

Markets to the Fed: Go fund me

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In an interesting turn of events, we had a Federal Open Market Committee (FOMC) meeting last month, but the results of this convocation were not what captured the lion's share of US Federal Reserve (Fed) headlines. Indeed, the dislocations that were witnessed in the funding markets, and attendant Fed responses, seemed to take centre-stage. Essentially, the stresses which emerged in this arena created a situation where participants were clamouring for the Fed to step in and provide the necessary funds to potentially alleviate the pressurized conditions.

Let's do a quick Fed 101. There's a certain level of reserves in the banking system that can fluctuate on a daily basis. The New York Fed, acting on behalf of the FOMC's monetary policy directive, is charged with keeping the federal funds target within its prescribed trading range, by either adding or deleting reserves via repurchase (repo) agreements with the primary dealer community, depending upon what is needed to achieve the aforementioned goal. Typically, these daily operations from the Fed go essentially unnoticed and don't garner any headlines. That's exactly the way it's supposed to work.

So, what happened this time around? Quite simply, there was a shortage of reserves, or think of it as a 'cash crunch'. The 'repo' market is a part of the financial system where participants borrow and lend money, using Treasury securities (as one example) as collateral within the transaction. It is in this repo market where the stresses became all too evident for three reasons.

1. The Fed's prior quantitative tightening (reducing their balance sheet) had been draining reserves up until this program ended only a month or so ago.
2. 15 September is a corporate tax date (the stresses first became evident on 16 September since the fifteenth was on a Sunday).
3. There was also a large Treasury securities settlement for prior auctions.

This confluence of events acted as too big of a drain of reserves from the banking system and resulted in various funding market rates spiking well above the federal funds target range. One of these key repo-related rates, the US Secured Overnight Financing Rate (SOFR) surged up to 5 ¼% or 300bp above the top end of the fed funds target prior to last month's rate cut.

In order to alleviate these upward pressures, the NY Fed intervened with multiple large-scale repo operations of their own where they provided much needed funding for a 'starved' market. Repo operations are temporary in nature, in this case of the overnight variety, and needed to be 're-upped' in order to achieve the desired result. Did it work? As of this writing, yes. SOFR has since fallen back to 1.85%, within the 'new' fed funds target range of 1 ¾ - 2%.

Conclusion

As we expected, the temporary repo route was not a solution for the longer run. Given the future reserve outlook, the NY Fed needed to take a more permanent approach, adding to their balance sheet. In theory, any buying of Treasuries can be defined as quantitative ease (QE), but in this occasion the Fed has signalled to the markets the exact purpose. In other words, this form of QE is not to boost the economy/inflation, but rather to provide sufficient reserves for the proper functioning of the funding markets. This message may be conveyed by what Treasuries they buy, namely shorter-term issues like T-bills versus longer-dated coupons, as the latter is usually more associated with the 'other' form of QE. In fact, the Fed just announced such a permanent measure and will begin buying \$60 billion of Treasury bills per month "at least into the second quarter of next year."

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