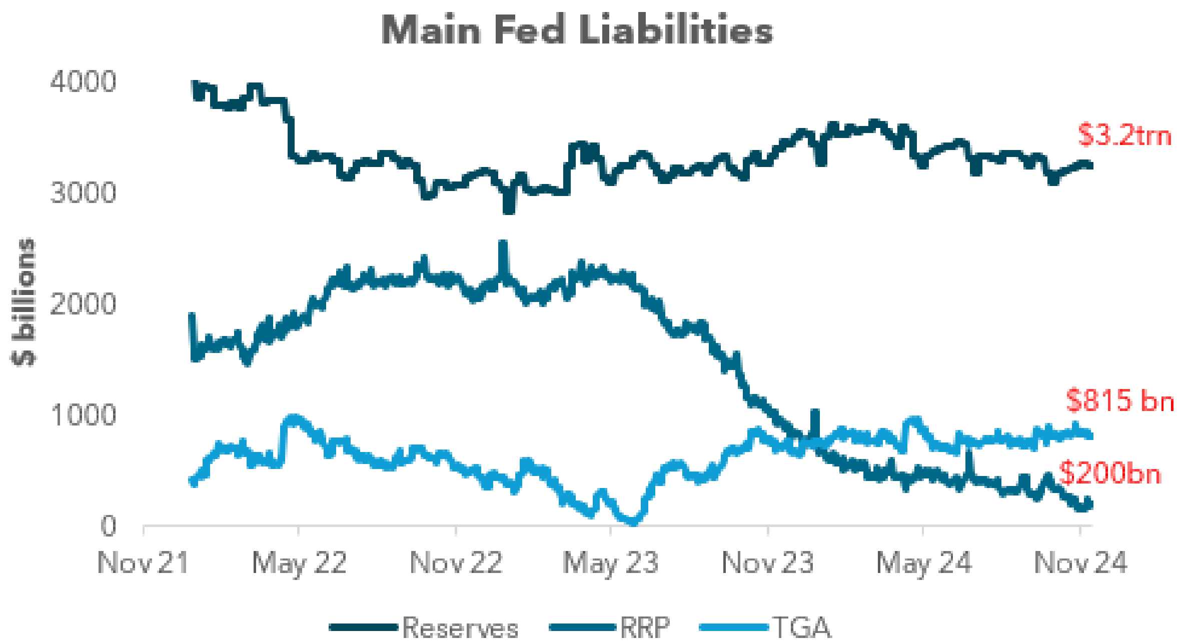
meaningful sum of around $2.6trn, the first – and, so far, only – use of the facility of notable size.

The Fed would argue that this use of the SRF was in keeping with its intended purpose as an alternative source of funding in times of stress, mitigating any need for would-be borrowers of short-term cash to face the federal funds market (which could drive up the EFFR). With the SRF borrowing rate set at the top of the EFFR target band, repo rates above that level should be economically less attractive than the terms of the SRF, driving borrowing needs to the facility.

Stigma may be associated with the SRF, not unlike that which is associated with discount window operations. While the Fed is unconvinced that this stigma is actually a concern, anecdotally this seems to us to be a plausible constraint in seeing more frequent SRF take up during times of repo strain. The Fed's view of this can be efficiently summed up by Perli's comments last week: "Some have pointed to potential stigma for usage of the facility – although whether such stigma exists remains to be seen. I personally see no reason why it should, given the SRF is not set at a substantial penalty rate, is offered against only high-quality collateral, and is substantially similar to the heavily used repo operations conducted in 2019 and 2020."

The existence of – and demand for – the SRF, however, by itself hasn't been sufficient to prevent repo from spiking at quarter-end, at least not this past September. We have written extensively about these funding market strains at the time (see here, for example). Our view is that reserves in the banking system are indeed abundant, something on which we agree with the Fed on. Steady at $3.2trn through last Wednesday, system total liquidity remains at 11% of nominal GDP, well above pre-pandemic levels, and very favorable when compared to the 7% ratio seen in September 2019.

Exhibit #1: Reserves Have Barely Budged



Source: BNY Markets, Board of Governors of the Federal Reserve

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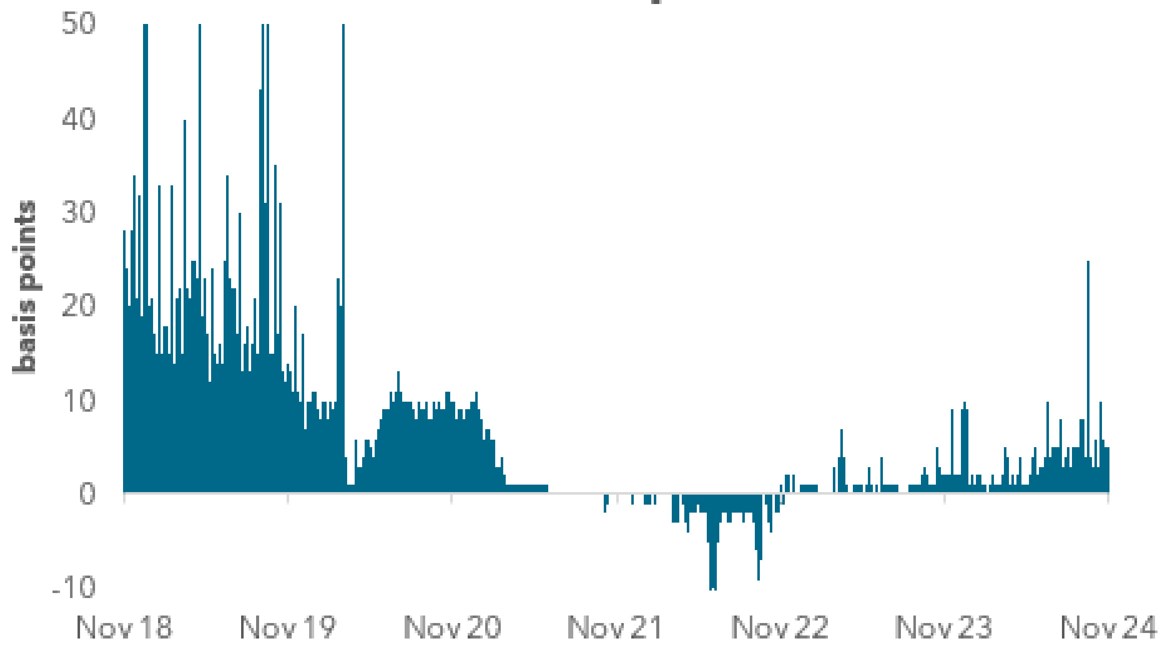
So-called “frictions” in the funding markets exist, which combined with the other conditions mentioned above, can conspire to yield elevated funding rates at period-ends. That the SRF remains largely untapped is curious considering the economically more attractive cost of funding available from the facility versus the repo market during these moments of pressure.

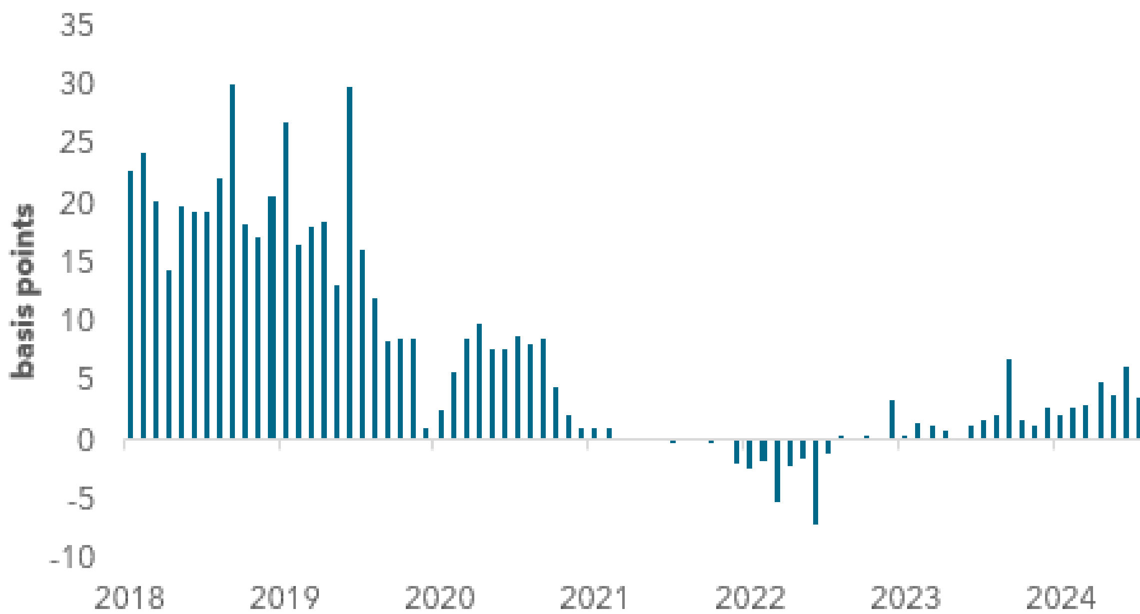
While this past September’s episode was noteworthy, we hasten to add that elevated and volatile repo rates were not uncommon at quarter- and month-end in the years before the pandemic. Exhibits #2 and #3 show the spread between overnight SOFR rates and the RRP rate, with the latter chart focused solely on month-end periods. The September 2024 episode was notable in recent context, but neither unique nor particularly outsized compared to the 2018–2020 interval. The operating assumption going forward is that period-end dates will exhibit September-like volatility, and that this would be compatible with historical, pre-Covid norms. The presence of the SRF as a funding backstop should – even with reluctance of whatever kind to use it – still be useful in containing repo strains lest they spill over into the federal funds market.

Exhibit #2: Funding Rates Aren’t Anomalously High



Source: BNY Markets, Bloomberg

Exhibit #3: Even Month-end Rates Are Within Pre-Covid Norms



Source: BNY Markets, Bloomberg

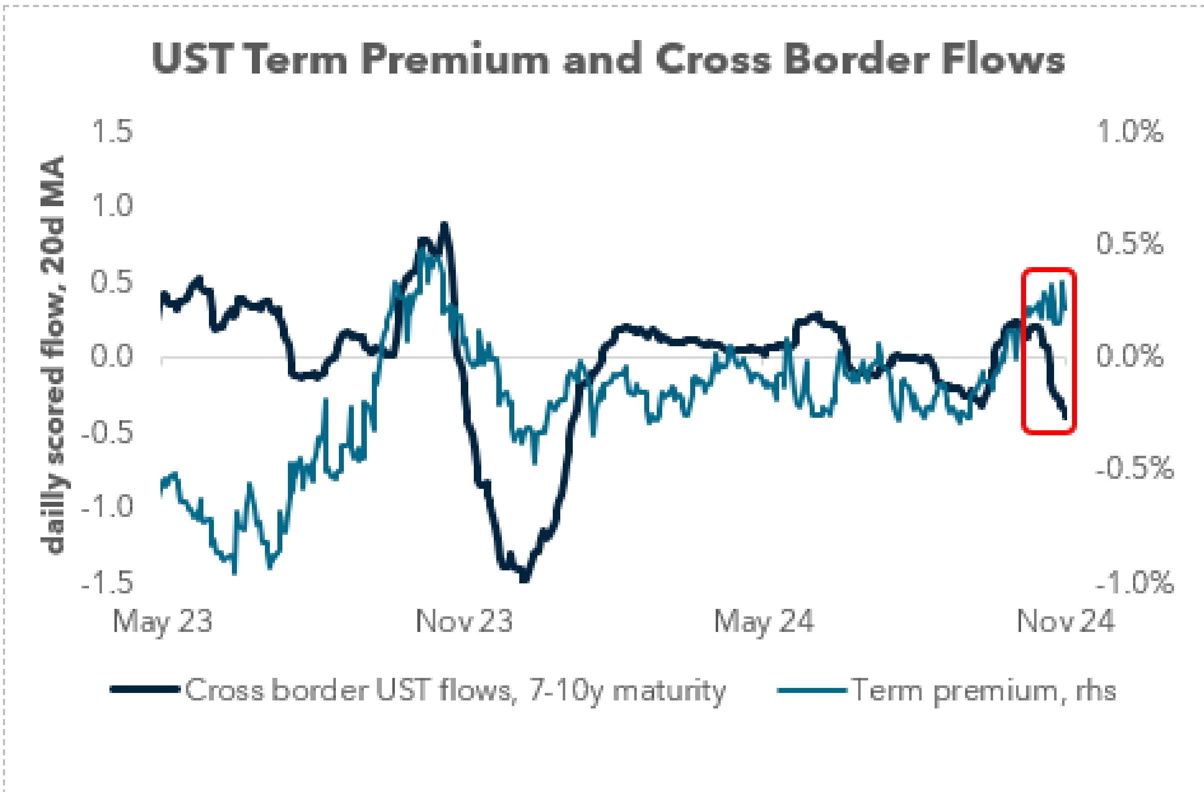
A Rising Treasury Term Premium Isn't Drawing in Cross Border Demand

The US 10y treasury term premium has risen from -29bp in early September to +28bp now, a 57-point increase in a short period of time. We attribute much of this rise in the additional compensation required by investors to lend to the government at long maturities to concerns over potential fiscal policy in an incoming Trump administration, for which tax cuts are a key policy priority. Potential tariff-related inflation is another possible driver of the rise in the premium, although we haven’t seen a similar rise in market-implied inflation expectations, yet.

In the past, a rising term premium has attracted cross-border flows into the UST market, as a rising premium has been seen as making bond prices attractive enough to draw overseas investors into the market. One obvious example occurred in late October of 2023, when bond yields reached nearly 5% and the term premium rose over 70bp in less than a month. Exhibit #4 below shows that cross-border investors stepped into the market in a significant way at this time. We plot scored flows into 7-10y bonds alongside the level of the premium.

What is worrisome for us is that currently, as the term premium is rising, cross-border investors are not (yet) coming in to buy. We have had concerns that potential curve steepening from expansionary fiscal policy, higher inflation from tariffs, and other considerations are actually discouraging such inflows from abroad, placing the UST market in a tough position. Foreign demand is essential to fund growing US deficits, and if it is not present, a vicious cycle could develop, in which foreign funding for US bond issuance remains elusive, exacerbating rising yields.

Exhibit #4: Cross-border Flows Not Attracted by Rising Term Premium



Source: BNY Markets, Bloomberg, Federal Reserve Bank of New York

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Please direct questions or comments to: iFlow@bny.com

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